

Approved: March 30, 1995
Date

MINUTES OF THE SENATE COMMITTEE ON ASSESSMENT AND TAXATION.

The meeting was called to order by Chairperson Audrey Langworthy at 11:00 a.m. on March 29, 1995 in Room 519--S of the Capitol.

Members present: Senator Langworthy, Senator Corbin, Senator Martin,
Senator Bond, Senator Feleciano, Jr.,
Senator Hardenburger, Senator Lee and Senator Ranson

Committee staff present: Tom Severn, Legislative Research Department
Elizabeth Carlson, Secretary to the Committee

Conferees appearing before the committee: Karen Warner, Arthur Andersen LLP
John LaFaver, Secretary, Department of Revenue

Others attending: See attached list

APPROVAL OF MINUTES

Senator Bond made a motion to approve the minutes of March 20, 1995. The motion was seconded by Senator Ranson. The motion carried.

SB 316--BUSINESS INCOME DEFINED FOR UDITPA PURPOSES

Senator Langworthy said she wanted the committee to have more information about **SB 316**. She thinks an overview of this concept would be helpful. There was discussion in the committee about the fiscal note which shows about \$6 million impact, \$1.5 million would be prospective and the \$5 million would be annual impact. Senator Bond asked if the *Chief* case gave the state a \$4.5 million windfall? Senator Ranson also asked if this money that has not been collected in the past, but because of this lawsuit, the state will be collecting this revenue. Senator Martin asked if the original bill would have taken care of the problem. Mr. Beshears said the bill as introduced just addressed the problem of in-state businesses that would be detrimentally impacted by *Chief*. The balloon which has been passed to the committee has made some changes and will hopefully solve the problem of constitutionality. (Attachment 1)

Karen Warner, representing Arthur Andersen LLP, said she would try to bridge the gap between where Kansas stands on this issue and compare it with other states. She gave some background on income classifications by labels which were used prior to the 1950's. (Attachment 2) In 1963, Kansas adopted the Uniform Division of Income for Tax Purposes Act. This act was enacted to provide uniformity of apportionment and allocation of income among the states and multi-state businesses. Ms. Warner spoke of the recent U.S. Supreme Court decision of *Allied Signal* and of the provisions of the decision which rejected the full apportionment theory. She spoke of non-business income and the Kansas domiciled taxpayer and compared it to the non-business income and the non-domiciliary corporation. She used the overhead projector to show the committee charts of differences in domiciled businesses and non-domiciled businesses and business income and non-business income. (These charts are in color at the end of Attachment 2)

Ms. Warner said in the balloon of **SB 316** the businesses would have an election. The election is to provide help to the Kansas domiciled businesses but out of state businesses will not be helped by the election.

John LaFaver, Secretary, Department of Revenue, said they are in total agreement with the purpose of this legislation. In-state firms need to be assured that they are not going to be taxed by more than one state on non-business income. He said he thinks there is a ready vehicle to assure this without this legislation. On the face, in-state firms will be treated differently than out-of-state firms and that is what will lead to constitutional problems. He said he thinks there are administrative solutions. He is willing to lock this in as tight as he can. He said within *Chief* there is room to interpret business in a way that does not work to a disadvantage to in-state firms. He says no other state has legislation such as this. They have not distinguished in-state firms differently from out-of-state firms. He said he would like to continue working with the in-state firms, whether it would be by private letter ruling or however, to insure that they are not disadvantaged.

CONTINUATION SHEET

MINUTES OF THE SENATE COMMITTEE ON ASSESSMENT AND TAXATION, Room 519-S
Statehouse, at 11:00 a.m. on March 29, 1995.

Senator Bond asked if Secretary LaFaver was saying that **SB 316** has constitutional problems. Does **SB 316** with the election added do little to improve that? If you fix *Chief* with a private letter ruling, how does that become constitutional when legislation doing something similar is not constitutional? Secretary LaFaver said the private ruling or regulation would instead focus on what is business income and what is not business income. The constitutional issue is treating in-state and out-of-state firms differently. The terms business income and non-business income should be defined.

Senator Bond said his goal is to not increase corporate income tax; he wants to fix the *Chief* problem for Kansas domiciled companies; and he does not want constitutional problems as it relates to non-domiciled corporations.

Secretary LaFaver said in a private letter ruling, he would be ruling on very specific cases, and he said he was reacting to those cases which he knows of. He said this bill does not get to the heart of what is business income and non-business income.

Senator Langworthy said her understanding is that the *Chief* case was the result of rulings by the Department of Revenue which were inconsistent.

Senator Bond spoke of having an interim study of a multitude of tax problems and the Secretary could come to the Committee with either legislative or administrative solutions throughout the interim so something could be decided as it relates to domiciled institutions. Secretary LaFaver said if it is in an interim, there would be a chance to rethink and modify any resolutions which have been made.

