Legal Services Bureau
915 SW Harrison St
Topeka KS 66612-1588

Samuel M. Williams, Secretary
David Clauser, General Counsel

Kansas
Department of Revenue

Phone: 785-296-2381
FAX: 785-296-5213
www.ksrevenue.org

Jeff Colyer, M.D., Governor

February 8, 2018

House Committee on Taxation

Testimony of The Kansas Department of Revenue in Support of House Bill 2489

by Michael Hale

Chairman Johnson and Members of the Committee:

The Department of Revenue respectfully submits the following testimony to the Committee in support of House Bill 2489. To fully appreciate the basis of the Department's proposal, a little history and explanation is necessary.

How does Kansas determine the income tax owed by a multi-national corporation doing business in this state? Since the early 1960s, Kansas, like many states, has apportioned a corporation's income based on certain factors: sales, payroll and property.

In its simplest form, it is the amount of the corporation's payroll in Kansas divided by the corporation's payroll everywhere, the corporation's property in Kansas divided by the corporation's property everywhere, and the corporation's sales in Kansas divided by the corporation's sales everywhere. Each of these provide a fraction, which are then added together and divided by three to provide a final ratio that is then applied to the corporation's Kansas taxable income.

There are many subtle adjustments, exclusions, additions, etc. to these numbers, but in its rawest, simplest form, that is the essence of how Kansas, and other states, calculate a multi-national corporation's state income taxes.

In the early to mid-1960s, the multi-state tax compact was adopted by a number of states. The Kansas Legislature adopted the multi-state tax compact in 1967 by enacting K.S.A. 79-4301 and K.S.A. 79-4302. Among other things, the compact provides uniform definitions, promotes

uniformity or compatibility in significant components of tax systems and avoids duplicate taxation, engages the states in a voluntary process, but does not compel them to conform, and establishes a commission.

The compact is not a binding, regulatory contract, and does not bar states from overriding its provisions. It is voluntary in nature, and a state may withdraw from the compact at any time. Moreover, there is no prohibition in the compact against piecemeal alterations, implicit revocation, or tacit elimination of compact provisions.

In approximately 1973, Florida was the first state to repeal the compact's income-tax provisions and mandate a different apportionment method. Since then, several former and current compact states have also modified their laws to restrict the compact's apportionment provisions in their jurisdictions. To date, Kansas still uses the three-factor formula in most instances.

In approximately 2005, a case called *Gillette v. California Franchise Tax Board* arose. California had previously adopted a single-factor formula for apportioning income, but the three-factor formula was still in the compact language within California's statutes. Because it benefited Gillette by $34,000,000.00 to file using the compact's three-factor formula, Gillette took the position that it had the election to apportion its income using the more beneficial three-factor formula under the compact, and not the state-specific statute requiring single-factor. California disagreed.

The Franchise Tax Board won round one, but in 2012 the California Court of Appeals reversed holding that the California legislature could not unilaterally repudiate the compact, and thus Gillette could elect to apportion income under the compact and disregard the specific state statute. The California Supreme Court reversed. Gillette filed a *writ of certiorari* with the United States Supreme Court, which was denied.

Taxpayers have continued, however, to challenge the states on this issue in Michigan, Minnesota, Oregon and most recently, Texas. While they have lost in every state, given the continual litigation, the issue of whether state-specific statutes will control over the compact language does not appear to be finished unless a state legislature specifies that it does. Since Kansas continues to use the three-factor formula, just like the compact, why this proposed bill? In a nutshell, business income and "churning," or distortion of the sales factor.

In 2008, the Kansas legislature amended the definitions of "business income" and "sales" within specific sections of the Income Tax Act, but not in the compact. Some taxpayers may use the same arguments used by Gillette in the apportionment litigation in California to argue that they can elect under Article III of the Multistate Tax Compact (K.S.A. 79-4301 *et seq.*), to determine "business income" as defined under the compact as construed by Kansas courts (income is business income if it satisfies the transactional test), rather under current state law (see K.S.A. 79-3271(a) (income is business income if it satisfies the transactional test, functional test, or is apportionable under federal law)). Additionally, some taxpayers may argue that they can use the definition of "sales" under the compact and dramatically reduce their sales factor by including recycled, or "churned," investment capital earned outside of Kansas to the denominator (all sales everywhere) to lower their sales in Kansas ratio. So, a word about business income and the sales factor is appropriate.

