

MINUTES OF THE HOUSE TAXATION COMMITTEE

The meeting was called to order by Chairman Kenny Wilk at 9:00 A.M. on March 5, 2008 in Room 519-S of the Capitol.

All members were present except: Representative Dillmore - Excused

Committee staff present:

Chris Courtwright, Legislative Research Department
Gordon Self, Office of Revisor of Statutes
Ryan Hoffman, Legislative Research Department
Richard Cram, Department of Revenue
Rose Marie Glatt, Committee Secretary

Conferees appearing before the committee:

Mark Beshears, Sprint
Marlee Carpenter, KS Chamber of Commerce (written only)
David White, AT & T (written only)
John Cmelak, Verizon wireless
Mark Burghart, Attorney, KS Chamber of Commerce
James Bartle - KDOR

Others attending:

See attached list.

Representative Wilk requested a bill introduction regarding a sales tax exemption for the art association. Representative Carlson seconded the motion. The motion carried.

Representative Wilk opened the public hearing on **HB 2288**.

HB 2288 - Refund of retailers' sales tax paid on certain purchases of telecommunications machinery and equipment.

The Chairman invited Mark Beshears, Sprint, to brief the committee on the history of **HB 2288** (Attachment 1). He said the elimination of this tax on investment in telecommunications network assets would have significant benefits for Kansas businesses and constitutes sound tax policy:

- It is estimated that \$12 million in new network investment will occur in the first year following enactment.
- Additional jobs will be created including positions that go beyond those directly related to the installation of such network equipment.
- Telecommunications is one of the few industries in Kansas without a sales tax exemption for the purchase of equipment used in production operations.
- Tax experts universally agree that the sales tax should be on the final consumption of a product, not on the input used to produce the product, in order to prevent the pyramiding of tax.
- There are a total of 23 states plus the District of Columbia that do not tax the purchase of telecommunications equipment.

HB 2288, with amendments agreed to by the Department and the Telecom Coalition has the following features:

- A refund mechanism is established for all purchases of telecommunications machinery and equipment occurring on and after July 1, 2008.
- Only the state tax (currently 5.3%) would be subject to the refund provision.

CONTINUATION SHEET

MINUTES OF THE House Taxation Committee at 9:00 A.M. on March 5, 2008 in Room 519-S of the Capitol.

- Any refund claim would be subject to a one year statute of limitations. No interest would be paid by the state on any refund claim.
- Under the Streamline Sales Tax System (SST), sales tax exemptions are required to be uniform for state and local sales tax purposes. Since the relief sought by this legislation applies only to the state imposition, a refund mechanism must be utilized as opposed to an exemption for any qualifying purchases so as not to impact the SSTP.

The industry has worked with the Department of Revenue to ensure that the language of the exemption is precise and clearly enumerated. He called attention to the balloon amendment contained in his testimony.

There was a question on a discrepancy of figures reflected in the fiscal note. Richard Cram explained how the Department had determined their projected figures. Mark Breashers agreed to clarify the figures on the fiscal note with their accounting source and return and explain the numbers.

It was noted that written testimony was received in favor of **HB 2288** from: Marlee Carpenter, KS Chamber of Commerce, David White, AT &T, and John Cmelak, Verizon Wireless (Attachment 2).

The Vice Chairman closed the public hearing on **HB 2288**.

Unitary Tax Briefing

The Vice Chairman invited Mark Burghart, Attorney, KS Chamber of Commerce, to brief the Committee on the utilization of credits in a corporate unitary (Attachment 3). Kansas currently employs the unitary business principle when it taxes multistate corporations. This particular approach to taxing multistate companies is long-standing and has been sanctioned by the Kansas Supreme Court on several occasions.

He described two proposals that are under consideration during this legislative session:

- *Utilization of High Performance Incentive Program (HPIP) credits in a Unitary Group.* The first proposal would amend statute to provide clarifying guidance that credits, earned under the HPIP, may be shared among members of a unitary group of companies, filing a combined report, for Kansas corporate income tax purposes.
- *Qualifying for the Job Expansion and Investment Credits and Enterprise Zone Credits in a Unitary Group.* The second proposal would clarify the Job Expansion and Investment Credit Act, and the Kansas Enterprise Zone, as these Acts relate to capital expenditures and job creation by corporations which are part of a unitary group.

In response to a committee question on how many other states use the unitary formula, Mr. Burghart agreed to get that information for the Committee.

James Bartle, General Counsel, KDOR, distributed a copy of letter to Senator Allen, Chairperson of the 2007 Interim Committee, that addressed the Interim Tax Topic #1, Corporate Income Tax Shelters - Use of an HPIP credit by multiple members of a unitary group. The letter explained the language and manner in which such language has been construed by the courts (Attachment 4).

A second memorandum was distributed that listed several important concepts utilized in the taxation of corporations under the Kansas Income Tax Act (Attachment 5). The summary included:

Unitary Business - Description as defined by the Kansas Supreme Court in Pioneer Container Corp. v. Beshears, 235 Kansas 745, 684 P.2d 396

Combined Reporting - When two or more corporations are engaged in a multi-state unitary business, statute authorizes utilization of the combined report method of allocation of income and expenses.