Senator Langworthy asked the committee to think over this problem for 24 hours and the committee will meet again tomorrow at 11:00 a.m.

The meeting adjourned at 12:10 noon.

The next meeting is scheduled for Thursday, March 30, 1995.

SENATE ASSESSMENT AND TAXATION COMMITTEE GUEST LIST

DATE: March 29, 1995

NAME	REPRESENTING
MARK Beshears	Sprint
DAVE WEEKS	Yellow Corp.
TERRY FREDERICK	SPRINT
Gordon Hartwig	Koch Industries
Karen Warner	Arthur Andersen
Gene Nold	Koch Industries
Inch Jones	Lepaco
MARK A. BURGHART	
Judy Johnson	Merriam Ke
Ed Woodward	
Jim Allen	Seaboard
Michelle Peterson	Ks. Governmental Consulting
Dick Dilavere	The Coleman Co.
Ken Peterson	KS Petroleum Council
J Schwab	Sprint
Ron Herz	MESA
Cleta Winkelman	
ALAN COBB	KS Assoc For Small Business
Ian Johnson	SELF.

SENATE BILL NO. 316

AN ACT relating to taxation; regarding the definition of business income; amending K.S.A. 1994 Supp. 79-3271 and repealing the existing section.

Section 1. K.S.A. 1994 Supp. 79-3271 is hereby amended to read as follows: 79-3271. As used in this act, unless the context otherwise requires: (a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. ~~Provided, however, that if a taxpayer's commercial domicile is in the state of Kansas, the income arising from the acquisition, management, use or gain or loss from the disposition of tangible or intangible property shall constitute business income.~~

Provided, however, that a taxpayer may elect that all income arising from the acquisition, management, use, or disposition of tangible or intangible property constitutes business income. The election shall be effective and irrevocable for the taxable year of the election and the following nine years. The election shall be binding on all members of a unitary group of corporations. Notwithstanding the above, the Secretary of Revenue may upon the request of the taxpayer, grant permission to terminate the election under this paragraph prior to expiration of the ten-year period.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(d) "Financial organization" means any bank, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, credit union, cooperative bank, investment company, or any type of insurance company, but such term shall not be deemed to include any business entity, other than those hereinbefore enumerated, whose primary business activity is making consumer loans or purchasing retail installment contracts from one or more sellers.

(e) "Nonbusiness income" means all income other than business income.

(f) "Public utility" means any business entity which owns or operates for public use any plant, equipment, property, franchise, or license for the transmission of communications, transportation of goods or persons, or the production, storage, transmission, sale, delivery, or furnishing of electricity, water, steam, oil, oil products or gas.

(g) "Sales" means all gross receipts of the taxpayer not allocated

Senate Bureau & Staff
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attach 1-1

under K.S.A. 79-3274 through 79-3278, and amendments thereto.

(h) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

(i) "Telecommunications company" means any business entity or unitary group of entities whose primary business activity is the transmission of communications in the form of voice, data, signals or facsimile communications by wire or fiber optic cable.

New Sec. 2. ~~The provisions of section 1 shall be applicable to all taxable years commencing after December 31, 1979.~~

Sec. 3. K.S.A. 1994 Supp. 79-3271 is hereby repealed.

Sec. 4. This act shall take effect and be in force from and after its publication in the statute book.

New Section 2. The election in Section 1 shall be made by July 1, 1995 for any tax years ending prior to July 1, 1995. Elections for tax years ending after July 1, 1995 shall be made by including a statement with a timely filed tax return indicating that the taxpayer elects to apply the provision of Section 1.

Kansas Senate Bill 316

ARTHUR ANDERSEN LLP
Karen L. Warner, MBA, CPA
Manager, State and Local Taxes
March 29, 1995

*Senate Assessment + Tax
march 29, 1995
attach 2-1*

DISCUSSION OUTLINE

I. BACKGROUND

A. Business Income vs. Nonbusiness Income

1. Prior to the 1950's, classification of income by labels was important. For example, interest, dividends, gain on sale of assets, rents and royalties were treated as specifically allocable income. (Allocated to the state of commercial domicile.) The remaining income ("trading profit") was treated as apportionable income.
2. The Uniform Division of Income for Tax Purposes Act (UDITPA) was introduced in the 1950's and adopted by Kansas in 1963. Twenty-three states have adopted UDITPA. UDITPA was enacted to provide for uniformity of apportionment and allocation of income among the states.
3. "Business Income" (UDITPA) Sec. 1(a) - income arising from transactions and activity in the regular course of the taxpayer's trade or business (*transactional test*) and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business (*functional test*). This is also found in K.S.A. 79-3271.
 - a. Kansas Supreme Court has interpreted this statute to mean that only the transactional test applies.
 - b. Some states apply these tests as alternative tests, effectively interpreting the words "..... and includes....." to mean "....or...".

