

Not (Taxable) in Kansas Anymore: A Statutory Analysis of K.S.A. § 79-3271(a) and Its Application to the Gain on Sale of a Nondomiciliary Taxpayer's Pass-Through Equity Interest

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I. INTRODUCTION

State income taxation is based on the fundamental principle that when a business generates income, that income is allocated to and taxed by the state where the income was earned.¹ Because a local business typically earns its income in the state in which it operates, it is relatively easy for a local business to allocate its income.² However, when a business operates across multiple states, it is harder to determine where the income was earned and should be taxed.³ Additionally, different states have various statutory standards to determine where income should be sourced, which makes multi-state taxation extremely complex.

In 1957, the National Conference of Commissions of Uniform State

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1. See generally Ferdinand P. Schoettle, *When Can a State Tax a Nondomiciliary Business?*, 35 PREVIEW 176 (2008) (discussing the “level playing field” of “normative capitalistic economics” through an example). The example is as follows: “If a taxpayer earns \$10 in a jurisdiction and the tax rate is 6 percent, the taxpayer should pay a tax of \$.60. The taxpayer should not pay a higher tax because the taxpayer earns more money elsewhere.” *Id.*

2. The author notes this statement is not as simple as it is made here. Characteristics of modern business practice, such as internet sales, add significant complexity to small, local business taxation. See, e.g., *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018) (discussing sales tax as it pertains to internet sellers without a physical presence in the taxing state). Such complexities, however, are outside the scope of this Comment.

3. See generally Arthur D. Lynn, Jr., *Formula Apportionment of Corporate Income for State Tax Purposes: Natura Non Facit Saltum*, 18 OHIO STATE L.J. 84 (1957).

Laws promulgated the Uniform Division of Income for Tax Purposes Act (“UDITPA”) to address the complexity of multi-state taxation.⁴ Despite the Conference’s work, states still disagree about the basic definition of “business income,” which makes compliance difficult for businesses that operate in multiple states. Currently, one transaction is treated inconsistently among the states: the sale of a nondomiciliary taxpayer’s equity interest in a pass-through entity.⁵ The inconsistency centers around whether the UDITPA business income definition allows for one test (the transactional test) or two tests (the transactional test and the functional test) to classify a receipt as business income.⁶ Given the inconsistency among the states and the Kansas Legislature’s multiple amendments to its statutory definition of business income, it is unclear how such a transaction would be treated under Kansas law.

This Comment engages in an analysis of Kansas’ statutory definition of business income in K.S.A. § 79-3271(a) to determine how the sale of a nondomiciliary taxpayer’s interest in a pass-through entity should be treated in Kansas. Using textual canons of statutory construction, legislative history, and lessons learned from other states, this Comment concludes that the text of K.S.A. § 79-3271(a) fails to incorporate a standard (the “functional test”) that would permit Kansas to treat a nondomiciliary taxpayer’s sale of its interest as business income. As a result, the sale would not be taxable in Kansas.

II. BACKGROUND

Taxation of multi-state apportionment is rooted in the Due Process Clause and the Commerce Clause of the United States Constitution. Under constitutional standards, the unitary business principle is deemed to be the

4. UNIF. DIV. INCOME FOR TAX PURPOSES ACT (NAT’L CONF. COMM’RS ON UNIF. STATE L. 1957) (Prefatory Note) [hereinafter UDITPA]; David B. Sarver & Robert E. Hynes, *Proposal for a Uniform Regulation on Business Income Under UDITPA*, 22 HASTINGS L.J. 31, 35 (1970).

5. Recently, the United States Supreme Court denied certiorari to determine whether a nondomiciliary state can classify a gain earned by a passive holding company on the sale of an interest in an LLC as business income. See generally *Noell Indus., Inc. v. Idaho State Tax Comm’n*, 470 P.3d 1176 (Idaho 2020), *cert. denied*, 141 S. Ct. 1391 (2021); Hollis Hyans, *Supreme Court Denies Review in Taxpayer Apportionment Win*, JD SUPRA (Apr. 16, 2021), <https://www.jdsupra.com/legalnews/supreme-court-denies-review-in-taxpayer-6314813/> [<https://perma.cc/385Z-ZYZD>] (discussing *Noell Indus., Inc. v. Idaho State Tax Comm’n*, 470 P.3d 1176 (Idaho 2020), *cert. denied*, 141 S. Ct. 1391 (2021)).

6. Jamie S. Fenwick, Michael W. McLoughlin, Scott A. Salmon, Patrick H. Smith, Arthur E. Tilley & Brian W. Wood, *Sale of a Pass-Through Entity: State Approaches*, in STATE TAXATION OF PASS-THROUGH ENTITIES AND THEIR OWNERS (Thomson Reuters/Tax & Accounting 2006, with updates through Nov. 2021).

“linchpin” of the apportionment of multistate taxation.⁷ Apportionment is the term used to describe the amount of a business’ income subject to tax under a given jurisdiction.⁸ Whether income is apportionable to a particular state depends on whether the transaction constitutes business income.⁹ Depending on the jurisdiction, business income is defined by the transactional test, functional test, or both.¹⁰ Kansas judicial decisions have held the Kansas definition of business income only incorporates the transactional test.¹¹ Courts decided these cases, however, before the Kansas Legislature amended the governing statute. That statute, in fact, has been amended three times,¹² changing the statutory definition of business income.

A. *The Unitary Business Principle*

The United States Constitution grants a state the authority to tax income generated outside its borders.¹³ Specifically, the Due Process Clause requires “there be ‘some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.’”¹⁴ The unitary business principle later personified the Due Process requirement.¹⁵ The unitary business principle began in the industrial revolution as multi-state business enterprises became more common.¹⁶

7. *Mobil Oil Corp. v. Comm’r of Taxes of Vt.*, 445 U.S. 425, 439 (1980).

8. *Apportionment*, TAX FOUND., <https://taxfoundation.org/tax-basics/apportionment/#:~:text=Apportionment%20is%20the%20determination%20of,sales%20located%20within%20their%20borders> [https://perma.cc/V33N-268P] (last visited Apr. 4, 2022).

9. See Jerome Hellerstein & Walter Hellerstein, *The Distinction Between Allocable Income and Apportionable Income Under UDITPA and Similar State Statutes*, in STATE TAXATION ¶ 9.05 (Thomson Reuters/Tax & Accounting, 3d ed. 2022).

10. M. Bernadette Welch, Annotation, *Construction and Application of Uniform Division of Income for Tax Purposes Act (UDITPA)—Determination of Business Income*, 74 A.L.R. 6th § 1 (2012).

11. See *W. Nat. Gas Co. v. McDonald*, 446 P.2d 781, 783–84 (Kan. 1968); *In re Appeal of Chief Indus., Inc.*, 875 P.2d 278, 286 (Kan. 1994).

12. See generally 1996 Kan. Sess. Laws Ch. 264 (H.B. 2038); 2003 Kan. Sess. Laws Ch. 158 (S.B. 284); 2008 Kan. Sess. Laws Ch. 182 (S. Substitute H.B. 2434).

13. Clark Milner, *Taxation-State Tax Apportionment of Out-of-State Business Income—Constitutionality and Propriety of a State’s Apportionment and Taxation of Capital Gains as Business Earnings*, 79 TENN. L. REV. 437, 446–47 (2012).

14. *Id.* at 446 (quoting *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344–45 (1954)).

15. See generally *Mobil Oil Corp. v. Comm’r of Taxes of Vt.*, 445 U.S. 425 (1980). *Mobil Oil* is famous for the quote “the linchpin of apportionability in the field of state income taxation is the unitary-business principle.” *Id.* at 439.

16. *MeadWestvaco Corp. ex rel. Mead Corp. v. Ill. Dep’t of Revenue*, 553 U.S. 16, 25 (2008) (discussing the history of the unitary business principle).

The unitary business principle “shift[ed] the constitutional inquiry from the niceties of geographic accounting to the determination of the taxpayer’s business unit.”¹⁷ The unitary business principle evolved from physical unity into a theory “to justify the taxation . . . of net income, dividends, capital gain, and other intangibles.”¹⁸

MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Department of Revenue applied the unitary business principle constitutional standard specifically to the business income/nonbusiness income distinction. *MeadWestvaco* refined the unitary business doctrine in 2008 with the “operational function test.”¹⁹ The operational function test classifies a transaction as business income where “an asset served ‘an operational function rather than an investment function’ within the business in question.”²⁰ To determine whether the asset serves an operational function, the inquiry is based on how the asset is used with respect to the taxpayer and the taxing state.²¹ The operational function test is not a separate test for business income,²² rather it should be considered in reference to the three “‘hallmarks’ of a unitary relationship.”²³ The three hallmarks of a unitary relationship are “functional integration, centralized management, and economies of scale.”²⁴ The operational function test provides a constitutional standard to determine business income.

