

MINUTES OF THE SENATE COMMITTEE ON COMMERCE.

The meeting was called to order by Chairperson Senator Karin Brownlee at 8:30 a.m. on February 25, 2002 in Room 123-S of the Capitol.

All members were present except:

Senator Brungardt (Excused)

Committee staff present:

April Holman, Legislative Research
Debra Hollon, Legislative Research
Norman Furse, Revisor of Statutes
Sherman Parks, Revisor of Statutes
Lea Gerard, Committee Secretary

Conferees appearing before the committee:

Richard Cram, Department of Revenue
Janet Buchanan, Kansas Corporation Commission
John Federico, representing Kansas Cable
Telecommunications Association

Others attending:

See attached list

Continued Hearings on **SB 501** Investment funds service company business income apportionment for income tax purposes:

Chairperson Brownlee explained **SB 501** was placed in subcommittee to understand and consider the amendments that the Department of Revenue proposed. Richard Cram, Department of Revenue indicated at the subcommittee meeting that the fiscal note was revised because there would be no administrative costs (Attachment 1). The Department of Revenue had placed some administrative costs for reprogramming the audit work papers. This bill actually involved very few tax payers and it was felt the reprogramming work would not be necessary. The administrative costs had initially been estimated to range from \$20,000. to \$200,000.

Senator Brownlee stated the fiscal note for tax treatment the first year will be a benefit of \$2M to Waddell & Reed and subsequent years will be \$4M.

Following are the amendments for **SB 501** adopted by the subcommittee:

Page 1, Line 34 strike the word "investment".

Page 1, Line 35 strike the word "company".

Page 2, Section 1, insert subsection (g) "*Original Return*" means the first return filed to report the income of a taxpayer for a taxable year or period, irrespective of whether such return is filed on a single entity basis or a combined basis.

Re-letter each subsection after (g).

Page 2, Line 22, Line 26 and Page 3, Line 6 strike the words "but are not limited to".

Page 3, Line 1, Line 2, Line 7 and Line 18 strike the words "directly or indirectly".

Page 3, starting with Line 22, subsection (7) should read "*residence*" is the fund shareholder's primary residence or principal place of business.

Page 3, Line 22 thru Line 31, subsection (7) strike the words "is presumptively the fund shareholder's mailing address on the records of the investment company. If, however, the investment company or the investment funds service corporation has actual knowledge that is different than the fund shareholder's mailing address such presumption shall not control. To the extent an investment funds service corporation does not have access to the records of the investment company, the investment funds service corporation may employ reasonable methods to determine the investment company fund shareholder's residence.

Page 4, Line 10 strike the word "percentage" and insert the word "fraction".

Page 5, Line 2 following the word "operations" insert "*or a branch facility that employees at least 100 individuals*".

Page 5, Line 18 following the word "each" insert "*fund of each*".

Page 5, Line 19 strike the word "for" and insert the word "from".

Page 5, Lines 19 and 20 strike the words "respective percentage of each fund, as".

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Page 5, Line 19 following the word "the" insert "*fraction*".

Page 5, Line 20, (A) insert "*for each fund of such investment company*".

Page 5, Line 21, Section 2 (b) (5) (C) Insert: "*The qualifying portion of total business income of an investment funds service corporation shall be determined by multiplying such total business income by a fraction, the numerator of which is the gross receipts from the provision of management, distribution and administration services to or on behalf of an investment company, and the denominator of which is the gross receipts of the investment funds service company*".

Page 5, Line 23 strike "~~without regard to this subsection~~" and insert "*pursuant to K.S.A. 79-3279(b)(1)*".

Page 5, Line 24 strike "~~amount of~~".

Page 5, Line 25 strike "~~company resulting from the apportionment of~~" and insert "*corporation that has elected to apportion its*".

Page 5, Line 28 strike "~~without regard to paragraph~~" and insert "*pursuant to K.S.A. 79-3279(b)(1)*".