- B. The most recent U.S. Supreme Court decision on this issue, *Allied Signal* provided the following:
1. Rejection of the full apportionment theory.
 2. *Functional/transactional tests of UDITPA rejected as the sole constitutional standard.*
 3. The transaction must serve an operational purpose, regardless of whether a unitary relationship exists. The use of the proceeds of the transaction are not indicative of serving an operational function.
 4. Regardless of the states' attempt to deny that nonbusiness income exists, and is therefore out of reach of the taxing arm of the state, the U.S. Supreme Court has held that nonbusiness income does indeed exist.
- C. Because of the U.S. Supreme Court decision discussed in "B." above, there will always be some income which is not able to be taxed by Kansas.

II. NONBUSINESS INCOME AND THE KANSAS DOMICILED TAXPAYER

- A. Generally, if income is determined to be nonbusiness income, it is directly allocated to the company's state of commercial domicile. For example, if a Kansas domiciled taxpayer has *nonbusiness* income, 100% of it could be taxed in Kansas. The taxpayer's *business* income is apportioned and taxed in Kansas based on a percentage which represents its business activity in the State.
- B. The possibility of multiple taxation for Kansas domiciliary corporations exists because the corporation's nonbusiness income is taxed 100% in Kansas (its domicile state), while a percentage of the same nonbusiness income is taxed in a state in which it does business, if such state apportions all income or utilizes a different definition of nonbusiness income.
- C. The practice has been to allow Kansas domiciled companies to treat their income as apportionable, and therefore, not wholly allocable to Kansas. This practice was based on Kansas regulations which provided that the transactional and functional tests are to be used in determining nonbusiness income.
- D. An election like S.B. 316 to allow Kansas taxpayers to treat all income as business income would maintain this practice, and therefore likely result in little, if any, revenue consequence.

III. NONBUSINESS INCOME AND THE NONDOMICILIARY CORPORATION

- A. If a nondomiciliary corporation has nonbusiness income, the income is generally allocated to the corporation's state of commercial domicile. Accordingly, none of the nondomiciliary corporation's nonbusiness income would be taxed in Kansas. However, the company's *business income is apportioned to Kansas* based on a percentage which represents its business activity in the State.
- B. If a nondomiciliary corporation does not make the S.B. 316 election, then that corporation pays the same amount of tax to Kansas as they are currently paying.
- C. If a nondomiciliary corporation did make the S.B. 316 election, then that corporation would pay no less tax to Kansas than what they are currently paying.

IV. OTHER STATES' TREATMENT OF NONBUSINESS INCOME

- A. The states have varied and diverse treatment of business/nonbusiness income. There is no national standard on the business/nonbusiness issue due to numerous state and federal court decisions and the different states' interpretations of the same concept.
 - 1. Journal of State Taxation, March/April 1995, provides an analysis of 14 state cases involving gain from the disposition of assets between 1968 and 1994. The analysis shows that eleven out of the fourteen cases have come out in favor of nonbusiness income. The author states: "If one seeks something common in the cases, the best that can be said for these decisions is that the Tennessee Supreme Court appears to have taken the straightforward position that the statute involves only a single, *transactional* test for business income,.....and that the Kansas and Iowa Supreme Courts appear to agree with this view." (Emphasis added).
 - 2. The same article points out that an analysis of the early cases on this issue indicate that the "*functional test*" advocated and introduced by the Multistate Tax Commission (MTC), which looks to whether the asset was used in the business, was *rejected by the courts* even before the MTC took a position.
- B. Sixteen of the states imposing a corporate income or franchise tax require apportionment of all income unless the income is specifically allocated or make no statutory distinction between business and nonbusiness income.
- C. Half of the 46 states which impose a corporate income or franchise tax classify income as business or nonbusiness in accordance with UDITPA.
- D. As a policy matter, some states that have statutorily adopted UDITPA standards (for example, Pennsylvania) do not attempt to wholly allocate nonbusiness income of domiciliary corporations or corporations with in-state tangible property into their state tax bases.

V. WHAT INCOME IS THE STATE ENTITLED TO TAX?

- A. The state is entitled to tax the business income of a corporation as defined in K.S.A. 79-3271. Senate Bill 316 does not change that definition. The definition, along with the court decisions in *Chief and Western Natural Gas*, provides the State with the ability to fully tax its domiciliary corporations' nonbusiness income. The definition does not allow the state to tax nonbusiness income of nondomiciliary corporations. Further, there are constitutional limitations as to what the State can tax.
- B. Senate Bill 316 provides a solution to the issue of Kansas domiciliary corporations being taxed multiple times on the same nonbusiness income.
- C. Senate Bill 316 does not change the definition of business income.
- D. The election in S.B. 316 is an issue separate and apart from broadening the definition of business income, which we believe happens under the proposed amendment.