B. UDITPA

In 1957, the National Conference of Commissioners on Uniform State Laws drafted the UDITPA to address the need for a uniform allocation of income for tax purposes among the states.²⁵ Before the promulgation of the UDITPA, the states implemented a variety of mechanisms for

17. *Id.* at 26.

18. *Id.* at 27.

19. See generally Levi Bennett, *Substance Over Form: Refinement of the Unitary Business Doctrine in MeadWestvaco Corp. v. Ill. Dep’t of Revenue*, 553 U.S. 16 (2008), 34 S. ILL. U. L.J. 773 (2010).

20. *Id.* at 781 (quoting *Mead Corp. v. Dep’t of Revenue*, 861 N.E.2d 1131, 1139 (Ill. App. Ct. 2007)).

21. *Id.*

22. *MeadWestvaco Corp.*, 553 U.S. at 29 (“As the foregoing history confirms, our references to ‘operational function’ . . . were not intended to modify the unitary business principle by adding a new ground for apportionment. The concept of operational function simply recognizes that an asset can be a part of a taxpayer’s unitary business even if . . . a ‘unitary relationship’ does not exist between the ‘payor and payee.’”).

23. *Id.* at 30.

24. *Id.* (citing *Mobil Oil Corp. v. Comm’r of Taxes of Vt.*, 445 U.S. 425, 438 (1980)).

25. UDITPA, *supra* note 4, at Prefatory Note.

determining the amount of tax to be apportioned to each state.²⁶ As a result, tax compliance and administrative costs increased as states found it difficult to keep track of a magnitude of taxation regimes.²⁷ As of 2022, twenty-four states have, to some extent, adopted the UDITPA into their statutory schemes, including Kansas.²⁸

1. Business and Nonbusiness Income

The UDITPA simplifies multi-state taxation because it requires the taxpayer to categorize the receipt as either business income or nonbusiness income.²⁹ If a receipt meets the definition of business income, it is allocated via an apportionment formula among the states where the business has a nexus.³⁰ If the receipt does not meet the definition of business income, it is classified as nonbusiness income and allocated to the state of the taxpayer's commercial domicile.³¹ The UDITPA defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes 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."³² Conversely, nonbusiness income is "all income other than business income."³³

Depending on the circumstances, there are significant tax implications tied to the distinction between business income and nonbusiness income. For example, consider a taxpayer with a commercial domicile in Texas, operates in multiple states, and realizes income in California. If the receipt is classified as nonbusiness income, it will be sourced to the state of the commercial domicile. Because the taxpayer's commercial domicile is Texas, a state without an income tax, the taxpayer will not pay tax on the receipt.

26. *Id.*; Lynn, Jr., *supra* note 3, at 86–87.

27. Lynn, Jr., *supra* note 3, at 87 n.19 (discussing a 1954 study that estimated savings of 35% for businesses if a uniform apportionment formula was introduced).

28. *See Division of Income for Tax Purposes Act*, UNIF. L. COMM'N, <https://www.uniformlaws.org/committees/community-home?communitykey=f2ef73d2-2e5b-488e-a525-51be29fbee47&tab=groupdetails> [<https://perma.cc/5GPN-Z3RW>] (last visited Apr. 28, 2022).

29. UDITPA, *supra* note 4, § 1(a); Welch, *supra* note 10.

30. *State Income Taxation of Multicorporate Unitary Businesses: Mobil Oil Corp. v. Commissioner of Taxes*, 94 HARV. L. REV. 117, 117–18 (1980) [hereinafter *State Income Taxation of Multicorporate Unitary Businesses*].

31. UDITPA, *supra* note 4, § 1(e); Welch, *supra* note 10.

32. UDITPA, *supra* note 4, § 1(a).

33. UDITPA, *supra* note 4, § 1(e).

2. State Courts Are Split on the Interpretation of Business Income

The UDITPA business income definition is interpreted inconsistently among the states. The inconsistency boils down to the distinction between two tests—the transactional test and the functional test.³⁴ The primary difference between the two tests is the transactional test focuses on the nature of the transaction that produced the income while the functional test focuses on the relationship between the property and the taxpayer.³⁵ The transactional test classifies a receipt as business income if the receipt was earned in the taxpayer’s ordinary course of business.³⁶ Several factors can determine whether the income was earned in the taxpayer’s ordinary course of business. These factors include the nature, frequency, and regularity of the transaction that generated income.³⁷ The functional test takes a broader approach³⁸ and “focuses on the utilization of the property in the business.”³⁹ Under the functional test, a receipt is business income if the property that generated the income was used in the business.⁴⁰ If a receipt passes the functional test, it is included in the apportionment formula and allocated among the states of which the taxpayer has nexus.⁴¹

The transactional and functional tests play an important role in the classification of gain from a nondomiciliary taxpayer’s sale of their interest in a pass-through entity. Pass-through entity interests are classified as intangible assets.⁴² Generally, capital gains and losses from the sale of intangible assets are allocable to the state where the owner is domiciled.⁴³ The nondomiciliary taxpayer’s gain on sale of their interest is an intangible asset. Therefore, without a rule stating otherwise, the gain will be sourced to the state where the owner is domiciled.⁴⁴

34. Fenwick, McLoughlin, Salmon, Smith, Tilley & Wood, *supra* note 6.

35. Milner, *supra* note 13, at 443–44.

36. *In re Appeal of Chief Indus., Inc.*, 875 P.2d 278, 282–84 (Kan. 1994); Fenwick, McLoughlin, Salmon, Smith, Tilley & Wood, *supra* note 6.

37. *Am. States Ins. Co. v. Hamer*, 816 N.E.2d 659, 664 (Ill. App. Ct. 2004).

38. Fenwick, McLoughlin, Salmon, Smith, Tilley & Wood, *supra* note 6.

39. *In re Appeal of Chief Indus., Inc.*, 875 P.2d at 283.

40. *Id.*

41. *State Income Taxation of Multicorporate Unitary Businesses*, *supra* note 30, at 117–18.

42. Fenwick, McLoughlin, Salmon, Smith, Tilley & Wood, *supra* note 6.

43. UDITPA, *supra* note 4, § 6(c).

44. Fenwick, McLoughlin, Salmon, Smith, Tilley & Wood, *supra* note 6. Regarding partnerships, this treatment is explained by the aggregate and entity theories of partnerships. *Id.*

Even though a state will generally apply the aggregate theory in regard to a corporate partner’s treatment of its receipt of partnership income, it will look to the entity theory

By definition, the gain on sale of the interest in a pass-through entity fails the transactional test. The transactional test requires the transaction to be in the taxpayer's ordinary course of business. Unless a corporate partner in a partnership is "in the business of buying and selling partnership interests," the gain generated by that partner's sale of their interest will not qualify as business income.⁴⁵ Therefore, whether the transaction qualifies as business income requires the taxing state to recognize the functional test in their statutory definition of business income and interpret the functional test to include the gain on sale of a pass-through entity interest.

To say state courts vary on treatment of the transaction would be an incredible understatement. Some states have simply held the gain was not business income under *both* the transactional test and the functional test.⁴⁶ Some state statutes have been drafted to explicitly include the gain from sale of equity interest or stock in business income.⁴⁷ States have also enacted broad statutes that list specific examples of business income.⁴⁸ Due to the variety among the states, it is necessary to analyze a state's statutory definition of business income to determine the taxation of a

when the partnership interest is sold. As a result, the determination of whether the state where the partnership is located is able to tax any gain on the sale will likely depend on whether the partner is a resident or nonresident of the state.

Robert Rivitz, *Massachusetts Couldn't Tax Floridians' Gain from Sale of Realty Partnership Interest*, in STATE & LOC. TAXES WKLY. Vol. 6, No. 43 (Thomson Reuters/Tax & Accounting Oct. 30, 1995).

[T]he *aggregate concept* predominates in connection with the taxation of partnership income to the partners. But the *entity approach* predominates in the treatment of *transfers of partnership interests* as transfers of an interest in a separate entity rather than in the assets of a partnership. It's like the treatment of transfers of corporate shares.

