

MINUTES OF THE HOUSE TAXATION COMMITTEE.

The meeting was called to order by Chairperson John Edmonds at 9:00 a.m. on March 20, 2003 in Room 519-S of the Capitol.

All members were present except: Representative Vaughn Flora

Committee staff present: Chris Courtwright, Legislative Research Dept.
Gordon Self, Office of Revisor of Statutes
Carol Doel, Committee Secretary

Conferees appearing before the committee: Representative Bruce Larkin
Richard Cram, Department of Revenue
Ace Rowley, Regional Trust Executive for the
Central Region, Bank of America
Jack Ovel, Executive Vice-President
Commerce Bank

Others attending: See attached sheet

Chairman Edmonds opened the meeting with the request for any bill introductions. There were none.

For the next item of business, the Chairman asked for a motion for the adoption of the House Taxation minutes from March 3-10, 3-11, 3-12, 3-13, 3-14, and 3-17. Representative Larkin made a motion that those sets of minutes be adopted as read. Representative Owens seconded the motion. Vote was taken, minutes were adopted as read.

Chairman Edmonds opened the meeting for hearing on **HB 2266** - *Modification of definition of resident trust for income tax purposes* with Representative Bruce Larkin testifying in support of the bill. His testimony reported the bill is a proposed solution to a tax loophole that was first brought to the attention of the legislature in the early 90's. As the search continues for revenue to help solve the state's budget crisis, the first action should be to close loopholes and attempt to collect taxes that are owed. (Attachment 1)

Also appearing in support of **HB 2266**, was Richard Cram from the Department of Revenue. The Department supports the bill with a suggested amendment to mirror Missouri's definition of "resident trust: at MO. Rev. St. 143.331. **HB 2266** would significantly broaden the definition of a Kansas resident trust, to include: (1) a trust created by the will of a decedent who at the time of death was domiciled in this state; (2) a trust created by or consisting of property of a person domiciled in this state on the date the trust or portion of the trust became irrevocable; (3) a trust administered in this state; (4) a trust any of the property of which is located in this state; or (5) a trust any of the beneficiaries of which is domiciled in this state. (Attachment 2) Mr. Cram also included the suggested amendment changes to the bill. (Attachment 3)

The Greater Kansas City Community Foundation submitted written testimony in favor of **HB 2266**. (Attachment 4)

With no further proponents for the **HB 2266**, Chairman Edmonds introduced Ace Rowley, Regional Trust Executive for the Central Region Bank of America and the first opponent. Mr. Rowley's testimony commented that the resident trust bill will focus on three areas. First, he commented on the strengths of the present statute, stating that the statute is not broken, therefore, it does not need to be fixed. Second, his comment was on the controversies that will accompany the adoption of the proposed bill. The compliance and enforcement burden that would be created by the proposed bill will be significant. His third comment was on the unintended consequences the proposed bill may cause. (Attachment 5)

Jack Ovel, Executive Vice President Commerce Bank, appeared in opposition to **HB 2266**. His opposition will emphasize the minimal positive impact this bill might have in the short run. Secondly, he commented on the unintended consequences of the bill which he believes would be significant. (Attachment 6)

CONTINUATION SHEET

MINUTES OF THE HOUSE TAXATION COMMITTEE at 9:00 a.m. on March 20, 2003 in Room 519-S of the Capitol.

With no further opponents or proponents wishing to address the bill, Chairman Edmonds closed the meeting for public hearings on **HB 2266**.

HB 2419 was also scheduled to be heard, however, time did not permit hearing on this bill, and it will be rescheduled at a later date.

With no further business before the committee, Chairman Edmonds adjourned the meeting at 10:33 a.m.