We hope this information is helpful to you as you consider the issues related to Senate Bill 316. In summary, Senate Bill 316 does offer a solution to Kansas domiciliary companies dealing with the nonbusiness issue, while leaving the nondomiciliary companies paying the same amount of tax to Kansas as they have previously. Please feel free to contact us if you have any questions regarding this information.

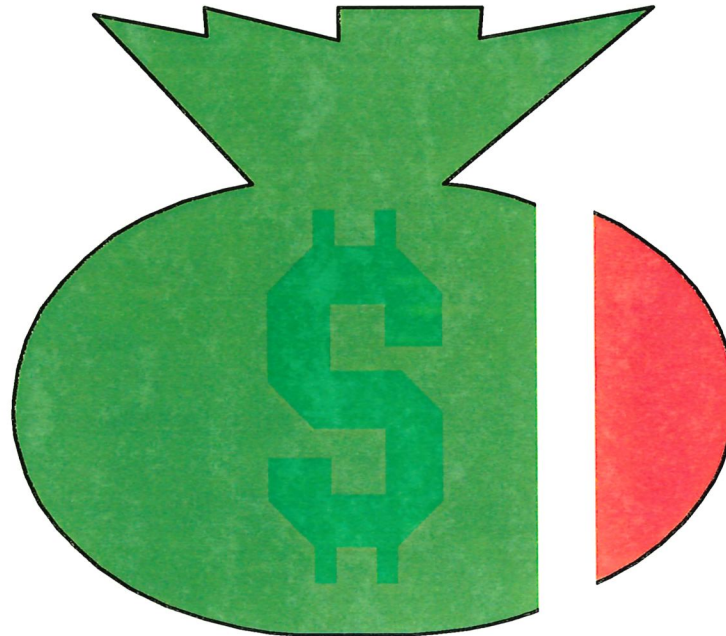
WHAT IS NONBUSINESS INCOME ?

SPREAD OVER ALL STATES

SOURCED TO COMMERCIAL DOMICILE
OR OTHER SITUS OF PROPERTY

BUSINESS INCOME

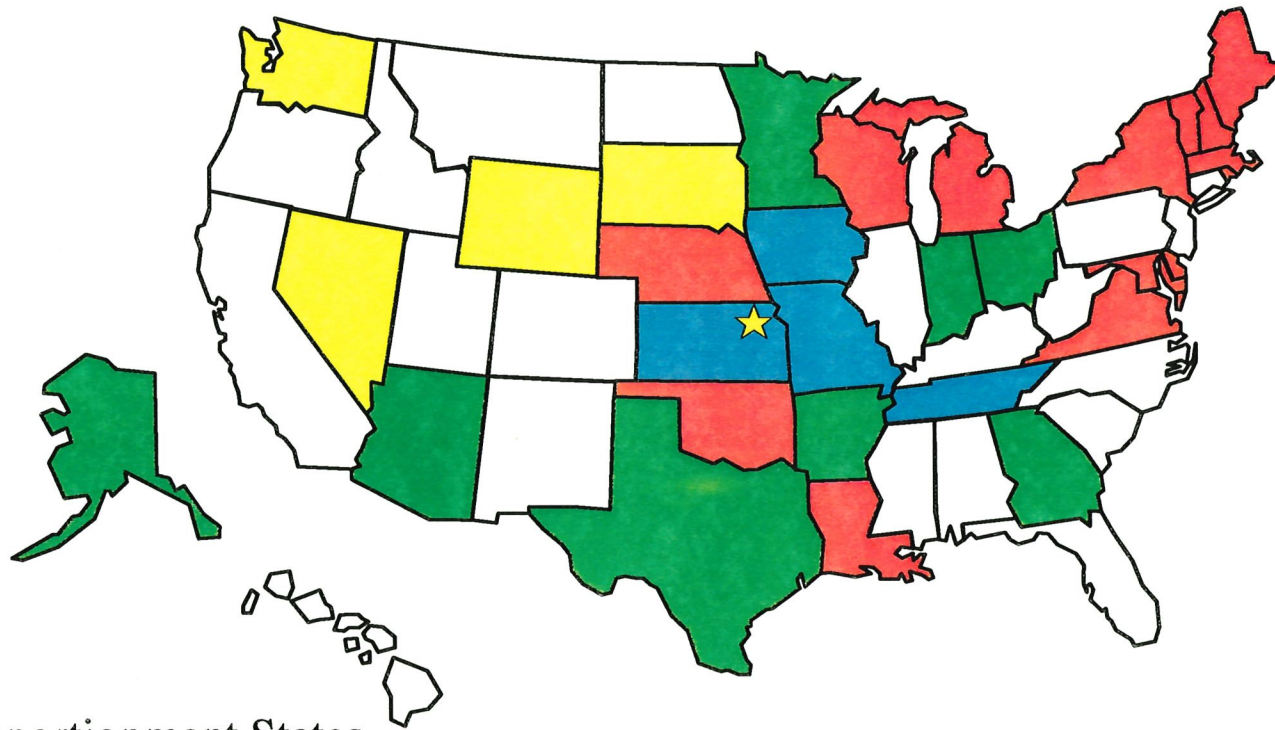
- Income From Transactions and Activity in the Regular Course of Business