First, "churning" is a term coined to describe a business practice of depositing idle funds in bank accounts overnight to earn interest. Done repetitively with hundreds of millions of dollars night after night after night, significant interest is earned. In an effort to reduce their state income tax liabilities, many taxpayers attempted to claim that the continuous investment of these same funds churned over and over again qualified as "sales" as that term was defined in the income tax act. Since this activity was invariably performed out-side of Kansas, the businesses would attempt to place this massive amount of receipts in their sales denominator (sales earned everywhere) to lower their sales factor in arriving at one of the three factors used in apportioning their income. The Department disallowed treatment of receipts in this manner, limiting sales to mean what a common person would use to describe sales. This, however, began to lead to increasing disagreement between the Department and various businesses.

Second, corporate income tax is imposed on business income, but can also be imposed on nonbusiness income. That sounds simple enough, but just what is business income, and how is it determined when a state may impose its tax? Generally, there are two tests: the transactional test defines business income to include income arising from transactions and activities in the regular course of the taxpayer's trade or business; and, the functional test that defines business income to also include income from tangible and intangible property, if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

They sound almost alike, but there are subtle, yet, significant differences. The transactional test is far more restrictive. Under the functional test, for example, business income need not be derived from transactions or activities that are in the regular course of the taxpayer's trade or business.

Most states statutes have adopted the functional test or both the transactional and functional tests in ascertaining business income. Kansas statutes too seemed to incorporate the functional test, but in 1968, the Kansas Supreme Court in *Western Natural Gas Co. v. McDonald* determined that Kansas statute only embraced the more restrictive transactional test.

In 1994, the Kansas Supreme Court declined to modify *Western Natural Gas* and broaden its narrow business income test in *Chief Industries*, and Kansas remained largely alone among the states as a transaction test state only.

In 2008, the Kansas legislature made significant changes to the Kansas Income Tax Act. It lowered the income surtax rate for corporations under 79-32,110, while at the same time redefining the term "sale" to clarify that "churning" of investment capital would not be included in the sales factor 79-3271(h) and 79-3285, and adopting the broader functional test definition of business income under 79-3271(a). So, the tax rate was lowered, but the tax base was broadened by the legislature. For reasons unknown, however, conforming language was not applied to address the multistate tax compact language.

Nevertheless, for the past decade, the Department and businesses have operated under the practice that the tax rate has been lowered, that Kansas has now joined all of the other states by having the broader, functional test for business income, and that business could no longer place overnight investments in their sales denominator in an effort to lower their Kansas sales factor.

Given that businesses continue to contend through litigation that sections of the multistate compact provide an election for them if those provisions read differently than state-specific tax statutes, and the distinct possibility exists that a Kansas court could allow them to make that election, the Department believes that passage of this bill is necessary to maintain harmony between the income tax act and the multistate tax compact, and retain the 2008 legislation intact by mirroring it within the multistate tax compact.

There is nothing to suggest that when it enacted the 2008 legislation the legislature intended to lower the tax rate for corporations while at the same time have their specific broadening of the tax

base by expanding the definition of business income to include the functional test and defining sales in a manner that eliminates churning in the sales factor to be undone by the use of the multistate tax compact.

Many states have found themselves in the same position and have repealed or amended the compact. Enacting this bill will keep Kansas consistent with her sister states.

The loss of revenue through inconsistencies between the income tax act and the compact would be significant; tens of millions of dollars annually, when there is no indication whatsoever that this is what the legislature intended in 2008.

The bill does clarify that the compact is to be interpreted and applied as subordinate to the income tax act, and that this bill, and any future amendments to the income tax act, will always supersede the compact. This is an effort to avoid this conundrum in the future.

Finally, this bill does operate retroactively back to 2008. This is a further effort to have the compact mirror the income tax act, maintain the *status quo* and reinforce what the legislature did in 2008 without leaving an alternative avenue open to circumvent specific statutes enacted by the legislature. The legislature cannot have intended to lower the tax rates for business and broaden the tax base, while also leaving the door open to undo all that they did. This bill, operating retroactively, precludes such an outcome.