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MEMORANDUM

TO: Governor's Council on Tax Reform

FROM: Mark A. Burghart
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RE: Kansas Income Tax Conformity

DATE: October 15, 2019

I. KANSAS HISTORY OF FEDERAL CONFORMITY

Following the adoption of a constitutional amendment in 1932 (Article 11, §2) authorizing the state to levy and collect taxes on income which taxes could be graduated and progressive, the Kansas income tax act was enacted in 1933. Subsequently, a privilege tax for financial institutions was enacted in 1963 and a premium tax for insurance companies was enacted in 1970.

During the 1965 Session of the Kansas Legislature, Senate Concurrent Resolution No. 15 was adopted and directed the then Kansas Legislative Council to undertake a study and make recommendations as to how the Kansas income tax provisions could be brought into closer conformity with the provisions of the federal Internal Revenue Code. A Technical Advisory Committee (Advisory Committee) to the Committee on Assessment and Taxation was appointed and embarked on a two year study that resulted in the adoption of an amendment to the Kansas Constitution in 1966 (Article 11, §11) authorizing prospective conformity by reference to the federal code, with such exceptions and additions as the Legislature may later adopt and the enactment of a new state income tax code during the 1967 legislative session which focused on state-federal conformity. The feature of prospective conformity was not fully implemented until 1970.

The concept of conformity with the Internal Revenue Code was neither a new or novel idea in 1966. Nearly half of the states at the time taxed individuals and corporations by reference to the Internal Revenue Code. The original Kansas income tax provisions enacted in 1933 were copied largely from the federal code. Thus the need and desire for conformity was recognized early on with the State's very first income tax statutes. This recognition has continued to today's date.

During its review of the Kansas income tax code, the Advisory Committee discovered that Kansas had not kept pace with changes occurring at the federal level since the original act was enacted in 1933 and concluded that Kansas was no longer in substantial conformity. When considering whether conformity should continue to be the goal, the Advisory Committee concluded there were compelling reasons to maintain conformity including, in their own words:

"1. Simplicity of returns and compliance for the taxpayer. Under the present state of affairs, the Kansas taxpayer must master two sets of income tax laws: the federal and the state. He must know that child care is deductible on one return, but not on the other, that certain death benefits are taxable in one, but not in the other, that imputed interest on sales is taxable on one return, but not on the other. In addition, the cost basis in assets often is different under the two codes. As a result, many taxpayers are forced to keep what amounts to two sets of books, one pertaining to Kansas and the other to the federal code. Two different computations of gross income, itemized deductions, standard deductions and taxable income must be made. The result is that the taxpayer either hires professional help at additional cost to himself, or simply files his state return on the hopeful assumption that conformity exists. This undesirable feature of the present situation promises to be even more irritating with the development of such services as "Computax." "Computax" is a service offered by a large national company whereby returns can be prepared by a computer process. While this service is still in its infancy, it shows great promise and has been most successful in states where conforming legislation exists. In states such as Kansas, however, it will be exceedingly difficult to have any such service available as long as the two codes are vastly different.

2. Elimination of unfairness to taxpayer. In view of the high rates of the federal income tax, most taxpayers plan their affairs in light of the federal income consequences. Because the Kansas income tax laws were originally patterned after the federal Internal Revenue Act of 1934, many, if not most, taxpayers naively assume that Kansas income tax consequences will generally follow the federal law. Unfortunately, this is not the case in many situations, and the result is irritation on the part of the taxpayer. This applies both to the small taxpayer who works with the thought that child care expenses are deductible on both returns, or to the large taxpayer who plans a liquidation under the tax exemption provisions of the federal code only to find that the very steps that make the liquidation tax free at the federal level operate to make it taxable at the state level.

3. Ease of administration. Inasmuch as the income tax is based on the self assessment and voluntary compliance of each individual taxpayer, it naturally follows that anything which makes the task of compliance easier for the taxpayer will also ease the burden of administration for the state. There is also another feature to conformity. This state, along with most of the other states, has entered into a cooperation agreement with the Internal Revenue Service whereby information is shared between the state and federal income tax agencies. As long as there are many differences between the federal and state code, the value of this cooperation agreement is impaired. As a corollary, closer conformity would enable the state

> Department of Revenue to capitalize on the cooperation agreement and obtain full utilization of the auditing and investigating efforts of the Internal Revenue Service. This would not only result in more efficient administration, but it could also bring about a higher degree of taxpayer compliance. Either result means greater revenue to the state without increased taxes."

See Income Tax Conformity, Report of the Technical Advisory Committee on Taxation, December, 1966, pp. 4-5.

The Advisory Committee also recognized that there were factors that detracted from the beneficial aspects of the conformity concept, such as creating budgetary uncertainty for a state at times. Notwithstanding these problems, other tax review commissions have recommended that the state maintain its policy of conformity whereby the computation of state income tax liability begin with federal adjusted gross income for individuals and federal taxable income for corporations. Any departure from this policy should be taken only for the most compelling of reasons. See Final Report and Recommendations, Kansas Tax Review Commission, June, 1985, p. INC. 9 and Report and Recommendations of the Governor's Task Force on Tax Reform, January, 1985, p. 12.

II. CONSEQUENCES OF NOT CONFORMING TO FEDERAL LAW

One of the principal benefits of conforming to the Internal Revenue Code relates to the audit function performed by the Internal Revenue Service (IRS). Through an exchange agreement with the IRS, the Kansas Department of Revenue is able to rely on the IRS to verify the accuracy of the data reported by taxpayers. By nonconforming or decoupling from the Internal Revenue Code, Kansas loses its ability to verify taxpayer income and expense information. As an example, if taxpayers are allowed to itemize on their Kansas return while still claiming the standard deduction on their federal return, an estimated 200,000 Kansas individual income tax returns would be filed for which there is no effective means of determining the accuracy of any claimed itemized deductions. The Department would need to increase its workforce to provide the required audit capability for individual income tax returns which is currently unnecessary because of federal conformity and the information exchange agreement with the IRS.

The justifications for conformity cited by the original Advisory Committee are every bit as applicable today. Decoupling will increase complexity and its related compliance costs as well as the costly burden of administrating the tax. As noted by prior tax review commissions, any attempt to decouple should be taken for only the most compelling of reasons with a full understanding that the tax administration and compliance costs will increase.

Thank you for the opportunity to address the Council. I would be happy to respond to any questions you might have.