GUEST LIST

DATE March 20, 2003

NAME	REPRESENTING
Cheryl Caldwell	Loyola Chase
Diane Turner	KSCo-op Council
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Walter Joe Smith	KMHA
Deann Williams	KMCA
Ann Burkes	DOB
Michelle Peterson	Ks Gov. Consulting
Jennifer Lee	Johnson County
Judy Nolan	KAC
Fester Kaufman	KFB

BRUCE F. LARKIN
REPRESENTATIVE, DISTRICT 62
R.R. 1
BAILEYVILLE, KANSAS 66404



TOPEKA

HOUSE OF
REPRESENTATIVES

Testimony before the
House Taxation Committee

Regarding

HB 2266

on

March 20, 2003

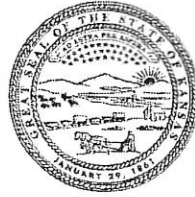
COMMITTEE ASSIGNMENTS
RANKING MINORITY MEMBER: TAXATION
MEMBER: AGRICULTURE
TRANSPORTATION
INTERSTATE COOPERATION
MEMBER OF ADVISORY COMMITTEE
TO DEPT. OF REV. ON USE VALUE
TAXATION ON AGR. LAND

HB 2266 is a proposed solution to a tax loophole that was first brought to our attention in the early 90's. This was reintroduced last year and passed out of this committee and by the full House. The Senate would not consider this proposal in a committee or in conference.

The loophole in our tax laws allows a Kansas trust that is administered by an out of state bank to avoid state income taxes. Kansas trusts that are administered in Kansas are subject to Kansas income tax. This loophole was closed by the Missouri legislature in the late 80's. This law was twice appealed to the Missouri Supreme Court and then recently modified to reflect the court's opinions.

As we continue to search for revenues to help solve the state's budget crisis, the first action should be to close loopholes and attempt to collect taxes that are owed. This is a fairness issue and a loophole that should be closed.

House Taxation
Attachment 1
Date 3-20-03



K A N S A S

JOAN WAGNON, SECRETARY

DEPARTMENT OF REVENUE
OFFICE OF THE SECRETARY

KATHLEEN SEBELIUS, GOVERNOR

Testimony to House Tax Committee
Joan Wagon
Secretary of Revenue

March 20, 2003

House Bill 2266

Chairman Edmonds and Members of the Committee:

The Department supports House Bill 2266, with a suggested amendment to mirror Missouri's definition of "resident trust" at Mo. Rev. St. 143.331. House Bill 2266 would significantly broaden the definition of a Kansas resident trust, to include: (1) a trust created by the will of a decedent who at the time of death was domiciled in this state; (2) a trust created by or consisting of property of a person domiciled in this state on the date the trust or portion of the trust became irrevocable; (3) a trust administered in this state; (4) a trust any of the property of which is located in this state; or (5) a trust any of the beneficiaries of which is domiciled in this state.

A trust's undistributed income is subject to taxation by the state of the trust's residence, assuming there is sufficient nexus between the trust and the state. Current law defines a Kansas resident trust as one administered in Kansas. A Kansas resident wishing to establish a trust need only have a Missouri trustee administer the trust in order for it to be considered a non-resident trust, for Kansas tax purposes.

In *Swift*, 727 S.W. 2d 880 (Mo. 1987), trustees of testamentary trusts created under the will of a Missouri resident successfully challenged Missouri income tax assessments on trust income. The trust property, trust administration, and all beneficiaries were located outside of Missouri. The Missouri Supreme Court reversed the assessments and held that there was insufficient nexus between the State of Missouri and the trusts to justify imposing Missouri income tax on the trusts' income. The Missouri statute on which the assessments were based defined a resident trust as a trust created by the will of a decedent domiciled in the state at the time of death. The court held imposition of Missouri income tax under this statute unconstitutional under the Fourteenth Amendment, given the lack of connection between the trusts and Missouri.

In *Westfall v. Director of Revenue*, 812 S.W.2d 513 (Mo. 1991), the Missouri Supreme Court upheld as constitutional income taxation of a trust created under the will of a Missouri domiciliary on the date of death, based on the settlor's domicile being in Missouri, the situs of the trust's creation being in Missouri, the trust's ownership of real estate in Missouri, and certain contingent beneficiaries being located in Missouri.