CONTINUATION SHEET

MINUTES OF THE House Taxation Committee at 9:00 A.M. on March 5, 2008 in Room 519-S of the Capitol.

Formula Apportionment - A combined report has been used to determine the total net income of a unitary business, an apportionment formula is then applied to determine for each member of the unitary group the amount of income that is attributable to the taxing state.

Kansas Tax Review Commission - Final report and recommendations

Discussions followed on possible unintended consequences of passing legislation on the tax credits before them.

The Chairman thanked Mr. Burghart and Mr. Bartle for their Unitary Tax Briefing. The meeting was adjourned at 10: 30 A.M. The next meeting is March 6, 2008.

HOUSE TAXATION COMMITTEE

DATE: March 5, 2008

NAME	REPRESENTING
DINA FISK	VERIZON WIRELESS
MARK Beshears	Sprint/Nextel
Patrick Fucile	Sprint/Nextel
Tom Dammann	Sprint/Nextel
Kit Wolf	LITTLE BROTHER REVENUE
Marlee Carpenter	Kansas Chamber
Dustin Meyer	Piniger, Smith, & Assoc.
Nate Michel	Hein Lav Firm
Mike Murray	Funkhous
Joe Heck	PMCA of KS
CARRY R BAZER	LICM
Ben Cleaves	DOB
James Bartle	Dept. of Revenue
Richard Cream	KDOR
Bud Burke	Issues Mgmt. Group, Inc.

MEMORANDUM

TO: The Honorable Kenny Wilk, Chairperson
House Committee on Taxation

FROM: Mark Beshears
Vice-President - State and Local Tax
Sprint/Nextel

DATE: March 5, 2008

RE: House Bill No. 2288

Thank you for the opportunity to appear in support of H.B. 2288. I am appearing on behalf of Sprint/Nextel, Embarq, AT&T, Verizon Wireless, T-Mobile, Alltel, Cox Cable, Kansas Cable Telecommunications Association, U.S. Cellular, Rural Telephone Service Company, Inc., Nex-Tech, Inc., Nex-Tech Wireless, LLC, WestLink Communications, LLC and High Plains Telecommunications, Inc. The bill creates the right to a refund for sales tax paid on telecommunication machinery and equipment purchased on and after July 1, 2007. The State of Kansas has made significant strides in the past few years in creating a more favorable tax environment for businesses which has had the effect of stabilizing the job market and increasing tax receipts. Unfortunately, Kansas still imposes a sales tax on telecommunication companies that purchase equipment to expand and upgrade the state's telecommunication networks. Telecommunication providers are one of the few business taxpayers that pay sales tax on the acquisition of machinery and equipment. Superior telecommunications networks improve business productivity and remains a high priority for the local economic development officials. A report in the January, 2008 issue of *Governing* magazine found that excessive taxes on wireless and other telecommunication services may actually be harming economic development efforts by discouraging necessary network investment. The elimination of this tax on investment in telecommunications network assets would have significant benefits for Kansas businesses and constitutes sound tax policy:

- It is estimated that \$12 million in new network investment will occur in the first year following enactment.
- Additional jobs will be created including positions that go beyond those directly related to the installation of such network equipment.

- Telecommunications is one of the few industries in Kansas without a sales tax exemption for the purchase of equipment used in production operations.
- Tax experts universally agree that the sales tax should be on the final consumption of a product, not on the input used to produce the product, in order to prevent the pyramiding of tax. This is the same rationale for not taxing the purchases of machinery and equipment acquired by manufacturers in the state.
- More states are moving toward the elimination of sales tax on telecommunication equipment. Since 2004, Iowa, Utah and Pennsylvania have eliminated such taxes. In addition, the Missouri Supreme Court has determined that such equipment is exempt as manufacturing machinery and equipment under the Missouri statute addressing such purchases. Also, Oklahoma and Puerto Rico are currently considering a telecommunications equipment exemption.
- There are a total of 23 states plus the District of Columbia that do not tax the purchase of telecommunications equipment.

The telecommunication industry has invested more than \$36 billion in telecommunication networks nationwide since 2006. This investment includes the installation of fiber optic cable which allows a significant increase in network speeds. In addition, wireless providers are expected to invest an additional \$20 billion to provide better coverage in rural areas and to upgrade existing coverage to provide seamless high speed internet access and other new services.

H.B. No. 2288, with amendments agreed to by the Department and the Telecom Coalition has the following features:

- A refund mechanism is established for all purchases of telecommunications machinery and equipment occurring on and after July 1, 2008.
- Only the state tax (currently 5.3%) would be subject to the refund provision.
- Any refund claim would be subject to a one year statute of limitations. No interest would be paid by the state on any refund claim.
- Under the Streamline Sales Tax System (SST), sales tax exemptions are required to be uniform for state and local sales tax purposes. Since the relief sought by this legislation applies only to the state imposition, a refund mechanism must be utilized as opposed to an exemption for any qualifying purchases so as not to impact the SSTP.
- The industry has worked with the Department of Revenue to ensure that the language of the exemption is precise to ensure that the items included in the exemption are clearly enumerated.

In order to minimize the initial fiscal impact, the industry would be amenable to a four year phase-in of the refund provision. The attached balloon includes the phase in language.