Page 5, Line 30, add new subparagraph (E) to Section 2 (b) (5): "*When an investment funds service corporation is part of a unitary group, the business income of the unitary group attributable to the investment funds service corporation shall be determined by multiplying the business income of the unitary group by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three. The property factor is a fraction, the numerator of which is the average value of the investment funds service corporation's real and tangible personal property owned or rented and used during the tax period and the denominator of which is the average value of the unitary group's real and tangible personal property owned or rented and used during the tax period. The payroll factor is a fraction, the numerator of which is the total amount paid during the tax period by the investment funds service corporation for compensation, and the denominator of which is the total compensation paid by the unitary group during the tax period. The sales factor is a fraction, the numerator of which is the total sales of the investment funds service corporation during the tax period, and the denominator of which is the total sales of the unitary group during the tax period.*"

Senator Steineger moved, seconded by Senator Jordan that **SB 501** be recommended favorable for passage. Motion carried.

Continued Hearings on **SB 614**—KUSF funding for KAN-ED:

Chairperson Brownlee asked if there was anyone that would like to comment on **SB 614** or does the committee have questions for anyone in the room regarding the bill.

Senator Jordan asked Janet Buchanan to comment on the impact of KUSF funding for KAN-ED. Janet Buchanan stated that if \$10M was added to the KUSF fund, given the other funding requirements for the March begin date, the wireline assessment would move from 3.7% to 4.5%, the wireless assessment would move from 3.4% to 4.02%. The Commission also calculated the amount of pass through that the CLEC's can charge their customers. The charge for the majority of the independent companies would be from .49 cents to .59 cents, Tri-County will move from .42 cents to .51 cents, Cass County will move from \$1.10 to \$1.33, Southwestern Bell will move from \$1.19 to \$1.43 and for Sprint United it would be from .98 cents to \$1.18.

Senator Barone asked Janet Buchanan what would be the impact if opposed to adding to the size of the KUSF money, we made KAN-ED the first dispersal of the KUSF fund. Janet Buchanan explained there would not be enough money in the KUSF fund to take care of the other requirements for high cost service areas in the rural areas of the state. We would be depriving some of the carriers revenue promised to them from the KUSF fund if \$10M were not added to the fund.

Senator Barone asked Janet Buchanan if she was able to determine the benefits that would be received from the \$400M to \$500M that is invested in the KUSF fund. Janet stated she requested all of the companies to get that information to her by Friday, March 1, 2002.

John Federico, representing the Kansas Cable Telecommunications Associations stated the cable companies do not necessarily have a problem with **SB 614** and the funding mechanism for KAN-ED. There is concern that the cable customers do not pay into the KUSF fund and if there should be a

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competitive bidding scenario down the road for the KAN-ED project, the cable associations may be at a disadvantage in competing against the competitors that are subsidized by KUSF money. Is this money to be used for infrastructure or for services?

There being no conferees wishing to testify, the hearing for **SB 614** was closed.

The Chairperson stated the big policy issue is do we want to fund KAN-ED via KUSF money?

Senator Emler moved, seconded by Senator Steineger that as a matter of policy KAN-ED would be funded with KUSF money. Motion did not carry on a voice vote.

The Chairperson stated she would ask that **SB 614** be blessed so that if there is interest, the committee could pursue this issue at a later date.

Meeting adjourned at 9:30 a.m.

The next meeting is scheduled for February 26, 2002 at 8:15 a.m.

SENATE COMMERCE COMMITTEE
GUEST LIST

DATE: February 25, 2002

NAME	REPRESENTING
Kathy Dameron	Waddell & Reed
Bob Marcusse	KCASE
Scott Anglemyer	KDOCEN
Erik Santorius	City of Overland Park
JANET BUCHANAN	KCC
TOM DAY	KCC

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Office of Policy & Research

February 15, 2002

To: Senator Karin Brownlee, Chair
 Senate Committee on Commerce

From: Richard Cram

Re: Department of Revenue Suggested Amendments to Senate Bill 501

Attached hereto are proposed amendments to Senate Bill 501. This bill, which evolved from 2001 House Bill 2061, was the subject of study by the Special Committee on Assessment and Taxation last summer and fall. The Committee recommended:

that the 2002 Kansas Legislature give favorable consideration to new legislation similar to HB 2061, with several amendments. The new bill should have changes suggested by the Department of Revenue that would bring it into closer conformity with Missouri's law for investment fund service companies; should be effective for tax year 2002 in lieu of tax year 2001; and should contain a mechanism by which the fiscal impact is phased in over two years. The new legislation should be introduced as soon as the Department of Revenue and proponents of the change in the income apportionment formula have agreed to language that would accomplish this recommendation.