EXAMPLES OF NONBUSINESS INCOME

- Gains (Losses) From Sales of Tangible Personal Property
- Gains (Losses) From Sales of Intangible Property
- Patent/Copyright Royalties
- Dividends
- Interests
- Rents/Royalties From Tangible Personal Property
- Rents From Real Property

DIVERSE TREATMENT FOR NONBUSINESS INCOME



• Full Apportionment States



• States Which Do Not Tax NonBusiness Based on Commercial Domicile



• States Which Classify NonBusiness Income Using Transactional Test



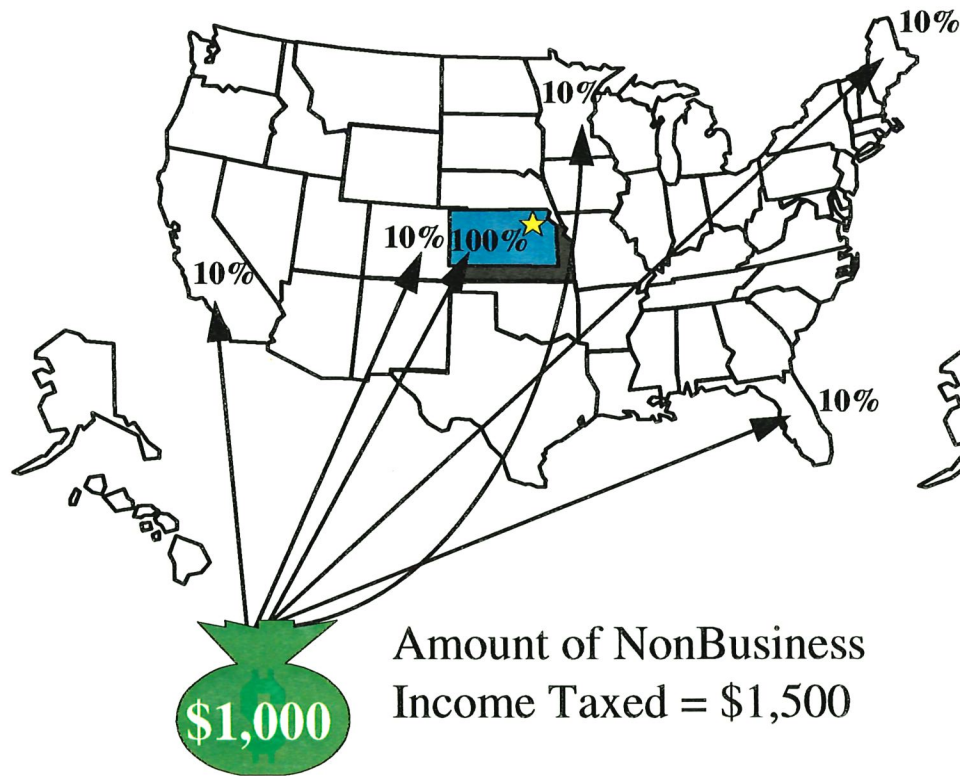
• No Corporate Income Tax States

Source: 1995 Multistate Corporate Tax Guide, Panel Publishers, 1995

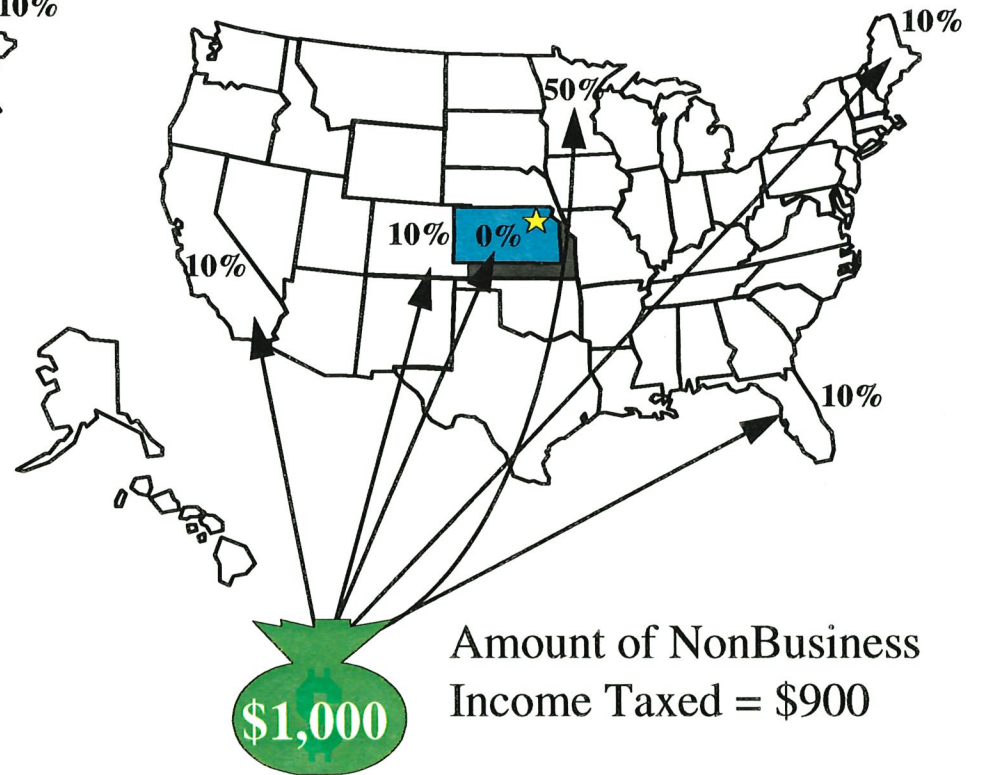
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WHAT CAN HAPPEN UNDER CURRENT LAW



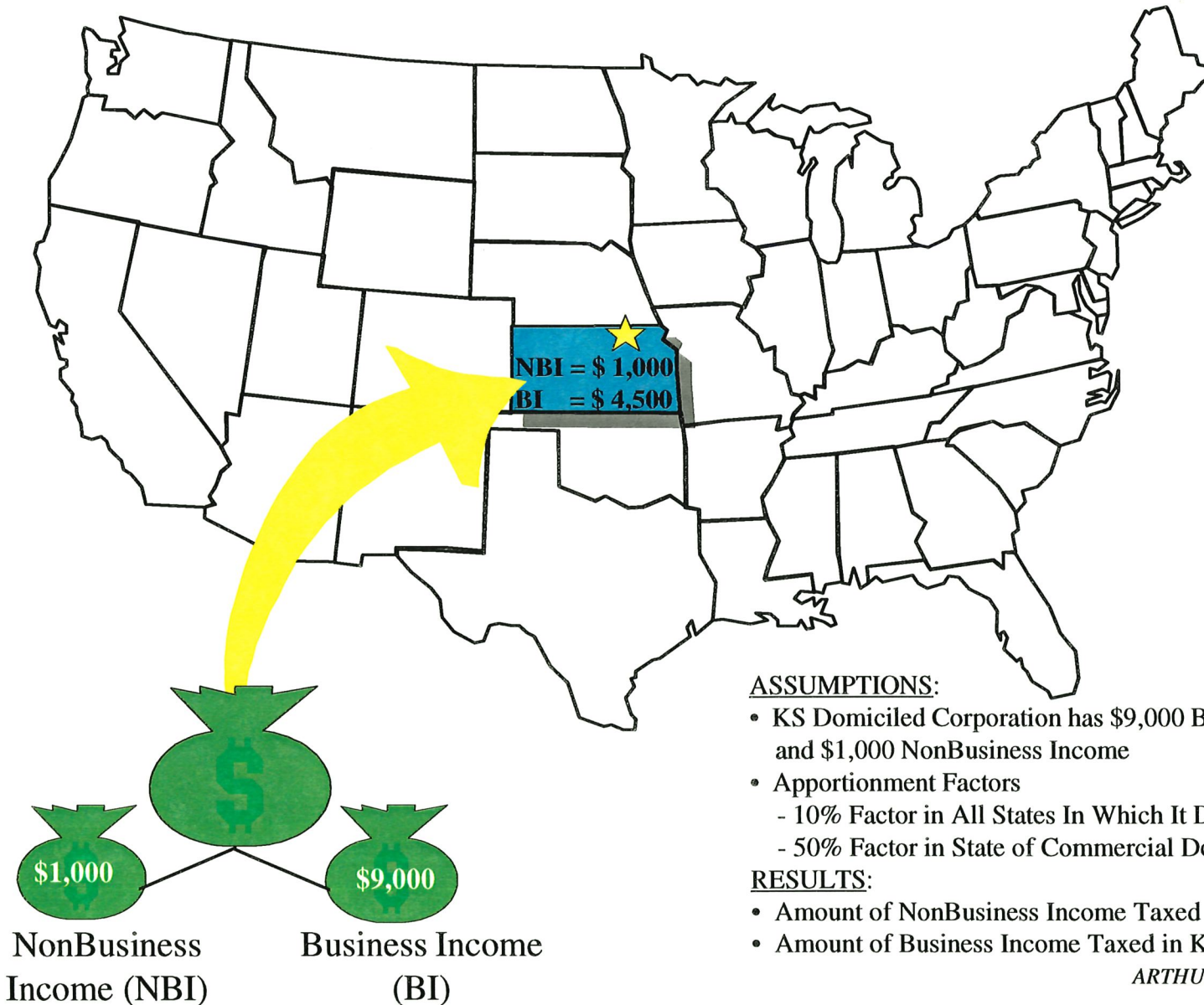
Kansas
Domiciled Taxpayer



Out of State (MN)
Domiciled Taxpayer

KANSAS DOMICILED CORPORATION

Chooses Not To Make S.B. 316 Election



ASSUMPTIONS:

- KS Domiciled Corporation has \$9,000 Business Income and \$1,000 NonBusiness Income
- Apportionment Factors
 - 10% Factor in All States In Which It Does Business
 - 50% Factor in State of Commercial Domicile

RESULTS:

- Amount of NonBusiness Income Taxed in Kansas = \$1,000
- Amount of Business Income Taxed in Kansas = \$4,500

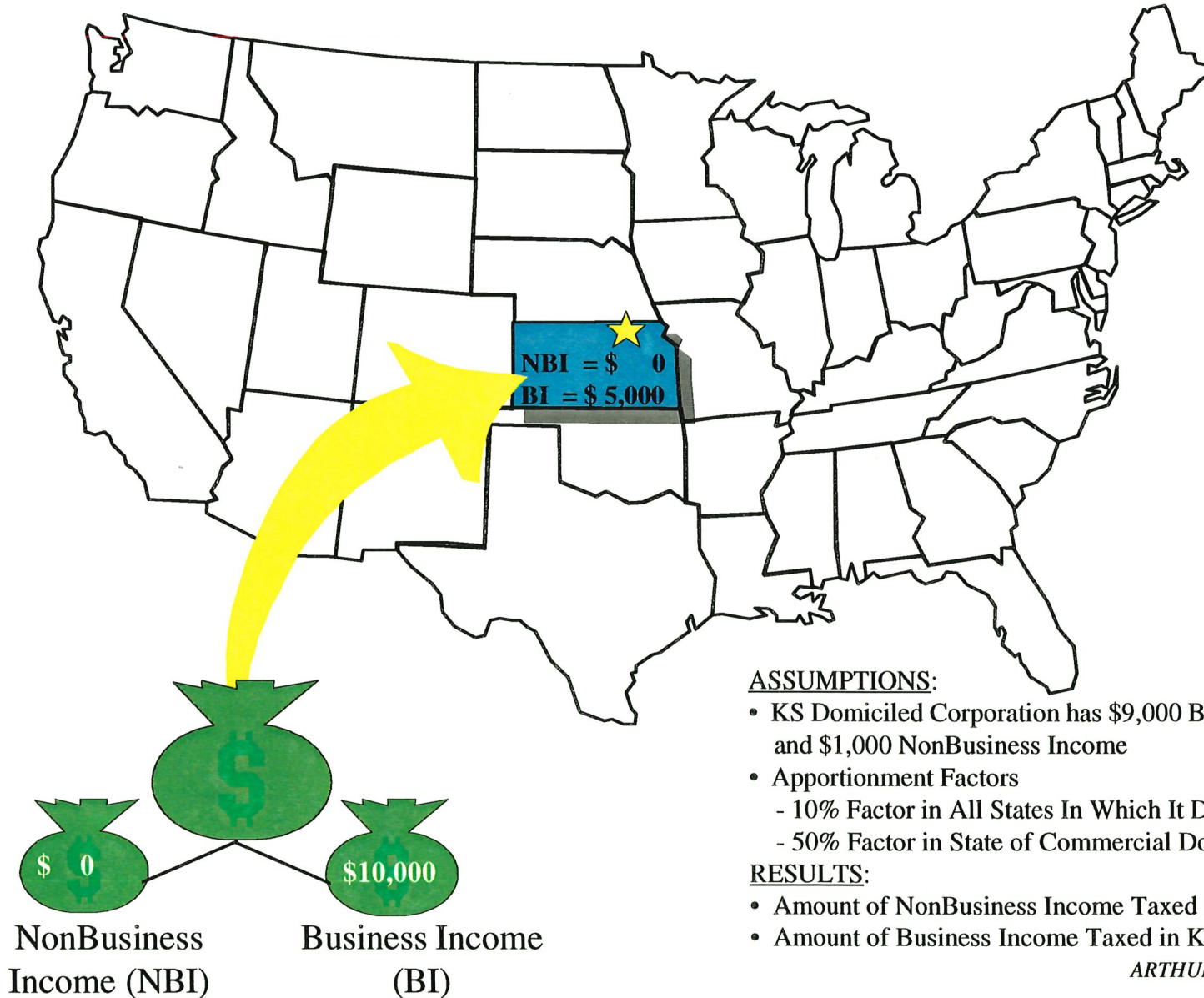
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KANSAS DOMICILED CORPORATION