Thank you for the opportunity to appear in support of the bill. On behalf of Sprint/Nextel and the telecommunication industry, I encourage the Legislature to take this necessary step to further enhance the telecommunication networks within the State of Kansas.

Session of 2007

HOUSE BILL No. 2288

By Committee on Taxation

1-30

9 AN ACT concerning sales taxation; relating to refunds; certain purchases,
10 of telecommunications machinery and equipment.
11

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

13 Section 1. (a) ~~On and after July 1, 2007, all sales tax paid on the sale~~
14 ~~of telecommunications machinery and equipment pursuant to K.S.A. 79-~~
15 ~~3603, and amendments thereto, by a person providing services taxable~~
16 ~~pursuant to the provisions of subsection (b) of K.S.A. 79-3603, and~~
17 ~~amendments thereto, shall be refunded as provided in this section. Any~~
18 ~~claim for refund shall be submitted within the time period prescribed by~~
19 ~~K.S.A. 79-3603, and amendments thereto. Each claim for a sales tax re-~~
20 ~~fund shall be verified and submitted to the director of taxation upon forms~~
21 ~~furnished by the director and shall be accompanied by any additional~~
22 ~~documentation required by the director. The director shall review each~~
23 ~~claim and shall refund the amount of sales tax paid as determined under~~
24 ~~the provisions of this section. All refunds shall be paid from the sales tax~~
25 ~~refund fund upon warrants of the director of accounts and reports pur-~~
26 ~~suant to vouchers approved by the director or the director's designee.~~
27 ~~The secretary of revenue is hereby authorized to adopt rules and regu-~~
28 ~~lations to administer the provisions of this section.~~

29 (b) For purposes of this section, "telecommunications machinery and
30 equipment" means machinery, equipment and software that is used for
31 the purpose of sending, receiving or storing voice or data communications
32 and all equipment that is used to enable, facilitate, maintain or monitor
33 such machinery, equipment and software. "Telecommunications machin-
34 ery and equipment" includes, but is not limited to: Antennas, towers,
35 amplifiers, poles, wires, cables, rectifiers, duplexers, multiplexers, receivers,
36 ers, repeaters, transmitters, power equipment, modems, routers, storage
37 devices and general central office switching equipment such as circuit
38 switches, analog electronic switches, digital electronic switches and
39 switches for operator assistance.

40 Sec. 2. This act shall take effect and be in force from and after its
41 publication in the statute book.

(1) Sales tax paid pursuant to K.S.A. 79-3603, and amendments thereto, on the sale of telecommunications machinery and equipment by a person providing services taxable pursuant to subsection (b) of K.S.A. 79-3603, and amendments thereto, shall be refunded as follows:

(A) one-quarter of said tax paid by such person on the sale of telecommunications machinery and equipment during the period July 1, 2008 through June 30, 2009 shall be refunded;

(B) one-half of said tax paid by such person on the sale of telecommunications machinery and equipment during the period July 1, 2009 through June 30, 2010 shall be refunded;

(C) three-quarters of said tax paid by such person on the sale of telecommunications machinery and equipment during the period July 1, 2010 through June 30, 2011 shall be refunded; and

(D) all of said tax paid by such person on the sale of telecommunications machinery and equipment on and after July 1, 2011 shall be refunded.

(2)

one year from the date of payment of the tax.

No interest shall be paid on refunds granted under this section. In no event shall any city or county sales tax paid on the sale of telecommunications machinery and equipment be refunded under this section.

directly and predominantly

network

network

fiber optic cable

triplexers,

, closures, conduits, controllers, filters, input devices, insulators, microwave equipment, output devices, pedestals, power converters, radio channels, terminals, timing units, transformers, bridges, network computers, cross connects, plug in circuitry, oscillators, network software, servers, power transport equipment, test equipment, connectors, attenuators,



Legislative Testimony

HB 2288

March 5, 2008

**Testimony before the House Taxation Committee
By Marlee Carpenter, Vice President of Government Affairs**

Chairman Wilk and members of the Committee:

The Kansas Chamber supports equitable tax treatment for all Kansas companies. The Kansas Chamber supports HB 2288, a refund of retailers' sales tax on certain purchases of telecommunications machinery and equipment will only increase our competitiveness advantage throughout the region.

A state's business climate is key when businesses make decision on where to locate, expand and create jobs. Moving towards a more competitive environment for the telecommunications industry will help retain key jobs and make Kansas a more attractive place to do business. The telecommunications industry is a key business sector, making capital investments and creating jobs in the state.

HB 2288 and equitable treatment for all businesses is critical especially when looking at Kansas' business climate. The Kansas Chamber's 2007 CEO and Business Owners Poll makes the point of how important taxes are to Kansas businesses. The CEO and Business Owners poll is a scientific survey of 300 businesses from all parts of the state. The Chamber annually conducts this survey to gauge the mood of Kansas businesses. This year's poll ranks lower business taxes as the most important issue to the profitability of a business. This is significant because for the first time in four years lower taxes has eclipsed health care costs. In addition, sixty-seven percent of business owners believe that they pay too much in taxes. These two indicators are significant because despite the progress we have made in the last couple of years in the area of business taxes, more needs to be done to improve the business climate in the state. I have attached this polling information to my testimony.