Last fall, pursuant to the Committee's recommendations, the Department reviewed the corresponding Missouri statute applicable to investment funds service corporations (IFSC), Mo. Stat. § 143.451 *et seq.*, and suggested a draft proposal (using the Missouri statute as a starting point for the draft) to Waddell and Reed, along with a list of questions about some of the provisions. This draft appears to have been used in the development of Senate Bill 501. Upon review of Senate Bill 501, the Department proposes the following amendments, which are intended to clarify the bill and make it easier and more practical to administer, should it be enacted.

Senate Bill 501 would enable certain IFSCs to apportion their qualifying business income (QBI) using a single factor formula that is based on the number of shares in the IFSC held by shareholders residing in Kansas. This bill raises several legal concerns that can be addressed with amendments.

Section 1 of the bill would amend K.S.A. 79-3271 by adding subsection (k), which includes a definition of "investment company." However, K.S.A. 79-3271(d) already provides that an "investment company" is included in the definition of "financial organization." This overlap in terminology could result in confusion when construing references to "investment

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company" and "financial organization" that appear in Uniform Division of Income for Tax Purposes Act, K.S.A. 79-3271 *et seq.* The term "investment company" should be deleted from the definition of "financial organization" in K.S.A. 79-3271(d), at Lines 34-35 of Page 1.

Qualifying taxpayers must elect to use the single factor apportionment formula. The election must be made at the time of filing the "original return." See Section 2(a)(5). In the past, disputes have arisen with regard to whether taxpayers have properly made an election and whether a return is the "original return," particularly where returns have been filed on both a separate and combined basis. Without more specific language in the bill, it is possible that similar disputes may arise in the future with IFSC returns. A definition for "original return" should be inserted between Lines 2-3 on Page 2 to add new paragraph (g) to K.S.A. 79-3271 as follows: "'original return' means the first return filed to report the income of a taxpayer for a taxable year or period, irrespective of whether such return is filed on a single entity basis or a combined basis."

"Qualified business income"(QBI) consists of income derived from the providing of certain specific services, such as "administration services," "distribution services," and "management services," terms which are specifically defined in Section 1. However, these definitions are vague in certain respects and could be difficult to construe and administer. For example, QBI is income derived from the provision "directly or indirectly" of these enumerated services. The term "indirectly" would give rise to differences of opinion as to whether certain income is QBI. The definition of "administration services" is "not limited to" those services expressly set forth in Section 1 (k) (1). In order to add clarity to the bill and avoid use of open-ended and vague terms, the phrases "directly and indirectly" and "not limited to" should be deleted where used at Lines 22 and 26, Page 2, Lines 1-2, 6-7, and 18 of Page 3.

Subsection 1(k)(4) of the bill defines "investment funds service corporation" to include corporations or S corporations headquartered in this state that derive more than 50% of their gross income from the provision of management, distribution or administration services to or on behalf of an investment company "or from trustees, sponsors and participants of employee benefit plans which have accounts in an investment company." Providing management, distribution or administration services to trustees, sponsors and participants of employee benefit plans having accounts in an investment company, appears to go beyond the scope of services that Waddell and Reed currently provides. Thus, the Department would request that the quoted language above be deleted from the bill at Lines 3-5 and 19-21 of Page 3, in order to narrow its focus.

Section 1(k)(7) of the bill would allow an investment funds service corporation to estimate the percentage of Kansas shareholders to total shareholders if they do not have access to the investment company's records. Similarly, the phrase "reasonable methods" in referring to attempts by IFSCs to establish the residence of the shareholders can be subject to differing interpretations. The investment funds service corporation should be required to provide the Department access during audit to the actual address records. Thus, the Department believes that "residence" should be simply defined as "the fund shareholder's primary residence or principal place of business," at Lines 22-31, and the other provisions in Section 1(k)(7) should be deleted.