45. Fenwick, McLoughlin, Salmon, Smith, Tilley & Wood, *supra* note 6.

46. See generally Noell Indus., Inc. v. Idaho State Tax Comm'n, 470 P.3d 1176 (Idaho 2020); Corrigan v. Testa, 73 N.E.3d 381 (Ohio 2016) (holding an Ohio statute unconstitutional (as it applies to this taxpayer) that required a pass-through entity owner to apportion income from the sale of equity interest to be sourced to Ohio, noting that but for the unconstitutional statute, the taxpayer would source his gain from the sale of his membership interest in an LLC to his state of domicile).

47. See generally ALA. CODE § 40-27-1.1 (West, Westlaw through 2022 Reg. & 1st Spec. Sess.) ("or gain or loss resulting from the sale, exchange, or other disposition of stock in another corporation").

48. See 35 ILL. COMP. STAT. ANN. 5/1501 (West, Westlaw through 2021 Reg. Sess.); ILL. ADMIN. CODE tit. 86, § 100.3010 (West, Westlaw through Ill. Reg. Volume 46, Issue 13, Mar. 25, 2022) ("By adopting this definition, the General Assembly overruled the decisions in the following case[]: . . . Hercules, Inc. v. Zehnder, . . . which held that gain realized on the sale of the taxpayer's stock in a subsidiary corporation that it had received in exchange for the contribution of assets . . . was not business income.").

nondomiciliary taxpayer's gain on sale of pass-through interest.

C. Status of Business Income in Kansas

Although Kansas originally adopted the UDITPA definition of business income in 1963,⁴⁹ the Kansas Supreme Court and the Kansas Legislature have made several changes effecting the definition. The discussion below outlines, first, two seminal cases that interpreted the Kansas definition of business income. Finally, the discussion outlines how the statute has evolved into the current statutory definition of business income.

1. Judicial Interpretation of K.S.A. § 79-3271(a): 1996–2007

Before the legislature amended K.S.A. § 79-3271(a), Kansas defined business income using the UDITPA definition word-for-word. The statute read as follows: “[b]usiness income’ means income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes 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.”⁵⁰ Notably, two Kansas cases interpreted the statutory definition of business income, holding K.S.A. § 79-3271(a) only includes receipts that satisfy the transactional test: *Western Natural Gas Co. v. McDonald* and *In re Appeal of Chief Industries, Inc.*

i. *Western Natural Gas Co. v. McDonald*

In 1968, the Kansas Supreme Court addressed whether the income realized on the sale of leases was business income.⁵¹ *Western Natural Gas* did business in Kansas and its principal office was in Texas.⁵² Upon approval of a complete liquidation of the company, *Western Natural Gas*

49. 1963 Kan. Sess. Laws Ch. 485 (S.B. 41).

50. 1991 Kan. Sess. Laws Ch. 283 (S.B. 2492). The UDITPA definition of business income reads “income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes 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.” UDITPA, *supra* note 4, § 1(a).

51. *W. Nat. Gas Co. v. McDonald*, 446 P.2d 781, 784 (Kan. 1968).

52. *Id.* at 782.

realized an \$8,086,898 gain on the sale of the company.⁵³ The corporation included the \$8,086,898 gain on its Texas tax return—the state of its commercial domicile.⁵⁴ The corporation argued the gain on the sale was nonbusiness income as the sale of intangible personal property, by statute, sourced to the state of commercial domicile.⁵⁵ The Kansas Director of Revenue made an assessment against the corporation contending the gains were business income and thus taxable in Kansas.⁵⁶

Although the exact terminology was not used, the Kansas Supreme Court held that the transactional test shall be used to interpret whether a receipt was business income.⁵⁷ The court focused on the word “regular” as it pertains to “regular trade or business.”⁵⁸ The court used Webster’s Dictionary to define “regular” as “steady or uniform in course, practice or occurrence and not subject to unexplained or irrational variation.”⁵⁹ Because the liquidation needed the affirmative vote of the stockholders, it was not steady or uniform in practice and was not in the regular course of business for Western Natural Gas.⁶⁰ The court held that the complete cessation, rather than the operation of the business, was not in the regular course of business.⁶¹ Therefore, the gain on sale was not business income and not apportionable to Kansas.⁶²

ii. *In re Appeal of Chief Industries, Inc.*

In *In re Appeal of Chief Industries, Inc.*, a non-resident corporation challenged the Kansas Department of Revenue’s ruling that proceeds from the sale of stock were business income.⁶³ The Department argued that K.S.A. § 79-3271(a) defined business income to include both the transactional and functional test.⁶⁴ The Department believed the functional test existed in Kansas based on a regulation adopted in 1979,

53. *Id.*

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.* at 784 (“The present sale of leases cannot be considered made in the regular course of business operations.”).

58. *Id.* at 783; 1963 Kan. Sess. Laws Ch. 485 (S.B. 41).

59. *W. Nat. Gas Co.*, 446 P.2d at 784.

60. *Id.*

61. *Id.*

62. *Id.*

63. 875 P.2d 278, 279 (Kan. 1994).

64. *Id.* at 281.

K.A.R. § 92-12-73, which stated “[g]ain or loss from the sale . . . [of] intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer’s trade or business.”⁶⁵

The Kansas Supreme Court rejected the use of K.A.R. § 92-12-73 because the regulation conflicted with the precedent in *Western Natural Gas Co.*⁶⁶ The court restated that *Western Natural Gas Co.* required only the transactional test.⁶⁷ Because the holding of *Western Natural Gas Co.* had not been modified nor had the legislature acted to change the statute since its decision, the regulation was not controlling.⁶⁸ The court concluded that the only test required by K.S.A. § 79-3271(a) was the transactional test and the sale of the stock was not business.⁶⁹

2. Legislative Action: 1996–2008

In *In re Appeal of Chief Industries, Inc.*, the Kansas Supreme Court concluded that if the Department of Revenue wanted to incorporate another standard to classify a receipt as business income (the functional test), the legislature would need to act to change the definition of business

65. *Id.* at 283 (citing KAN. ADMIN. REGS. § 92-12-73 (1979)).

66. *See id.* at 284.

67. *Id.* at 284–85. While the Kansas Supreme Court in *Western Natural Gas Co.* did not use term “transactional test” directly, later courts interpret its holding to be the transactional test. As the Kansas Supreme Court discussed,

[i]t is not the use of the property in the business which is the determining factor under the statute. The controlling factor by which the statute identifies business income is the nature of the particular transaction giving rise to the income. To be business income the transaction and activity must have been in the regular course of [the] taxpayer’s business operations.

W. Nat. Gas Co., 446 P.2d at 783. This language is consistent with the transactional test which requires the taxpayer to look at the nature of the transaction in the taxpayer’s ordinary course of business. Milner, *supra* note 13, at 442–43.

68. *In re Appeal of Chief Indus., Inc.*, 875 P.2d at 284 (quoting *State v. One Bally Coney Island No. 21011 Gaming Table*, 258 P.2d 225, 228 (Kan. 1953)).

It would seem that a judicial construction placed upon its language by a united court for more than ten years must be deemed to have received the sanction and approval of the legislative bodies. If this court in the first instance mistook the purpose and intent of the statute, there has been an abundant opportunity for the law-making power to give further expression to its will, and that its failure to act amounts to a ratification of the interpretation placed upon that act by this court.

69. *Id.* at 286.

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income.⁷⁰ In 1996, the legislature amended the definition of “business income” in K.S.A. § 79-3271(a), which would come to be one of three amendments in a twelve-year span.⁷¹ House Bill 2038 retained the UDITPA language and added an election provision italicized below:

(a) “Business income” means income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes 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, *except that for taxable years commencing after December 31, 1995, a taxpayer may elect that all income derived from the acquisition, management, use or disposition of tangible or intangible property constitutes business income. The election shall be effective and irrevocable for the taxable year of the election and the following nine taxable years. The election shall be binding on all members of a unitary group of corporations.*⁷²

In 2003, the legislature amended K.S.A. § 79-3271(a) and deleted language previously adopted from the UDITPA uniform language.⁷³ Although no judicial decision prompted the legislature to act, in 2003 Kansas passed the Kansas Certified Capital Formation Company Act.⁷⁴ The purpose of this act was to “enhance the development of seed and venture capital in Kansas and to support the modernization and expansion of the state’s economy.”⁷⁵ A strike-through indicates the deleted language in the 2003 statute below:

(a) “Business income” means income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes 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, except that for taxable years commencing after December 31, 1995, a taxpayer may elect that all income ~~derived from the acquisition, management, use or disposition of tangible or intangible property~~ constitutes business

70. *Id.* at 285 (“Neither BOTA nor the Department can change the test this court established in *Western Natural Gas* by reliance on a regulation. The legislature can modify this court’s statutory construction, but it has not done so.”).