The Kansas Chamber is supportive of equitable tax treatment for all companies and encourages HB 2288 be passed.

Kansas Chamber, with headquarters in Topeka, is the leading statewide pro-business advocacy group moving Kansas towards becoming the best state in America to live and work. The Chamber represents small, medium and large employers all across Kansas.





AT&T Testimony In Support of HB 2288
Before the House Taxation Committee
March 5, 2008

Chairman Wilk and members of the Committee:

My name is David White and I am the Director of Tax Policy for AT&T Kansas. We appreciate the opportunity to provide written testimony to you today in support of HB 2288.

AT&T and its affiliates have been doing business in Kansas for over 125 years. As the result of AT&T's commitment to Kansas, we are a large employer with over \$150 million in Kansas payroll. AT&T is also among the state's largest taxpayers, remitting in excess of \$130 million annually in taxes/fees to the state and local governments. AT&T's experience with the tax system in Kansas, and 49 other states, has given us a unique perspective on tax policy.

Over the past few years, there has been a consistent increase in consumer demand for more advanced, accessible, and affordable communication services – a trend that will undoubtedly continue in a high-tech global economy. In order to satisfy this demand and to maintain growth, it is imperative that the state of Kansas encourage investment in the equipment necessary to provide these services. AT&T is cognizant that the immediate removal of this revenue stream could cause some unintended consequences for the state and are therefore supportive of the four year phase-in process that has been proposed by the coalition supporting this legislation.

The good news is that the combination of increased investment and growing demand for communication services equates to growing state and local tax revenues. This may explain why a large number of states and the District of Columbia do not tax telecommunication equipment purchases. Additionally, states that implement policies to stimulate the deployment of advanced communications infrastructure will be at the forefront of attracting industry and jobs to their states. Again, this growth expands the tax base and helps ensure a steady revenue stream from taxes/fees levied on these services and on other general activities in these expanding economies.

On the other hand, ill conceived tax policy can be devastating to the economy. It is no coincidence that high-tax states in the northeast have seen significant population outflows, as investment capital and associated job growth had fled for more business friendly areas. Unfortunately, according to a study conducted by the National Committee on State Taxation (COST), the average combined state and local tax/fee rate on communications services in Kansas is in excess of 22% – more than three times as much as general businesses pay on the sale of their goods and services. This Committee should carefully consider the negative effect these high taxes may have on the Kansas economy. However, HB 2288 would send the right signal to businesses that invest in the Kansas communications infrastructure.

AT&T is thankful to the Committee for considering HB 2288. AT&T supports HB 2288 and we look forward to working with the Committee to encourage investment in the Kansas communications infrastructure.

David White, Director of Tax Policy- AT&T
1010 North St. Marys St.
San Antonio, TX 78215



TESTIMONY OF JOHN CMELAK
VICE PRESIDENT – STATE TAX POLICY

The Honorable Kenny Wilk, Chairperson
House Committee of Taxation

Sales Tax Exemption on Telecommunications Equipment, HB2288
Wednesday, March 5, 2008

Thank you for the opportunity to support the testimony of Sprint Corporation. Verizon Communications and Verizon Wireless (“Verizon”) respectfully offer the following additional comments in support of HB 2288.

The telecomm industry respectfully requests that the Kansas legislature extend its existing sales tax exemption to include the purchase of equipment used in the business of providing telecommunications services to Kansans. Local exchange carriers, inter-exchange carriers, and wireless providers universally view this 2008 legislative objective as very important. It’s a responsible goal that this legislature can achieve this session; one that would place Kansas in a strong competitive position to attract new investment and create new jobs.

Economists and policymakers have long recognized that consumption taxes should be imposed at final sale. Imposing taxes at final consumption allows companies to choose the most economically efficient mix of capital and labor to produce goods as inexpensively as possible. Taxes on inputs distort these investment decisions. They result in “pyramiding” or “cascading” of taxes – the imposition of a tax on a tax. Pyramiding occurs when taxes paid for machinery, equipment, and other inputs to production are then added to the price of a good, which is then taxed at final sale. The good news is that we are not breaking any new ground here -- Kansas policymakers have already endorsed this important tax policy principle by providing the manufacturing sector with a sales tax equipment exemption. We are merely requesting that the legislature promote parity in taxation by treating the fiercely competitive telecommunications industry on a footing equal to the manufacturing industry.

There are compelling economic reasons why a telecommunications equipment exemption is a key ingredient to Kansas’ future economic development and prosperity. I urge each respected member of this committee to ask yourself the question: “Is Kansas doing all that it should to attract new and speedier telecommunications technologies?”

As a Vice President for the nation’s second largest wireless telecommunications service provider, I can offer this committee my own perspective. The hard economic reality is that telecommunications service providers no longer can tap a virtually unlimited supply of investment capital to upgrade our networks within each venue. Investors remain nervous. The rapid slowdown in our economy in the early 2000’s and the resulting deterioration in capital markets have forced companies such as Verizon to carefully scrutinize each capital investment decision to generate maximum return. And although it would be disingenuous to suggest that all capital investment decisions are driven exclusively by state tax policy, it is absolutely accurate to state that the increased cost of Kansas’s state and local sales tax is factored into the “rate of return” computations that companies use to determine where to make new capital investment.