Section 2 (b) (5) (B) provides that QBI derived from the provision of services to investment companies shall be multiplied by the respective "percentage" of each fund, as calculated pursuant to paragraph (A). However, paragraph (A) refers to the multiplication of QBI by a "fraction." If the legislative intent is that the terms "percentage" and "fraction" are synonymous, it is recommended that consistent terminology be used to avoid confusion. This provision should be revised at Page 5, Lines 17-20, as follows: "A separate computation shall be

made to determine the qualifying business income from each fund of each investment company. The qualifying business income from each investment company shall be multiplied by the fraction calculated pursuant to paragraph (A) for each fund of such investment company."

Section 2(b)(5)(C) provides that to the extent an IFSC has business income that is not QBI, such business income shall be apportioned to Kansas "without regard to this subsection." This is intended to mean that business income other than QBI must be apportioned pursuant to the standard three-factor formula, which is set forth at K.S.A. 79-3279(b)(1). The Department suggests that this provision be clarified at Page 5, Line 23, by replacing the phrase "without regard to this subsection" with the language "pursuant to K.S.A. 79-3279(b)(1)."

Section 2(b)(5)(D) of the bill, the transitional provision for tax year 2002, refers to the tax liability of an IFSC "from the apportionment of business income pursuant to paragraph (5)." However, since this bill draws a clear distinction between the apportionment of "qualifying business income" and the apportionment of "business income that is not qualifying business income," it is unclear which type of business income is being referred to in Section 2 (b) (5) (D). This language could be read to refer to business income that is not QBI, resulting in excluding QBI from taxation – which appears contrary to legislative intent. Further, subparagraph (D) does not specify whether its terms are applicable to all IFSCs or only those that elect to use the single factor apportionment method. The language used could be read to require all IFSCs -- even those that do not make the election -- to comply with its terms. For clarity, this provision should be revised at Page 5, Lines 24-29, as follows: "For tax year 2002, the tax liability of an investment funds service corporation that has elected to apportion its business income pursuant to paragraph (5) shall be increased by an amount equal to 50% of the difference of the amount of such tax liability if determined pursuant to K.S.A. 79-3279(b)(1) less the amount of such tax liability determined with regard to paragraph (5)."

A special apportionment formula (based on the ratio of shares owned by Kansas residents to total shares) is applied to the qualifying business income of an investment funds service corporation. The standard apportionment formula is used against the non-qualifying income of an investment funds service corporation. How is the apportionable (net) income of an investment funds service corporation divided between the two? More importantly, if an investment funds service corporation is a member of a unitary group, how is the combined apportionable income divided between the investment funds service corporation(s) and the rest of the unitary group?

As contemplated in Section 2 (b) (5) (C), there may be circumstances in which not all of an IFSC's business income is QBI. In such cases, it appears that the non-QBI business income is to be apportioned pursuant to K.S.A. 79-3279(b)(1) [the three-factor formula consisting of property, payroll and sales], although this is not specifically stated in the bill. This would cause difficulty, inasmuch as there are practical problems in using two different formulae to apportion the income of one taxpayer. Further, similar difficulties would be encountered if an IFSC is a member of a unitary group of corporations, all or many of which use a different statutory method to apportion their income. Some method of "pre-apportionment" is required before the different formulae could be applied. Kansas statutes currently provide no guidance in this area.

The following are suggested additions to Senate Bill 501 to resolve these issues:

Add at the end of Line 29, Page 5, new subparagraph (E) to Section 2(b)(5):

When an investment funds service corporation is part of a unitary group, the business income of the unitary group attributable to the investment funds service

corporation shall be determined by multiplying the business income of the unitary group by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three. The property factor is a fraction, the numerator of which is the average value of the investment funds service corporation's real and tangible personal property owned or rented and used during the tax period and the denominator of which is the average value of the unitary group's real and tangible personal property owned or rented and used during the tax period. The payroll factor is a fraction, the numerator of which is the total amount paid during the tax period by the investment funds service corporation for compensation, and the denominator of which is the total compensation paid by the unitary group during the tax period. The sales factor is a fraction, the numerator of which is the total sales of the investment funds service corporation during the tax period, and the denominator of which is the total sales of the unitary group during the tax period.

Add to the beginning of Section 2(b)(5)(C) at Line 21, Page 5:

The qualifying portion of total business income of an investment funds service corporation shall be determined by multiplying such total business income by a fraction, the numerator of which is the gross receipts from the provision of management, distribution and administration services to or on behalf of an investment company, and the denominator of which is the gross receipts of the investment funds service company.