71. *See generally* 1996 Kan. Sess. Laws Ch. 264 (H.B. 2038); 2003 Kan. Sess. Laws Ch. 158 (S.B. 284); 2008 Kan. Sess. Laws Ch. 182 (S. Substitute H.B. 2434).

72. 1996 Kan. Sess. Laws Ch. 264 (H.B. 2038).

73. The uniform language included the terms “and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer’s regular trade or business operations.” UDITPA, *supra* note 4, § 1(a).

74. 2003 Kan. Sess. Laws Ch. 154 (S.B. 285).

75. *Id.*

income. The election shall be effective and irrevocable for the taxable year of the election and the following nine taxable years. The election shall be binding on all members of a unitary group of corporations.⁷⁶

In 2008 the legislature amended K.S.A. § 79-3271(a) a final time to create the current definition of business income.⁷⁷ The 2008 amendment was the most substantial amendment because it adds a new three-pronged test to the definition of business income.⁷⁸ The italicized language and strike-through language below indicate added and deleted language respectively in the 2008 amendment as follows:

(a) *For tax years commencing prior to January 1, 2008, “business income” means income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes 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, except that for taxable years commencing after December 31, 1995, a taxpayer may elect that all income constitutes business income. For tax years commencing after December 31, 2007, “business income” means: (1) Income arising from transactions and activity in the regular course of the taxpayer’s trade or business; (2) income arising from transactions and activity involving tangible and intangible property or assets used in the operation of the taxpayer’s trade or business; or (3) income of the taxpayer that may be apportioned to this state under the provisions of the Constitution of the United States and laws thereof, except that a taxpayer may elect that all income constitutes business income. The election Any election made under this subsection shall be effective and irrevocable for the taxable tax year of the election and the following nine taxable years. The election in which the election is made and the following nine tax years and shall be binding on all members of a unitary group of corporations.*⁷⁹

The 2008 amendment follows a Board of Tax Appeals decision that held income from an installment sale of a major business asset was deemed nonbusiness income under K.S.A. § 79-3271(a).⁸⁰

Since *In re Appeal of Chief Industries, Inc.*, when the Kansas Supreme

76. 2003 Kan. Sess. Laws Ch. 158 (S.B. 284).

77. 2008 Kan. Sess. Laws Ch. 182 (S. Substitute H.B. 2434).

78. *Id.*

79. *Id.* The italicized and strike-through language mirrors how the legislature indicates added and deleted language respectively in Senate Substitute for House Bill 2434.

80. Charles F. Jensen, *Business Asset Installment Sale: Appeals Board Rules on Nexus, Business/Nonbusiness Income; Legislature Acts*, 18-JAN J. MULTISTATE TAX’N & INCENTIVES 29, 29 (2009) (discussing Appeal of Frontier Oil Corp., Kan. Bd. Tax. App., Docket No. 2006-913-DT, 3/20/08).

Court rejected the notion that the Kansas statute incorporated both the transactional and functional tests to determine whether business income exists, the Kansas courts have not yet ruled on the issue. Similarly, Kansas courts have yet to rule on whether K.S.A. § 79-3271(a), as amended in 2008, incorporates both the functional and transactional tests. Other states, however, have cited Kansas' amendment to support a determination that states adopting the UDITPA construe the second clause⁸¹ of the business income definition to include a separate functional test.⁸²

D. The Functional Test Explained

Because the Kansas courts have rejected the notion that the Kansas statute incorporated both the transactional and functional tests, the functional test has not been discussed or analyzed in Kansas. However, several state courts have interpreted their statutory definitions of business income to include the functional test in addition to the transactional test. These courts' analyses are integral to show what language is necessary for a statute to incorporate the functional test. The discussion below summarizes cases from Illinois and California, specifically discussing how each court determined that its statute incorporated the functional test.

1. Texaco-Cities Service Pipeline Co. v. McGaw

The Illinois Supreme Court in *Texaco-Cities Service Pipeline Co. v. McGaw* was one of the first to expand the interpretation of the functional test.⁸³ The issue in *Texaco-Cities Service Pipeline Co.* was whether the

81. States are split as to whether the second clause in the UDITPA contains the functional test. That clause is as follows: “[business income] includes 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.” UDITPA, *supra* note 4, § 1(a).

82. *See, e.g.*, *Gannett Satellite Info. Network, Inc. v. State*, 2009 MT 5, ¶ 36, 348 Mont. 333, 201 P.3d 132 (citing *In re Appeal of Chief Industries, Inc.* in support of the statement “[c]ourts in several states that have adopted the UDITPA admittedly have found the definition of business income to contain solely a transactional test. . . . The legislatures in a majority of these jurisdictions promptly changed the statute, however, to reflect a functional test.”) (citations omitted). The Montana Supreme Court, however, does not analyze any of the statutes to which it cites in this statement and provides no discussion about how the statutes reflect the functional test. *See, e.g.*, *Harris Corp. v. Ariz. Dep’t of Revenue*, 312 P.3d 1143, 1147 (Ariz. Ct. App. 2013) (citing briefly to *Western Natural Gas Co.* and indicating that the holding was superseded by statute). Like the Montana Supreme Court, the Arizona Court of Appeals does not discuss the how the statute relates to the case.

83. 695 N.E.2d 481 (Ill. 1998); Bret Eric Leas, *Sale of Pipeline Assets Held to Be Business Income Under Functional Test in Illinois: Texaco-Cities Service Pipeline Co. v. McGaw*, 4 STATE & LOC. TAX LAW. 159, 170 (1999).

gain on sale of pipeline assets constituted business income under the Illinois definition of business income.⁸⁴ *Texaco-Cities Service Pipeline Co.* (“*Texaco-Cities*”) was a Delaware corporation with its principal place of business in Texas.⁸⁵ *Texaco-Cities*’s business was to transport crude oil and petroleum products through pipeline assets “which ran through several states, including Illinois.”⁸⁶ In 1983, *Texaco-Cities* sold its pipeline assets to other oil refinery companies in Chicago.⁸⁷ *Texaco-Cities* realized a gain of \$9,987,176 and classified the gain on sale of pipeline assets as nonbusiness income.⁸⁸

The Illinois Supreme Court rejected *Texaco-Cities*’s argument that the gain was not business income because it was not earned in a transaction occurring in the regular course of its business.⁸⁹ *Texaco-Cities* argued the transaction was a “one-time, extraordinary” gain and not “an integral part of its regular trade or business operations.”⁹⁰ The court argued the definition of business income resulted in two independent clauses.⁹¹ The first clause embodied the transactional test⁹² and the second⁹³ created a completely new definition, the functional test.⁹⁴

The Illinois Supreme Court focused the meaning of the functional test around the word “integral.” The court stated that the terms “integral” and “operations” “indicate that the acquisition, management and disposition of the income-producing property must closely relate to the taxpayer’s regular trade or whole process of operating its business.”⁹⁵ Additionally,

84. *Texaco-Cities Serv. Pipeline Co.*, 695 N.E.2d at 484. At the time of *Texaco-Cities Service Pipeline Co.*, Illinois defined business income as “income arising from transactions and activity in the regular course of the taxpayer’s trade or business . . . and includes 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.” 1993 Ill. Legis. Serv. 88–480 (West) (S.B. 553).

85. *Texaco-Cities Serv. Pipeline Co.*, 695 N.E.2d at 483.

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.* at 485.

90. *Id.*

91. *See id.*

92. *See id.* at 484–85 (noting that “[t]he first clause consists of general language encompassing all activity in the ‘regular course of the taxpayer’s trade or business’” and discussing the language in the statute “income arising from transactions and activity in the regular course of the taxpayer’s trade or business”); *see also* 1993 Ill. Legis. Serv. 88–480 (West) (S.B. 553).

93. *Texaco-Cities Serv. Pipeline Co.*, 695 N.E.2d at 484–85 (discussing the language in the statute “and includes 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”); *see also* 1993 Ill. Legis. Serv. 88–480 (West) (S.B. 553).