Cases litigated in other states have upheld as constitutional taxation of undistributed trust income by states defining a resident trust as one consisting of property transferred by will of a decedent who at the time of death was a resident of the state, or consisting of property of a person a resident of the state at the time transferred to an irrevocable trust. See *Chase Manhattan Bank v. Gavin*, 249 Conn. 172, 733 A.2d 782 (1999); *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C. App. 1997).

After amendments following *Swift* and other litigation, current Missouri law, Mo. St. 143.331, defines a resident trust as: (1) a trust created by the will of a decedent who at death was domiciled in the state and has at least one income beneficiary as a resident of the state on the last day of the taxable year; or (2) a trust created by, or consisting of property of, a person domiciled in the state on the date the trust became irrevocable and has at least one income beneficiary as a resident of the state on the last day of the taxable year.

This bill as introduced proposes a broader definition of resident trust than the Missouri statute, and the Department recommends the amendment shown on the attached balloon, which narrows the definition to resemble Missouri's.

HOUSE BILL No. 2266

By Committee on Taxation

2-11

AN ACT concerning income taxation; relating to resident trusts; amend- ing K.S.A. 79-32,109 and repealing the existing section.

Be it enacted by the Legislature of the State of Kansas:

Section 1. K.S.A. 79-32,109 is hereby amended to read as follows: 79-32,109. As used in this act, unless the context otherwise requires:

(a) Any term used in this act shall have the same meaning as when used in a comparable context in the federal internal revenue code. Any reference in this act to the "federal internal revenue code" shall mean the provisions of the federal internal revenue code of 1986, and amend- ments thereto, and other provisions of the laws of the United States re- lating to federal income taxes, as the same may be or become effective at any time, or from time to time, for the taxable year.

(b) "Resident individual" means a natural person who is domiciled in this state. A natural person who spends in the aggregate more than six months of the taxable year within this state shall be presumed to be a resident for purposes of this act in absence of proof to the contrary. A nonresident individual means an individual other than a resident individual.

(c) "Resident estate" means the estate of a deceased person whose domicile was in this state at the time of such person's death. "Nonresident estate" means an estate other than a resident estate.

(d) "Resident trust" means a trust which is administered in this state. A trust shall not be deemed to be administered in this state solely because it is subject to the jurisdiction of a district court within this state: (1) A trust created by will of a decedent who at the time of death was domiciled in Kansas; (2) a trust created by, or consisting of property of, a person domiciled in Kansas on the date the trust or portion of the trust became irrevocable; (3) a trust administered in this state; (4) a trust any of the property of which is located in this state; or (5) a trust any one of the beneficiaries of which is domiciled in this state. "Nonresident trust" means a trust other than a resident trust.

(e) "Resident partner" means a partner who is a resident individual, a resident estate, or a resident trust. "Nonresident partner" means a part- ner other than a resident partner.

and such trust has at least one income beneficiary who, on the last day of the taxable year, was a resident of Kansas

and such trust has at least one income beneficiary who, on the last day of the taxable year, was a resident of Kansas; or

1 (f) "Resident beneficiary" means a beneficiary of an estate or trust
2 which beneficiary is a resident individual, a resident estate, or a resident
3 trust. "Nonresident beneficiary" means a beneficiary other than a resident
4 beneficiary.

5 (g) "Director" means the director of taxation.