Once again, the telecomm industry speaks with a common voice, and our message remains consistent: we respectfully request that the Kansas legislature extend its current sales tax exemption to include the purchase of equipment used in the business of providing telecommunications services to Kansans. Your support will send a strong signal to senior management of Verizon and its telecommunications competitors that Kansas not only recognizes the value of tax parity, but that it has also taken affirmative steps to modernize its tax code to foster the continued deployment of 21st century, high-speed telecommunications infrastructure.

Thank you for your consideration.

MEMORANDUM

TO: Representative Kenny Wilk, Chairperson
House Committee on Taxation

FROM: Mark A. Burghart
Kansas Chamber of Commerce and Industry

DATE: March 5, 2008

RE: Utilization of Credits in a Corporate Unitary Group

Thank you for the opportunity to discuss several proposals which address the utilization of income tax credits by companies that are part of a unitary group for Kansas tax purposes. Kansas currently employs the unitary business principle when it taxes multistate corporations. A unitary business is one in which multiple related companies contribute to and depend upon one another, thus constituting one homogenous business enterprise for tax purposes. Under this principle, the income and expenses of all companies included in the unitary group are aggregated or combined and then apportioned to the various states in which the unitary business conducts its business operations. A standard three-factor formula of equally-weighted factors, including property, payroll and sales, is used to make the apportionment in most instances. This particular approach to taxing multistate companies is long-standing and has been sanctioned by the Kansas Supreme Court on several occasions.

Utilization of HPIP Credits in a Unitary Group

The first proposal would amend K.S.A. 79-32,141 to provide clarifying guidance that credits earned under the High Performance Incentive Program (“HPIP”) may be shared among members of a unitary group of companies filing a combined report for Kansas corporate income tax purposes. Under current Kansas Department of Revenue policy, only the company generating the credit within the unitary group is entitled to claim the credit. Any unused credit may be carried forward for up to 10 years by that single company. This interpretation has resulted in the carryforward of significant unused HPIP credits which will never be able to be utilized by the companies making these investments. The corporate business community believes the Department’s approach may not be consistent with the unitary business principle which is based on the premise that all of the property, payroll and sales of all of the companies included in the combined group contribute to the overall income of the business enterprise. The proposed amendment brings guidance clarifying that credits generated through investment by any company within the unitary group could be claimed by any other company in the unitary group

which files a Kansas corporate income tax return. This is the same approach that is followed by the State of Nebraska and is believed to be entirely consistent with the unitary business principle. If all corporate assets contribute to the generation of income of the unitary business enterprise, then the related credits resulting from the investment by the companies in the unitary group also should be available to the companies included in the unitary enterprise that do business in the state.

The proposed amendment to K.S.A. 79-32,141 would have limited retroactivity. It would only apply to: (1) taxpayers who filed original returns in which HPIP credits were shared, (2) taxpayers who have appeals on file supporting such filing methodology, and (3) all taxpayers on and after January 1, 2008. The Kansas Supreme Court has applied certain of its tax decisions in the manner proposed in this measure. Even if this legislation were to pass, there would still remain significant amounts of carryforward credits that will never be able to be utilized by the companies involved. Companies in a loss carryforward posture would not benefit from this legislation. We believe the fiscal note that was prepared may not necessarily reflect the fact that many of the credits will still remain as carryforwards and will expire before they will be able to be claimed within the 10-year carryforward period.

Qualifying for the Job Expansion and Investment Credits and Enterprise Zone Credits in a Unitary Group.

The second proposal would clarify the Job Expansion and Investment Credit Act, K.S.A. 79-32,153 et seq., and the Kansas Enterprise Zone Act, K.S.A. 79-32,160a, as these Acts relate to capital expenditures and job creation by corporations which are part of a unitary group. As you know, under both Acts, income tax credits are awarded for making capital expenditures and creating jobs in Kansas.

The Kansas Department of Revenue currently interprets the Job Expansion and Investment Credit Act and Enterprise Zone Act to require that all capital investment and employee hiring must occur within the same corporate entity in order to qualify for the credits. The current policy differs from that which had been in place in prior years when employee hiring and capital investment were not required to occur within the same corporate entity in order to qualify. Prior policy allowed companies to qualify for the credits if the company making the capital investment also directed the new employees who may actually have been employees of a separate corporate entity.

Under the clarifying legislation, if capital investment is made by a company within a combined group and employees are hired or maintained by another company within the same combined group, then the capital investment and new employees would qualify for the credits authorized by K.S.A. 79-32,153 and K.S.A. 79-32,160a. We believe this clarification is entirely consistent with the intent accompanying the original enactment of the tax credit legislation which was to promote capital investment and job creation within the State of Kansas. That is exactly what is accomplished under this proposal. Moreover, as a matter of principle, if all investment and employee hiring by companies within a unitary group are deemed to contribute to the unitary enterprise as a whole, then it should not matter that the investment and employee hiring do not occur within the same corporation. This proposal represents a logical extension of the unitary

business principle. The Department's current interpretation unnecessarily elevates form over substance.