94. *Texaco-Cities Serv. Pipeline Co.*, 695 N.E.2d at 485.

95. *Id.*

the Illinois Supreme Court went on to interpret the terms “acquisition,” “management,” and “disposition.” These three terms “suggest elements typically associated with the ‘keeping’ of corporate property, or . . . the ‘conditions of ownership’ of corporate property.”⁹⁶ Finally, the court concluded that “the sale of property will constitute business income [under the functional test] if the property and sale are essential to the taxpayer’s business operations.”⁹⁷ Because Texaco-Cities’s business operations included the transportation of oil and petroleum products, the pipelines were integral to that business; the Illinois Supreme Court classified the gain on sale of pipeline assets as business income.⁹⁸

2. *Hoechst Celanese Corp. v. Franchise Tax Bd.*

Only a few years after *Texaco-Cities*, California expanded the functional test more broadly than the Illinois Supreme Court.⁹⁹ The issue in *Hoechst Celanese Corp. v. Franchise Tax Board* was whether the \$388.8 million surplus that resulted from the division of Hoechst Celanese Corporation’s (“Hoechst”) pension plan was apportionable to California.¹⁰⁰ Hoechst was a Delaware corporation; its principal place of business was in New Jersey, its commercial domicile was in New York, and it conducted business in California.¹⁰¹ Hoechst sold and manufactured chemicals, fibers, and specialty products, however the property at issue was Hoechst’s qualified pension plan.¹⁰² While Hoechst did not have legal title of the pension plan, it did have control over the plan,¹⁰³ and in 1985 the company divided the pension plan held in trust to two separate trusts.¹⁰⁴ This resulted in a surplus of approximately \$388.8 million.¹⁰⁵ Hoechst did not apportion any of the income to California and the California State Franchise Tax Board issued a “Notice of Additional Tax Proposed to Be Assessed” that imposed an additional franchise tax of \$292,142 plus

96. *Id.* (citing *Kroger Co. v. Dep’t of Revenue*, 673 N.E.2d 710, 714 (Ill. App. Ct. 1996)).

97. *Id.*

98. *See id.* at 486–87.

99. *See* Macall S. Robertson, *Determining Business Income Under the UDITPA’s Functional Test: Hoechst Celanese Corp. v. Franchise Tax Bd.*, 7 STATE & LOC. TAX LAW. 107, 116–18 (2002) (describing the court’s expansion of the terms “ownership” and “integral”).

100. 22 P.3d 324, 329–30 (Cal. 2001).

101. *Id.* at 328.

102. *Id.*

103. *Id.* at 329.

104. *Id.*

105. *Id.* at 329–30.

interest from the pension plan reversion income.¹⁰⁶

The California Supreme Court held that the income was business income under the functional test.¹⁰⁷ The court rejected the idea that the term “property” requires legal title.¹⁰⁸ The conditional clause, “‘if the acquisition, management, and disposition of the *property* constitute integral parts of the taxpayer’s regular trade or business operations[,]’ . . . —and not the vague implications of the term ‘property’—defines the relationship between the property and the taxpayer required by the functional test.”¹⁰⁹ Additionally, the California Supreme Court agreed with the Illinois Supreme Court and concluded the phrase “acquisition, management, and disposition” refers to the taxpayer’s ownership of the property.¹¹⁰ However, because property does not require legal title, the court used the definitions of “acquisition,” “management,” and “disposition” to conclude the taxpayer must “(1) obtain some interest in and control over the property; (2) control or direct the use of the property; and (3) transfer, or have the power to transfer, control of that property in some manner.”¹¹¹

Like the Illinois Supreme Court, the California Supreme Court focused on the word “integral.” It determined the meaning of “integral” must fall somewhere between “contributing to” and “necessary or essential.”¹¹² Interpreting “integral” as “contributing to” would be too broad and run into constitutional issues.¹¹³ The court concluded the word “integral” “refers to an ‘organic unity’ between the income-producing property and the taxpayer’s business activities. . . . The property must be so interwoven into the fabric of the taxpayer’s business operations that it becomes ‘indivisible’ or inseparable from the taxpayer’s business

106. *Id.*

107. *Id.* at 344. Like Illinois, the California Supreme Court’s definition of business income was identical to the definition in the UDITPA. CAL. REV. & TAX. CODE § 25120(a) (West, Westlaw through Ch. 14 of 2022 Reg. Sess.) (“‘Business income’ means income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes 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.”). The court also discussed the portion of its statute that created the functional test. *Hoechst Celanese Corp.*, 22 P.3d at 337 (“Under the functional test, corporate income is business income ‘if the acquisition, management, and disposition of the [income-producing] property constitute integral parts of the taxpayer’s regular trade or business operations.’”) (citations omitted).

108. *Hoechst Celanese Corp.*, 22 P.3d at 337–38.

109. *Id.*

110. *Id.* at 338.

111. *Id.*

112. *Id.* at 339–40.

113. *Id.* (citing *ASARCO, Inc. v. Idaho State Tax Comm’n*, 458 U.S. 307, 326 (1982)).

activities.”¹¹⁴ The court held that the property must be material to the taxpayer’s business.¹¹⁵ Finally, the court summarized its analysis of the functional test to say “income is business income under the functional test if the taxpayer’s acquisition, control and use of the property contribute materially to the taxpayer’s production of business income.”¹¹⁶

The court held the surplus generated by the reversion of the pension plan was business income because the plan was used to induce and retain employees.¹¹⁷ Because employees were necessary to the conduct of Hoechst’s business operations, the surplus generated by the plan was business income under the functional test.¹¹⁸

III. ANALYSIS

The text of K.S.A. § 79-3271(a) is ambiguous and does not create the functional test as a standard to determine if a receipt is business income in Kansas. To define the functional test, this Comment synthesizes and analogizes other state court approaches. Through this analysis, it determines the functional test analyzes two relationships: the use relationship and the ownership relationship. The text of K.S.A. § 79-3271(a)(2) fails to indicate that either the use relationship or the ownership relationship exists and therefore does not create the functional test. Additionally, statutory evolution supports the textual analysis that the functional test does not exist in K.S.A. § 79-3271(a)(2). Because neither the text nor the statutory evolution creates the functional test, the nondomiciliary gain on sale of a pass-through interest must pass the transactional test to be taxable in Kansas. Using this analysis, this Comment concludes the gain from sale of a nondomiciliary pass-through equity interest is not business income under Kansas law.

A. Textual Analysis of K.S.A. § 79-3271(a)

The text of K.S.A. § 79-3271(a) does not create the functional test. Therefore, the only test to determine if a receipt meets the statutory definition of business income in Kansas is the transactional test. Statutory

114. *Id.* at 340 (citation omitted).

115. *Id.* at 339.

116. *Id.* at 340.

117. *Id.* at 343.

118. *Id.*

analysis always begins with the text of the statute.¹¹⁹ If “the intent of the legislature” can be ascertained from the text of the statute, the text governs.¹²⁰ When the text of the statute is ambiguous, other aids, such as canons of construction, may be used to determine the legislature’s intent.¹²¹ “A statute is ambiguous when two or more interpretations can fairly be made.”¹²² K.S.A. § 79-3271(a) lists three definitions of business income.¹²³ The first definition, K.S.A. § 79-3271(a)(1), is identical to the first clause of UDITPA definition.¹²⁴ Because state courts agree that the first clause of the UDITPA definition describes the transactional test, the first definition listed at K.S.A. § 79-3271(a)(1) describes the transactional test.¹²⁵ The first definition is not ambiguous and is not at issue in this discussion.

The second definition, however, is ambiguous. The second definition, K.S.A. § 79-3271(a)(2), defines a receipt as business income when the “income aris[es] from transactions and activity involving tangible and intangible property or assets used in the operation of the taxpayer’s trade or business.”¹²⁶ Because the statute borrows the terms “tangible and intangible property” from the UDITPA statute,¹²⁷ K.S.A. § 79-3271(a)(2) signals that this definition is *supposed* to prompt the reader to the

119. State v. Smith, 441 P.3d 472, 475 (Kan. 2019).

120. *In re Ford Motor Credit Co.*, 69 P.3d 612, 615 (Kan. 2003) (discussing statutory interpretation as it pertains to tax statutes in Kansas).