6 (h) "Modified Kansas source income" means that part of a nonresi-
7 dent individual's Kansas adjusted gross income as set forth in K.S.A. 79-
8 32,117, and amendments thereto, derived from sources in Kansas. Items
9 of income including unemployment compensation, gain, loss or deduction
10 reflected in Kansas adjusted gross income shall be considered derived
11 from sources in Kansas to the extent that they are attributable to: (1) The
12 ownership of any interest in real or tangible personal property in this
13 state; (2) a business, trade, profession or occupation carried on in this
14 state; (3) a business, trade, profession or occupation carried on partly
15 within and partly without this state as determined by the uniform division
16 of income for tax purposes act as set forth in K.S.A. 79-3271 through
17 K.S.A. 79-3293, and amendments thereto; (4) the distributive share of
18 partnership income, gain, loss and deduction determined under this sec-
19 tion as if the partnership were a nonresident individual; (5) the share of
20 estate or trust income, gain, loss and deduction determined under K.S.A.
21 79-32,137, and amendments thereto; (6) prizes won from lottery games
22 conducted by the Kansas lottery; (7) any winnings from parimutuel wa-
23 gering derived from the conduct of parimutuel activities within this state;
24 or (8) income from intangible personal property, including annuities, div-
25 idends, interest, and gains from the disposition of intangible personal
26 property to the extent that such income is from property employed in a
27 trade, business, profession or occupation carried on in Kansas. A nonresi-
28 dent, other than a dealer holding property primarily for sale to customers
29 in the ordinary course of such dealer's trade or business, shall not be
30 deemed to carry on a business, trade, profession or occupation in Kansas
31 solely by reason of the purchase and sale of property for such nonresi-
32 dent's own account.

33 "Modified Kansas source income" shall not include: (1) Compensation
34 paid by the United States for service in the armed forces of the United
35 States, performed during an induction period by an individual not domi-
36 ciled in this state; or (2) such individual's share of distributed or undi-
37 stributed taxable income or net operating loss of a corporation which is an
38 electing small business corporation unless an agreement is filed as pro-
39 vided in K.S.A. 79-32,139, and amendments thereto, in which event, the
40 "modified Kansas source income" of such nonresident individual shall
41 include such individual's share of such corporation's distributed and un-
42 distributed taxable income or net operating loss as such share is deter-
43 mined under the internal revenue code only to the extent, however, that

1 such income, gain or loss is at the corporate level, derived from sources
2 within Kansas.

3 Sec. 2. K.S.A. 79-32,109 is hereby repealed.

4 Sec. 3. This act shall take effect and be in force from and after its
5 publication in the statute book.

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EXPANDING CHARITABLE HORIZONS

March 19, 2003

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Chairman John Edmonds
House Taxation Committee
State of Kansas

Dear Chairman Edmonds:

I am writing in opposition to House Bill No 2266, commonly referred to as the Resident Trust Bill. The Greater Kansas City Community Foundation believes that the unintended consequences of the bill greatly outweigh the positive effects.

The present statute in Kansas works and there is no reason to invite problems experienced by other states such as Missouri and New York that have instituted similar legislating to HB No 2266.

In addition to the numerous economic issues such as individuals avoiding living in Kansas, investing in Kansas, and starting a business in Kansas, the Community Foundation believes that the bill could be bad for charity. The Resident Trust Bill could have adverse consequences for Kansas's charities and philanthropies that utilize trusts, such as CRTs, in charitable planning.

In short, the marginal increase in revenue that might be generated does not justify the unintended consequences and the Community Foundation recommends that you reject this bill.

Sincerely,

A handwritten signature in black ink, appearing to read 'Larry Jacob', written over a horizontal line.

Larry Jacob

Testimony in Opposition of Kansas House Bill No. 2266

Before the House Taxation Committee

Prepared by

Ace Rowley Regional Trust Executive for the Central Region

Bank of America

March 20, 2003

Good morning, Chairman Edmonds and members of the committee. My name is Ace Rowley. I am Bank of America's Regional Trust Executive for the Central Region that includes Kansas. On a national level, I am also a member of our company's Trust Policy and Fiduciary Executive Committees. I have worked in the trust industry for more than seven years. For eight years prior to that, I was a litigation attorney with the Kansas City law firm of Stinson, Mag and Fizzell.