Corporations require a stable tax environment. The second proposal merely codifies what was once the Department's interpretation of the controlling statutes and provides certainty to the Kansas income tax credit regime. The proposal also recognizes that corporations in a unitary group may be organized and operate in ways and for reasons that may be totally unrelated to state tax issues. Corporations should not be penalized under these programs for selecting an efficient corporate structure when the legislative objectives of increasing capital investment and creating additional jobs in the state are otherwise being met.

There will be several corporate tax credit bills considered during this legislative session. It is our understanding that the Secretary of Revenue believes that these proposals must be considered as part of a more comprehensive corporate income tax package and should not be considered in isolation. We pledge to work with the Department to arrive at a fair package that represents the interests of the corporate community, but also recognizes the fiscal constraints under which the 2008 Legislature must operate.

Thank you for your continuing efforts to make Kansas an attractive place for businesses to locate and expand. I would be happy to provide any additional information or respond to any questions that any Committee member may have.

Testimony to the House Taxation Committee
James Bartle, General Counsel, Kansas Department of Revenue
March 5, 2008

Briefing on Unitary Tax Policy

Dear Chairman Wilk and Members of the Committee:

The following is a summary of several important concepts utilized in the taxation of corporations under the Kansas Income Tax Act.

UNITARY BUSINESS

The Kansas Supreme Court in *Pioneer Container Corp. v. Beshears*, 235 Kan. 745, 684 P.2d 396 (1984), has described a unitary business as follows:

- The concept of a unitary business arises when a corporation has one or more subsidiaries or divisions which are dependent to or upon, or contribute to the parent corporation or other subsidiaries or divisions so, in essence, to constitute a homogenous enterprise. When such an entity exists it may be described as a unitary business and in determining the tax liability of the given subsidiary or division the taxing authority may consider the entire income of the unitary business and apportion taxes on the basis of the income attributable within the jurisdiction.
- A multi-state business is a unitary business for income tax purposes when the operations conducted in one state benefit and are benefited the operations conducted in another state or states. If its various parts are interdependent and of mutual benefit so as to form one integral business rather than several businesses, it is unitary.
- Whether a multi-state business is separate or unitary depends upon the manner in which its business is conducted. The essential test to be applied is whether or not the operation of the portion of the business within the state is dependent upon or contributory to the operation of the business outside the state. If there is such a relationship, the business is unitary.

LEGAL SERVICES

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Voice 785-296-2381 Fax 785-296-5213 <http://www.ksrevenue.org/>

HS Taxation
3-5-08
Attachment 4

COMBINED REPORTING

When two or more corporations are engaged in a multi-state unitary business, K.S.A. 79-32,141 authorizes utilization of the combined report method of allocation of income and expenses.

- A combined report is not the same thing as a consolidated return and does not in any way result in the taxing of one corporation on or measured by the income of another. . . . Notwithstanding its use, each corporation doing business in the taxing state is taxed on or measured by only its own income from sources within the state. However, if the corporation doing business in the state is a member of an affiliated group conducting a business within and without the state, then instead of computing the income attributable to the state on the basis of the corporation's books of account (which may reflect the operation of only a small segment of the business), the apportionment is made with reference to the income from the entire business just as would be done if the business had been conducted by one entity. *Pioneer Container Corp.*, 235 Kan. at 753, citing Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 J. Tax'n 106, 109 (1975).
- Combined reporting offers the advantage that it avoids the influence of boundaries that are often artificial and arbitrary and that have no true relationship to the production of income. These boundaries can be set up arbitrarily, as with state borders, or intentionally, as with corporate manipulation for the purpose of avoiding the taxation of income. In either case, the artificial boundaries create a problem for which the unitary method offers a workable solution. Mohan, *The Unitary Concept Today*, 5 J. of State Tax 57, 64 (1986).

FORMULA APPORTIONMENT

After a combined report has been used to determine the total net income of a unitary business, an apportionment formula is then applied to determine for each member of the unitary group the amount of income that is attributable to the taxing state.

- Under the formula method the business activities within the state are considered to be an inseparable part of a business carried on both within and without the state. The total gross income from the entire business is determined. The allowable deductions are then subtracted and the remaining net income is apportioned within and without the state by means of an allocation formula consisting of various factors which are thought to be relevant in the production of income, such as property, payroll and sales. Keesling & Warren, *The Unitary Concept In the Allocation of Income*, 12 Hastings L.J. 42, 43 (1960).

KANSAS TAX REVIEW COMMISSION

The following statements are taken from the Final Report and Recommendations of the 1985 Kansas Tax Review Commission, which examined the subject of State Income Taxation of Multijurisdictional Corporations.

- Under the domestic combination method, a portion of the combined taxable income of those corporations which are incorporated in the United States and which are part of a unitary business enterprise doing business in Kansas is included in the Kansas tax base.
- The unitary business principle is a judicial concept that has been developed to determine the in-state values attributable to a single taxing jurisdiction when a business is conducted in more than one jurisdiction.
- The Kansas domestic combination policy has been sanctioned by Kansas legislative committees on numerous occasions.
- The problems attendant in any method devised to tax the income of multijurisdictional corporations are some of the most complex of any faced by the state in the administration of the various tax laws.
- The unitary system of taxation whereby combined reporting of income is required of a unitary business enterprise appears to be a necessary policy for the state to ensure full accountability for 100 percent of the income of the enterprise. Absent such a policy, it would be possible for a multiple-entity business enterprise to shift income from state to state by means of manipulative accounting.
- Recommendation: The state should continue a unitary system of taxing income of multijurisdictional corporations through its present domestic combination policy.