121. *Stewart Title of the Midwest, Inc. v. Reece & Nichols Realtors, Inc.*, 276 P.3d 188, 195 (Kan. 2012) (“Only if the statute’s language or text is unclear or ambiguous does the court employ canons of construction, legislative history, or other background considerations to divine the legislature’s intent and construe the statute accordingly.”).

122. *Petty v. City of El Dorado*, 19 P.3d 167, 170 (Kan. 2001).

123. KAN. STAT. ANN. § 79-3271(a) (2008).

“[B]usiness income” means: (1) Income arising from transactions and activity in the regular course of the taxpayer’s trade or business; (2) income arising from transactions and activity involving tangible and intangible property or assets used in the operation of the taxpayer’s trade or business; or (3) income of the taxpayer that may be apportioned to this state under the provisions of the Constitution of the United States and laws thereof, except that a taxpayer may elect that all income constitutes business income. Any election made under this subsection shall be effective and irrevocable for the tax year in which the election is made and the following nine tax years and shall be binding on all members of a unitary group of corporations.

124. KAN. STAT. ANN. § 79-3271(a)(1) (2008) (“[i]ncome arising from transactions and activity in the regular course of the taxpayer’s trade or business”); UDITPA, *supra* note 4, § 1(a) (“income arising from transactions and activity in the regular course of the taxpayer’s trade or business”).

125. *Welch*, *supra* note 10, § 2.

126. KAN. STAT. ANN. § 79-3271(a)(2) (2008).

127. *Id.*; UDITPA, *supra* note 4, § 1(a).

functional test. However, the UDITPA definition is not the text of the statute. Because UDITPA is not the text, the text does not unequivocally create the functional test. While K.S.A. § 79-3271(a)(2) borrows words from the UDITPA definition, including terms and phrases that have been interpreted by other courts to create the functional test,¹²⁸ the statute omits other terms and phrases that create the requisite relationships between the property and taxpayer essential to create the functional test.¹²⁹ Because K.S.A. § 79-3271(a)(2) *could be read* to both create and not create the functional test, the statute is ambiguous.¹³⁰

1. Understanding the Functional Test and Its Application to K.S.A. § 79-3271(a)(2)

The functional test is defined by the relationship between the property and the taxpayer¹³¹ and is best described by requiring two relationships: a use relationship and an ownership relationship. The functional test is explained the clearest by states that have adopted the UDITPA definition of business income.¹³² It is accepted by those states that have both adopted the functional test and use the UDITPA definition that the second clause, “and includes 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” embodies the functional test.¹³³ Generally, the use relationship requires that control and power must be integral to the taxpayer’s regular trade or business operations¹³⁴ and the ownership relationship requires the property must be under the control and power of the taxpayer.¹³⁵ The following analysis derives the use and ownership relationships from the discussions

128. The terms “tangible and intangible property” are used in states that incorporate the functional test. Welch, *supra* note 10, § 2.

129. See discussion and accompanying notes *infra* Sections III.A.1.i, III.A.1.ii.

130. Note that the third statutory definition of business income at K.S.A. § 79-3271(a)(3) discusses a constitutional standard and does not relate to the textual analysis of K.S.A. § 79-3271(a) to determine if the functional test exists in the Kansas statutory definition of business income. The third definition at K.S.A. § 79-3271(a)(3) is discussed as it pertains to legislative history and the statute’s overall application to the nondomiciliary gain on sale of a pass-through interest. See discussion *infra* Sections III.B.3., III.C.

131. Milner, *supra* note 13, at 443–44.

132. See generally *Hoechst Celanese Corp. v. Franchise Tax Bd.*, 22 P.3d 324 (Cal. 2001); *Blue Bell Creameries, LP v. Roberts*, 333 S.W.3d 59 (Tenn. 2011); *Texaco-Cities Serv. Pipeline Co. v. McGaw*, 695 N.E.2d 481 (Ill. 1998).

133. UDITPA, *supra* note 4, § 1(a); Welch, *supra* note 10, § 2.

134. See discussion *infra* Section III.A.1.i.

135. See discussion *infra* Section III.A.1.ii.

of other state courts then applies those analyses to K.S.A. § 79-3271(a)(2) to conclude that the text of the statute does not create the functional test.

i. The Use Relationship: “Used in the operation of the taxpayer’s trade or business”

The ordinary meaning of “used in the operation of the taxpayer’s trade or business”¹³⁶ fails to create the use relationship required by the functional test. While not explicitly stated, the Illinois Supreme Court and California Supreme Court each used an ordinary meaning analysis to deduce the use relationship. Their identical statutes stated the property must “constitute integral parts of the taxpayer’s regular trade or business operations.”¹³⁷ Primarily, the ordinary meaning rule is a canon of statutory construction that states the text should be interpreted “by considerations of *how readers . . . would actually understand it.*”¹³⁸ Tools such as dictionaries and general linguistic intuitions are commonly used to interpret a statute’s ordinary meaning.¹³⁹ The Illinois and California Supreme Courts’ discussions reveal the word “integral” creates a use relationship between the property and the taxpayer: that the property must be directly used in the taxpayer’s trade or business to satisfy the functional test.

The term “integral” describes that the property must be used directly in the taxpayer’s essential business operations. The Illinois Supreme Court in *Texaco-Cities Service Pipeline Co.* described the relationship between the property and the taxpayer “focus[ed] [on] the role or function of the property as being *integral* to regular business operations.”¹⁴⁰ Using

136. KAN. STAT. ANN. § 79-3271(a)(2) (2008).

137. See *Texaco-Cities Serv. Pipeline Co.*, 695 N.E.2d at 484; *Hoechst Celanese Corp.*, 22 P.3d at 332. Note also that Illinois and California’s statutes are identical to the UDITPA model definition for business income. UDITPA, *supra* note 4, § 1(a) (“constitute integral parts of the taxpayer’s regular trade or business operations”).

138. Kevin P. Tobia, *Testing Ordinary Meaning*, 134 HARV. L. REV. 726, 739 (2020); see also *Phillips v. St. Paul Fire & Marine Ins. Co.*, 213 P.3d 1066, 1070 (Kan. 2009).

139. Tobia, *supra* note 138, at 739. There is an exception to the ordinary meaning rule for statutory definitions. If a statute defines a word, that definition is to be controlling. See ANTONIN SCALIA & BRYAN A. GARNER, *READING LAW: THE INTERPRETATION OF LEGAL TEXTS* 70 (2012); *Tuggle v. Parker*, 156 P.2d 533, 534 (Kan.1945) (using the dictionary definition of “line” in its analysis. “In this type of a case where we are confronted with the task of construing the meaning of the legislature, we must bring to our aid all the known definitions . . . as is possible.”). KAN. STAT. ANN. § 79-3271(a) is a statutory definition; however, because the statute is ambiguous, the ordinary meaning rule can be used to interpret the text of the statutory definition. *Farmers’ Nat’l Bank of Lincoln v. Francis*, 164 P. 146, 148 (Kan. 1917) (“We are required by the statute (Gen. Stat. 1915, § 10973, subdiv. 2) to construe words and phrases according to the approved uses of the language. Dictionaries are supposed to determine what approved usage is.”).

140. *Texaco-Cities Serv. Pipeline Co.*, 695 N.E.2d at 486 (emphasis added). The Illinois

dictionary definitions, the court deduced the ordinary meaning from the words “integral” and “operations” to mean the property must be essential to the taxpayer’s “regular trade or whole process of operating its business.”¹⁴¹

Arguably, this definition of operations expands the relationship between property and taxpayer with the definition “or whole process of operating its business.” Because the court’s interpretation uses the word “or”¹⁴² after “regular trade,” this conjunction indicates business income could be essential to *either* the regular trade or whole process. Because “whole process of operating its business” could imply that the asset must simply contribute to any part of the business operations, the phrase could indicate the existence of an indirect relationship. However, the word “essential” creates a direct relationship between the property and the taxpayer. “Essential” indicates the property must be requisite to the whole process and narrows the functional test.

Additionally, the California Supreme Court confirms the narrow use relationship. The court held “income is business income under the functional test if the taxpayer’s acquisition, control¹⁴³ and use of the

Supreme Court also notes *how* they ascertain the functional test from the UDITPA language.

The first clause consists of general language encompassing all activity in the “regular course of the taxpayer’s trade or business.” The second clause enlarges this definition to include income from property, as long as its “acquisition, management, and disposition” constitute “integral parts of the taxpayer’s regular trade or business operations.” The predicate phrase “in the regular course of business” is replaced in the second clause with “integral parts of regular business operations,” resulting in two manifestly different definitions.