My testimony in opposition to House Bill No. 2266, the resident trust bill, will focus on three areas. First, I will comment on the strengths of the present statute. The statute is not broken, and therefore, it does not need to be fixed. Second, I will comment on the controversies that will accompany the adoption of the proposed bill. The compliance and enforcement burden that would be created by the proposed bill will be significant. Third, I will comment on the unintended consequences the proposed bill may cause. House Bill No. 2266 may not generate any additional net revenue.¹

The Present Statute Embodies a Practical Taxing Policy

The current tax policy in K.S.A. Section 79-32,109(d) provides that if a trust is administered within Kansas, then Kansas income tax laws will apply to the trust. This approach gives all interested parties, including the Department of Revenue, what has been proven to be clear guidance regarding this issue. Indeed, the statute has never been challenged on constitutional or other grounds.

At its core, K.S.A. Section 79-32,109(d) is a practical taxing policy. Grantors and beneficiaries regularly choose to have their trusts administered in Kansas. They do so for a variety of reasons including a commitment to the people and institutions that make up Kansas. The individuals that choose to directly and continuously use Kansas resources expect to pay Kansas taxes. As a result, Kansas' current tax policy in this area appears to be sound and reasonable.

The Proposed Amendment Will Thrust Kansas into an Existing Controversy

If Kansas adopts House Bill No. 2266, Kansas will be stepping into the middle of an existing controversy. House Bill No. 2266, adds four new circumstances when Kansas will purport to tax trusts: (1) when a trust is created by will of a person domiciled in Kansas; (2) when a trust is created by a person domiciled in Kansas on the date that a portion or all of the trust becomes irrevocable; (3) when a trust holds any property which is located in Kansas; or (4) when any beneficiary of a trust is domiciled in Kansas. The first two conditions are known to be subject to judicial challenges. The second two conditions are on their face more overreaching and unfair. Under these circumstances, a decision to adopt House Bill No. 2266 must also be accompanied by an expectation that tax dollars will be spent to enforce and defend the new law.

¹ To simplify my testimony, I will use the term trust or trusts to refer to the types of non-grantor trusts that would be affected by this proposed amendment, which are testamentary trusts and inter vivos irrevocable trusts.

The weakness in Missouri's law is a good example of why Kansas should not adopt House Bill No. 2266. Many years ago Missouri enacted a statute similar to the grantor domicile aspects of House Bill No. 2266. Beginning in the late 1980's, Missouri's statute was subject to serious due process challenges. The Missouri Supreme Court on two separate occasions addressed the constitutionality of the statute with complex tests. This costly litigation introduced considerable compliance and enforcement uncertainty into the trust taxation area. In 2000, after 15 years of this uncertainty and in an attempt to address these problems, Missouri amended its statute to require an additional connection between Missouri and the trusts it taxes. There are, however, no assurances that this "fix" will resolve the due process concerns spawned by this approach. Because the present Kansas' statute works, there is no reason why Kansas should invite the problems experienced by Missouri by adopting House Bill No. 2266.

The additional taxing circumstances focused on the location of property or the domicile of a beneficiary on its face appears to be more overreaching and unfair. For example, a New York domiciled grantor creates an irrevocable trust administered in New York for his children all of whom also live in New York. After a decade, would it be appropriate for Kansas to tax the entire trust because the trustee elected to invest a small percentage of a trust in property located in Kansas? Alternatively, would it be appropriate to tax the entire trust because one of the children decided to live in Kansas for a time. These two alternatives would appear to be an even greater stretch than the circumstances discussed above that have known constitutional problems.

Unintended Consequences

If Kansas adopts House Bill No. 2266, the cost of the unintended consequences may far outweigh any marginal increase in revenue that might be generated. The proposed amendment could trigger the following costs:

- For individuals that desire to fashion an estate plan that is free from state income tax, the change in the law will create an incentive for such individuals to avoid residing in Kansas.
- For beneficiaries of existing trusts that are unrelated to Kansas, the change in the law will create an incentive for such individuals to avoid residing in Kansas.
- For trustees of existing trust that are unrelated to Kansas, the change in the law will create a disincentive for the trustees to invest in any Kansas property.
- For individuals desiring to relocate a business or start a new business, the change in the law will create a disincentive for such individuals to make such investments in Kansas for fear that available capital might be limited or their future estate planning might be adversely impacted.