October 16, 2007

Senator Barbara Allen, Chair
Special Committee on Assessment and Taxation

Re: Interim Tax Topic #1 – Corporate Income Tax Shelters
Use of an HPIP Credit by Multiple Members of a Unitary Group

Dear Senator Allen & Members of the Committee:

Thank you for the opportunity to address whether K.S.A. 79-32,141 permits a High Performance Incentive Program (HPIP) credit earned by a corporation that is a member of a unitary group to be claimed by other group members.

The Kansas corporate income tax is imposed on “every corporation” doing business within this state or deriving income from within this state. *See* K.S.A. 79-32,110(c). Consequently, each corporation is responsible for determining its Kansas taxable income and computing the tax thereon. Only in certain specific situations, such as when two or more corporations are authorized to file a consolidated return, may such corporations be treated as if they were a single corporation. *See* K.S.A. 79-32,142(a).¹

The HPIP credit is also computed and claimed on a separate entity basis. The credit is available to “any taxpayer” that satisfies the statutory criteria and is allowed against the tax imposed on “the taxpayer’s” Kansas taxable income. K.S.A. (2006 Supp.) 79-32,160a. Generally, Kansas statutes do not permit HPIP credits to be transferred to, or shared by, other related entities. A narrow exception was recently enacted to permit an HPIP credit earned by a “related corporation” to be assigned to an insurance company and credited against its premiums tax liability. *See* 2007 HB 2274.

¹ K.S.A. 79-32,142(a) provides:

In the event two or more corporations file federal income tax returns on a consolidated basis, and in the event that all of such corporations derive all of their income and expenses from sources within Kansas, then, in such events, such corporations shall file consolidated returns for purposes of determining their Kansas income tax liability the same as if such corporations were one corporation.

To understand the scope and purpose of K.S.A. 79-32,141, we first examine the language contained therein and the manner in which such language has been construed by the courts.

K.S.A. 79-32,141 has been held to authorize the Director of Taxation to require the combined report method of allocation of income and expenses when it is determined that two or more corporations are engaged in a multi-state unitary business, a portion of which is carried on in Kansas. Pioneer Container Corp. v. Beshears, 235 Kan. 745, Syl. ¶ 6, 684 P.2d 396 (1984).

The use of a combined report is not comparable to the filing of a consolidated return in which, as explained above, two or more corporations are taxed as one. Rather, a combined report “does not in any way result in the taxing of one corporation on or measured by the income of another. . . . Notwithstanding its use, each corporation doing business in the taxing state is taxed on or measured by only its own income from sources within the state.” Pioneer, 235 Kan. at 753.²

Under K.S.A. 79-32,141, allocating the income and expenses of two or more related entities is permitted when necessary “to prevent evasion of taxes or to clearly reflect income.”³ The use of combined reporting is clearly consistent with these statutory objectives. First, it “prevent[s] evasion of taxes” by ensuring full accountability for 100% of income and negates the shifting of income from state to state that would otherwise result from the use of manipulative accounting practices. *See* Kansas Tax Review Commission, *Final Report and Recommendations*, June 1985. *See also* Mohan, *The Unitary Concept Today*, J. of State Tax., 57, 64 (1986) (“[t]he unitary method helps to prevent the corporate shell game that is often played to hide income from state taxation”).

² Pioneer also states:

A combined report is an accounting method whereby each member of a group carrying on a unitary business computes its individual taxable income by taking a portion of the combined net income of the group. A consolidated return is a taxing method whereby two corporations are treated as one taxpayer. Pioneer, 235 Kan. at 752, *citing Caterpillar Tractor Co. v. Dept. of Rev.*, 289 Or. 895, 898, 618 P.2d 1261 (1980) (emphasis in original).

³ K.S.A. 79-32,141 provides:

The director may allocate gross income, deductions, credits, or allowances between two or more organizations, trades or businesses (whether or not incorporated, or organized in the United States or affiliated) owned or controlled directly or indirectly by the same interests, if the director determines such allocation is necessary to prevent evasion of taxes or to clearly reflect income of the organizations, trades or businesses.

Second, combined reporting “clearly reflect[s] income” by using the entire income derived from the unitary business as the basis for determining the income of each group member.⁴ Because the books of account of an individual group member may reflect the operation of “only a small segment of the business,” it is widely acknowledged that combined reporting provides a better reflection of income. *Pioneer*, 235 Kan. at 753. *See also* 235 Kan. at 747, *citing Caterpillar Tractor Co. v. Lenckos*, 84 Ill. 2d 102, 108, 417 N.E.2d 1343 (1981) (the claimed income of each member of the group standing alone does not, in a real sense, reflect the conducting of a unitary business because the income is not attributable solely to the efforts of the particular corporation); Mohan, *supra* at 63 (“use of the unitary method gives the state a clear picture of the income of the in-state corporation. This picture can be brought into focus only by looking at the whole group of affiliated corporations and apportioning income.”)