Id. at 485.

141. *Id.*

Turning to the meaning of the second clause, we note that the term “integral” means “of, relating to, or serving to form a whole: essential to completeness: organically joined or linked.” . . . The term “operations” is defined as “b: the whole process of planning for and operating a business or other organized unit . . . c: a phase of a business or of business activity.”

Id. (citations omitted).

142. Katharine Clark & Matthew Connolly, *A Guide to Reading, Interpreting and Applying Statutes*, WRITING CTR. AT GEO. UNIV. L. CTR. (2017), <https://www.law.georgetown.edu/wp-content/uploads/2018/12/A-Guide-to-Reading-Interpreting-and-Applying-Statutes-1.pdf> (stating that “‘or’ typically signifies a disjunctive list, meaning satisfying any one condition in the list is sufficient”).

143. Note that the California business income statute retained the three-word phrase “acquisition, management, and disposition” of the property from the UDITPA statute and discusses this phrase in

property *contribute materially* to the taxpayer's production of business income."¹⁴⁴ The property must be "'indivisible' or inseparable from the taxpayer's business activities."¹⁴⁵ Therefore, the California Supreme Court indicates for an activity to contribute materially to the production of business income, there must be a direct relationship between the property and the taxpayer. The Illinois and California Supreme Courts reveal that to satisfy the use relationship, the property must be integral and must materially contribute to the taxpayer's trade or business operations.

The ordinary meaning of K.S.A. § 79-3271(a)(2) does not satisfy the use relationship because the text does not create an integral relationship between the property and the taxpayer. K.S.A. § 79-3271(a)(2) is not identical to the UDITPA definition of business income, while the Illinois and California statutes are identical to UDITPA. Primarily, K.S.A. § 79-3271(a)(2) does not include the term "integral," a term critical in both the Illinois and California Supreme Courts' analyses. The absence of "integral" suggests the statute does not create the use relationship.

The text does not otherwise create the use relationship and does not create the functional test. Without the term "integral," other words and phrases must create the same relationship between the property and the taxpayer for the use relationship to exist. The ordinary meaning of the phrase "assets used in the operation of the taxpayer's trade or business" at K.S.A. § 79-3271(a)(2) does not create the use relationship. Because the text plainly states the term "used," this phrase, presumably, could create the use relationship. The ordinary meaning of "used" does not imply that the property must be essential or contribute materially to the operations of the business. Merriam-Webster's defines "used" as "employed in accomplishing something" or "accustomed, habituated."¹⁴⁶ The first

terms of control, which is also important to the functional test. See Robertson, *supra* note 99, at 113. This Comment will address the Kansas statute's evolution as it pertains to this phrase later in its discussion.

144. *Hoechst Celanese Corp. v. Franchise Tax Bd.*, 22 P.3d 324, 340 (Cal. 2001) (emphasis added). The court describes the relationship between the property and the taxpayer as an "'organic unity' between the income-producing property and the taxpayer's business activities." *Id.* (citation omitted).

145. *Id.* (citation omitted) ("The property must be so interwoven into the fabric of the taxpayer's business operations that it becomes 'indivisible' or inseparable from the taxpayer's business activities with both 'giving value' to each other."). While outside the scope of this Comment, some have criticized California's interpretation of the word "integral," indicating that it diminishes the overall goal of UDITPA—to create a more practical and uniform way to analyze multi-state taxation—by making the analysis as to whether the property "contributes materially" to the business operations too complicated. Robertson, *supra* note 99, at 116–17.

146. *Used*, MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY (11th ed. 2003). The second listed definition, "that has endured use; *specif.* secondhand" is ignored for the sake of this analysis because

definition, “employed in accomplishing something,” does not rise to the level of essential, as established by the Illinois Supreme Court, because it implies that the property can be used to accomplish anything, direct or indirect. Under this definition, proceeds from the sale of an asset as commonplace as an employee’s laptop would be an “asset[] used in the operation of the taxpayer’s trade or business”¹⁴⁷ simply because an employee used the laptop in their work. Indirect assets such as these, while certainly necessary to the day to day, do not contribute materially to the production of business income because taxpayers can still operate their business without these assets. Because the word “used” does not create an essential, material, and thus not direct relationship between the property and the taxpayer, the phrase “used in the operation of the taxpayer’s trade or business”¹⁴⁸ does not create the use relationship and the statute does not create the functional test.

ii. The Ownership Relationship: “Income arising from transactions and activity involving tangible and intangible property”

The ordinary meaning of “income arising from transactions and activity”¹⁴⁹ fails to create the ownership relationship created by the functional test. While not explicitly stated, the ownership relationship is deduced by the California and Illinois Supreme Courts’ analyses of the phrase “acquisition, management, and disposition.”¹⁵⁰ In *Hoechst*, the California Supreme Court relied on the Illinois Appellate Court’s holding in *Kroger* to conclude these three words “refer[] to the conditions of ownership of [the] property by the taxpayer.”¹⁵¹ The court used dictionary definitions of “acquisition,” “management,” and “disposition” to conclude, while legal ownership or title of the property is not required, the taxpayer must have some interest in and control over the property to fulfill the functional test.¹⁵² Because the terms acquisition, management,

“secondhand” does not apply to the business-operation context.

147. KAN. STAT. ANN. § 79-3271(a)(2) (2008).

148. *Id.*

149. *Id.*

150. *Hoechst Celanese Corp.*, 22 P.3d at 338 (quoting *Kroger Co. v. Dep’t of Revenue*, 673 N.E.2d 710, 713 (Ill. App. Ct. 1996)).

151. *Id.* (quoting *Kroger Co.*, 673 N.E.2d at 714).

152. *Id.* (discussing its conclusion after stating the dictionary definitions of “acquisition,” “management,” and “disposition,” and stating that the taxpayer must:

- (1) obtain some interest in and control over the property; (2) control or direct the use of the property; and (3) transfer, or have the power to transfer, control of that property in some

and disposition are present in the uniform statute promulgated by UDITPA as well as in states that have interpreted their statutes to contain both the functional and transactional tests, the functional test requires control over the property at issue.

The ordinary meaning of K.S.A. § 79-3271(a)(2) fails to indicate conditions of ownership necessary to create the ownership relationship. As of its amendment in 2003,¹⁵³ K.S.A. § 79-3271(a)(2) does not contain the specific terms, “acquisition,” “management,” or “disposition,” that indicate the ownership relationship.¹⁵⁴ Without these generally accepted terms, the issue is whether the phrase “income arising from transactions and activity involving tangible and intangible property” implicates the ownership relationship. Primarily, “income arising from transactions and activity” does not implicate the same control requirements as indicated by UDITPA and other courts.

The ordinary meaning of the terms “transactions,” “activity,” and “involving” included in the statute are not associated with control over the property, which is required to create the ownership relationship. The dictionary definition of “transaction” is “an act, process, or instance of transacting . . . a communicative action or activity involving two parties or things that reciprocally affect or influence each other.”¹⁵⁵ Transaction is defined using the term “reciprocal,” which does not imply control. Reciprocal implies the parties are on equal footing and neither has control over another.¹⁵⁶ Because transaction does not imply control, the term does not indicate any conditions of ownership to create the ownership relationship and thus the functional test.

manner. . . [L]egal ownership or title to the property is not necessary. Such a limitation is too restrictive because property ownership “finds expression through multiple methods.” . . . [W]e believe the phrase . . . encompasses the myriad of ways that corporations may control and use the rights and privileges commonly associated with property ownership.

(citation omitted)). Ten years later, the Tennessee Supreme Court used the California Supreme Court’s interpretation to deduce the functional test in its business income statute. *Blue Bell Creameries, LP v. Roberts*, 333 S.W.3d 59, 68 (Tenn. 2011) (“We agree that the language ‘acquisition, use, management or disposition of the property’ in the definition of business earnings suggests that the taxpayer must control, but not necessarily own, the property for earnings arising from that property to qualify as business earnings.”) (interpreting TENN. CODE ANN. § 67-4-2004(1) (2004)).

153. 2003 Kan. Sess. Laws Ch. 158 (S.B. 284). See discussion *infra* Section III.B.2.

154. KAN. STAT. ANN. § 79-3271(a)(2) (2008) (“For tax years commencing after December 31, 2007, ‘business income’ means: . . . (2) income arising from transactions and activity involving tangible and intangible property or assets used in the operation of the taxpayer’s trade or business.”).