- For Kansas, the change in the law increases litigation and enforcement expenses as the law is challenged and creates uncertainty regarding its taxing authority in this area.

These costs translate into a decline in revenue from income, sales and property taxes that might otherwise be earned from such individuals, a potential reduction in growth from lost investments in Kansas and a direct increase in tax enforcement and litigation expenses. In the face of these costs, the prospect of taxing some additional trusts, if those trusts accumulate income, which is a rare practice, or when those trusts realize capital gains, which trustees generally seek to minimize, seems insignificant.

Thank you for your time in considering my comments. It is my hope that you will not adopt House Bill No. 2266.

House Taxation Committee
Hearing on HB 2266 re: Resident Trusts
Presented by Jack Ovel, Executive Vice President Commerce Bank
Thursday, March 20, 2003

Good morning, Chairman Edmonds and members of the committee. My name is Jack Ovel. I am an Executive Vice President of Commerce Bank, responsible for the trust services we provide in our West Region, which includes the state of Kansas. I also serve as a member of the Trust Executive Committee for Commerce. I have worked in the trust industry for over 30 years.

My testimony in opposition to House Bill #2266, the resident trust bill, will emphasize the minimal positive impact this bill might have in the short run. Secondly, I will comment on the unintended consequences of this bill, which I believe would be significant.

The Proposed Bill Would Have Minimal Positive Impact in the Short Run

When trusts pay income to beneficiaries who live in Kansas, those beneficiaries pay Kansas income tax on that income, regardless of where that trust is administered. However, when trusts accumulate income or realize capital gains, there is a federal income tax due which is to be paid by the trust. There could also be a state income tax due to be paid by that trust. *Determining which state has a claim to that trust is often a controversial issue. The issue on the table today is what should Kansas' policy be.*

The current Kansas tax policy makes that determination very easy. If the trust is administered in Kansas, then Kansas is entitled to an income tax on those capital gains and accumulated income. But the tax itself is not significant, for two reasons:

1. There is a huge disincentive for a trustee to accumulate the income in a trust today. Trusts pay a very high rate of federal income tax on accumulations in trust, so the vast majority of trust income is paid to the beneficiaries each year. In fact, the federal tax rate balloons to 38.6% at income levels beginning at \$9,200.
2. Trustees actively manage the amount of capital gains they realize within a trust. They use capital losses in the trust to offset those capital gains just as individual taxpayers do.

Conclusion: Even if the state of Kansas substantially increases, as this bill would, the number of trusts deemed to be resident trusts, the additional tax to be derived would not be significant. This is especially true when compared to the Kansas income tax already being paid on the income Kansas residents receive from trusts.

The Unintended Consequences of This Bill Could Be Significant

Kansas residents who currently pay the highest levels of state income tax are typically working with professionals who advise them on issues such as trust and estate planning. There is a growing awareness among these financial planners as to which states offer the most attractive tax environment. Changing residency is not a difficult process. I am very concerned that the bill you are considering would give these individuals a major reason to consider leaving Kansas.

House Taxation
Attachment 6-1
Date 3-20-03

Like all states, Kansas strives to attract new people to its communities, and wants to welcome people who are interested in investing in Kansas. This bill would ironically discourage both of those objectives.

Anyone who is already a beneficiary of a trust would want to avoid a move to Kansas, since that would immediately subject that trust to a Kansas tax, no matter where the trust was administered. Here again, savvy advisors would warn their clients.

Secondly, if a trust anywhere in the country was interested in investing in Kansas property, this bill would discourage that, since it would automatically subject that trust to a Kansas tax, regardless of where the trust was administered.

Finally, the cost of pursuing a greatly expanded definition of resident trusts will be far in excess of any new revenue generated, in my opinion.

Conclusion: These unintended consequences are serious and significant for the state of Kansas. Furthermore, we do not believe that the additional tax revenue to be gained from passage of this bill would be meaningful. For these reasons it is my hope that you will not adopt House Bill No. 2266.

Thank you for providing me with this opportunity to address your committee.