Makes S.B. 316 Election

Practice Prior To *Chief Industries* Case



ASSUMPTIONS:

- KS Domiciled Corporation has \$9,000 Business Income and \$1,000 NonBusiness Income
- Apportionment Factors
 - 10% Factor in All States In Which It Does Business
 - 50% Factor in State of Commercial Domicile

RESULTS:

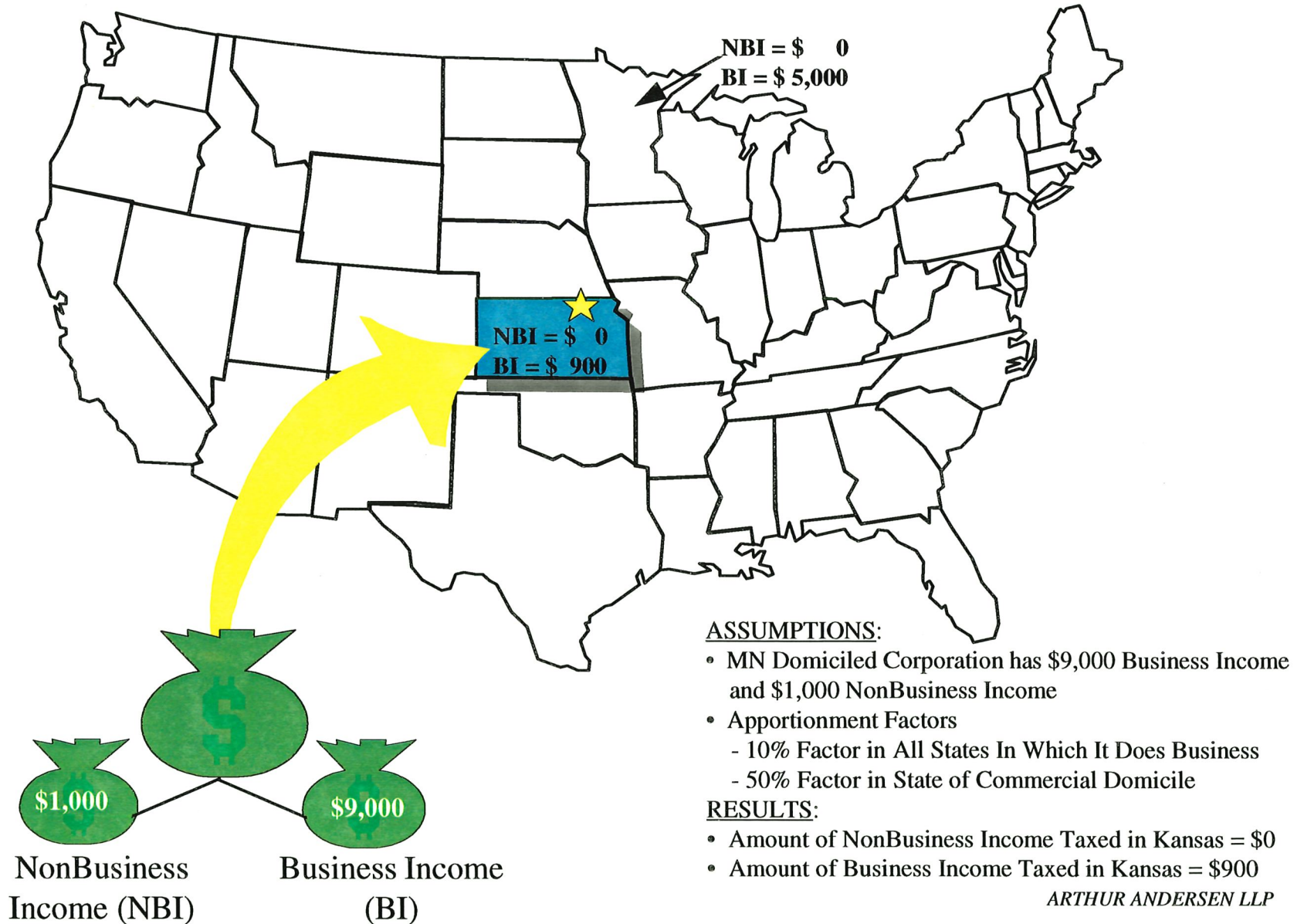
- Amount of NonBusiness Income Taxed in Kansas = \$0
- Amount of Business Income Taxed in Kansas = \$5,000

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OUT OF STATE (MN) DOMICILED CORPORATION

Chooses Not To Make S.B. 316 Election

Current Practice



OUT OF STATE (MN) DOMICILED CORPORATION

Makes S.B. 316 Election