With this analysis in mind, we turn our attention to whether K.S.A. 79-32,141 permits an HPIP credit to be shared by two or more members of a unitary group. Although K.S.A. 79-32,141 states that the “[t]he director may allocate . . . credits . . . between two or more organizations . . .” this language does not, in our opinion, support the conclusion that a credit earned by a member of a unitary group may be claimed by, or shared with, other group members. As discussed above, combined reporting is permitted because it prevents tax evasion and clearly reflects income. In contrast, allowing related entities to share income tax credits would not accomplish either result.

Liberalizing the manner in which HPIP credits may be claimed would simply reduce the total amount of taxes that a group of related corporations would otherwise be required to pay. It would, however, do nothing to prevent tax evasion. Likewise, allowing two or more group members to share a credit would have no bearing on the process of determining income, since it is not until *after* each corporation’s income is determined and tax computed thereon that credits are utilized.

⁴ See K.A.R. 92-12-77, which implements K.S.A. 79-32,141, and provides:

If a particular trade or business is carried on by a taxpayer and one (1) or more affiliated corporations, nothing in K.S.A. 79-3271 *et seq.*, and 79-4301, article IV or in these regulations shall preclude the use of a combined income method of accounting whereby *the entire business income of such trade or business* is apportioned in accordance with K.S.A. 79-3279 to 79-3287 and 79-4301, article IV.9 to IV.17. [Emphasis added.]

A more plausible explanation for the reference in K.S.A. 79-32,141 concerning the director's authority to "allocate . . . credits" is that it facilitates the inclusion in the combined report of certain statutory modifications necessary to establish the apportionable income of the unitary group. Specifically, K.S.A. (2006 Supp.) 79-32,117(c)(x) provides that certain federal income tax credits shall be subtracted from federal adjusted gross income for purposes of determining Kansas taxable income.⁵ When these credits are claimed on the federal level, the salaries of certain employees are excluded from the payroll expenses that would otherwise be deductible. The Kansas modification set forth in K.S.A. (2006 Supp.) 79-32,117(c)(x) reverses this treatment and allows such salaries to be deducted in determining the apportionable income of the combined group.

For the above reasons, we conclude that allowing HPIP credits to be shared by members of a unitary group is not "necessary" to prevent tax evasion or clearly reflect income as required by K.S.A. 79-32,141, and is therefore not permitted except to the limited extent authorized by current law.

This conclusion is consistent with the recent decision in General Motors Corp. v. Franchise Tax Bd., 39 Cal. 4th 773, 139 P.3d 1183 (2006), which concerned a credit allowed by the State of California for increased research spending, and raised the following question: "When research is performed by one member of a corporate family, does the credit go only to that member or may it be spread among the other members of the corporate family?" The court in that case ruled that only the corporation that incurred the research expenses was entitled to claim the credit. 139 P.3d at 1185.

The Multistate Tax Commission (MTC), of which Kansas is a member, filed an *amicus* brief in General Motors in support of the position that credits may be claimed only by the individual corporation that earned them. The MTC explained:

Even in the case of combined reporting, each individual taxpayer's state tax liability, and the application of any offsets to that liability, is established *after* its tax base has been apportioned and determined. There is simply no conceptual necessity for the apportionment of a tax credit.
[Emphasis in original.]

Brief *Amicus Curiae* of Multistate Tax Commission in Support of Defendant-Appellant, Franchise Tax Board, General Motors Corp. et al. v. Franchise Tax Bd., Calif. Sup. Ct. No. S127086 (Apr. 28, 2005), at 15.

⁵ That subsection provides that there shall be subtracted from federal adjusted gross income: "For taxable years beginning after December 31, 1976, the amount of the federal tentative jobs tax credit disallowance under the provisions of 26 U.S.C. 280 C. For taxable years ending after December 31, 1978, the amount of the targeted jobs tax credit and work incentive credit disallowance under 26 U.S.C. 280 C."

The MTC's brief also states that it has drafted and approved for public hearing a proposed model uniform combined reporting statute which provides: "[e]xcept where otherwise provided, no tax credit . . . earned by one member of the group, but not fully used by or allowed to that member, may be used in whole or in part by another member of the group . . ." *Id.* at 16. The justification for this approach was explained as follows:

Because members of the combined group are recognized as separate taxpayers, the proposed model statute adopts a consistent general rule that tax credits, unless otherwise specified by the statutory language creating a credit, are to be allowed only against the tax liability of the individual taxpayer that earned the credit, and are not allowed against the liabilities or other members of the combined group.

Id.

We believe the reasoning and conclusions of the California Supreme Court and the MTC, as set forth in General Motors, are consistent with, and provide support for, the opinions expressed herein. If it were the intention of the Kansas Legislature that all members of a unitary group should be permitted to claim an HPIP credit earned by one group member, legislation similar to that contained in 2007 HB 2274 would be required. Conversely, if the Legislature desired to make clear that the sharing of credits is not permitted, it could adopt the MTC's model statute, which is consistent with the Department's interpretation of current Kansas law.

Thank you for the opportunity to submit this information for the Committee's consideration. Please let us know if you have questions or require further information.

Sincerely,

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