155. *Transaction*, MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY (11th ed. 2003).

156. See *Reciprocal*, MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY (11th ed. 2003).

Additionally, “activity” does not implicate the ownership relationship. Activity is defined as “an organizational unit for performing a specific function; *also*: its function or duties.”¹⁵⁷ The definition alone implies an independent process in the phrase “performing a specific function.” Because the definition indicates an independent process and not control, it does not implicate conditions of ownership and does not create the ownership relationship.

The phrase “involving tangible and intangible property” does implicate control; however, in context with the rest of the text, it still does not create the functional test. “Involve” is defined as “to engage as a participant,” or “to oblige to take part.”¹⁵⁸ The first definition, “to engage as a participant,” clearly does not create the control relationship because “participant” implies equal footing, (like the *transaction* definition), and does not imply control over the property. The term “oblige” in K.S.A. § 79-3271(a)(2), however does imply a level of control. Merriam-Webster’s defines “oblige” as “to constrain by physical, moral, or legal force or by the exigencies of circumstance.”¹⁵⁹ The phrase “to constrain by physical, moral, or legal force” implies an element of control. Therefore, “involving” could imply control over the property.

However, although “involving” suggests control over the tangible and intangible property, it does not require control over tangible property used in the operation of the taxpayer’s business. Even if this phrase creates the ownership relationship, the following phrase, “assets used in the operation of the taxpayer’s trade or business,”¹⁶⁰ does not create the requisite use relationship to create the functional test.¹⁶¹ Because K.S.A. § 79-3271(a)(2) does not create both the ownership and use relationships between the property and the taxpayer, the functional test does not exist in Kansas.

iii. Two Independent Relationships: The Last Antecedent Doctrine

Even if K.S.A. § 79-3271(a)(2) accurately described the use and ownership relationships, the statute does not create the functional test because the relationships are independent of one another. This Comment

157. *Activity*, MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY (11th ed. 2003).

158. *Involve*, MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY (11th ed. 2003).

159. *Oblige*, MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY (11th ed. 2003).

160. KAN. STAT. ANN. § 79-3271(a)(2) (2008).

161. See discussion *supra* Section III.A.1.i.

has already established that, in the UDITPA definition,¹⁶² the phrase “acquisition, management, and disposition of the property” describes the ownership relationship¹⁶³ between the property and the taxpayer while the phrase “integral parts of the taxpayer’s regular trade or business operations” describes the use relationship.¹⁶⁴ In the UDITPA definition, the two relationships are joined by the word “constitute.”¹⁶⁵ This conjunction indicates that the use and ownership relationships are dependent on one another. Merriam-Webster’s defines “constitute” as “make up, form, compose,” or “set up, establish.”¹⁶⁶ Because the ownership relationship (“acquisition, management, and disposition of the property”) must make up or be established by the use relationship (“integral parts of the taxpayer’s regular trade or business operations”), the two relationships are dependent on one another to create the functional test.

The last antecedent doctrine illustrates that K.S.A. § 79-3271(a)(2) creates two independent relationships between the property and the taxpayer and therefore does not create the functional test. The last antecedent doctrine is a canon of statutory construction that states a modifying phrase or clause at the end of a series only modifies the last words or phrases in the end of the series.¹⁶⁷ Additionally, the doctrine depends heavily on the statute’s use of punctuation. Specifically, when a comma is present, the comma is evidence that the modifying phrase applies to all antecedents in the list rather than to only the last antecedent which immediately precedes the modifier.¹⁶⁸

Because the ownership and use relationships in K.S.A. § 79-3271(a)(2) are not dependent on one another, the statute does not create

162. Again, the UDITPA functional test is the language “if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.” UDITPA, *supra* note 4, § 1(a); Welch, *supra* note 10, § 2.

163. See discussion *supra* Section III.A.1.ii.

164. See discussion *supra* Section III.A.1.i.

165. The UDITPA functional test is the language “if the acquisition, management, and disposition of the property *constitute* integral parts of the taxpayer’s regular trade or business operations.” UDITPA, *supra* note 4, § 1(a) (emphasis added); Welch, *supra* note 10, § 2.

166. *Constitute*, MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY (11th ed. 2003).

167. *Barten v. Turkey Creek Watershed Joint Dist.* No. 32, 438 P.2d 732, 744–45 (Kan. 1968) (“In construing statutes, qualifying words, phrases and clauses are ordinarily confined to the last antecedent, or to the words and phrases immediately preceding. The last antecedent...has been regarded as the last word which can be made an antecedent without impairing the meaning of the sentence.”); SCALIA & GARNER, *supra* note 139, at 144–46.

168. *Alvarado v. J.C. Penney Co.*, 735 F. Supp. 371, 374 (D. Kan. 1990) (quoting 2A SUTHERLAND STATUTORY CONSTRUCTION § 47.33).

the functional test. K.S.A. § 79-3271(a)(2) defines business income as “income arising from transactions and activity involving tangible and intangible property or assets used in the operation of the taxpayer’s trade or business.”¹⁶⁹ Here, the modifying phrase is “used in the operation of the taxpayer’s trade or business.” Using the last antecedent doctrine, the modifying phrase only modifies “assets,” and not “transactions and activity involving tangible and intangible property.”

Additionally, the punctuation in the statute indicate the relationships are independent of one another. Specifically, no commas are present throughout any part of K.S.A. § 79-3271(a)(2). Most notably, no commas are present in the phrase “involving tangible and intangible property or assets *used in the operation of the taxpayer’s trade or business.*”¹⁷⁰ Because this part of the definition does not include a comma, the reader can deduce from the last antecedent doctrine that “used in the operation of the taxpayer’s trade or business” only modifies “assets” and not “tangible and intangible property.” Because “used in the operation of the taxpayer’s trade or business” only modifies “assets,” the ownership relationship, which is personified in “arising from transactions and activity involving tangible and intangible property”¹⁷¹ is independent from the use relationship in the following text. Therefore, K.S.A. § 79-3271(a) does not create the functional test by its text.

2. The Argument Against Surplusage

Subsequent case law and legislative history reveal that K.S.A. § 79-3271(a)(2), even if it does not create the functional test, is not surplusage. In statutory interpretation, the rule against surplusage states an interpretation that renders any part of a statute unnecessary should be avoided if reasonably possible.¹⁷² In K.S.A. § 79-3271(a)(2), if the definition does not create the functional test, presumably, it does not serve a purpose in the statute. Using this Comment’s interpretation thus far, K.S.A. § 79-3271(a)(2) is arguably meaningless. Under the rule against

169. KAN. STAT. ANN. § 79-3271(a)(2) (2008).

170. *Id.* (emphasis added).

171. See discussion *supra* Section III.A.1.ii.

172. *Excel Corp. v. Jimenez*, 7 P.3d 1118, 1123 (Kan. 2000); Nina A. Mendelson, *Change, Creation, and Unpredictability in Statutory Interpretation: Interpretive Canon Use in the Roberts Court’s First Decade*, 117 MICH. L. REV. 71, 81 (2018) (“Judges applying the rule against surplusage interpret statutory language to avoid making text redundant or meaningless, essentially assuming that Congress does not enact words without meaningful application, including because their function is duplicated elsewhere.”).

surplusage, because this interpretation renders the second definition meaningless, the statute should be read to create the functional test.

However, this Comment's interpretation is not surplusage because K.S.A. § 79-3271(a)(2) could be read as an extension of the transactional test in K.S.A. § 79-3271(a)(1). K.S.A. § 79-3271(a)(2) could be read to describe more transactions that fall under the transactional test. As noted above, K.S.A. § 79-3271(a) was amended three times after the Kansas Supreme Court's holding in *Western Natural Gas Co.*¹⁷³ The 2008 amendment, in particular, was likely made in response to *In re Frontier Oil Corp.*, in which the Kansas Board of Tax Appeals held installment sale proceeds of an oil refinery, a significant business asset, were not business income under the prior definition of business income.¹⁷⁴ The Kansas Board of Tax Appeals again rejected the functional test in the business income statute.¹⁷⁵ The sale of an oil refinery certainly was not in the regular course of the taxpayer's trade or business and clearly failed the transactional test.¹⁷⁶

While K.S.A. § 79-3271(a)(2) does not create the functional test because it fails to create an integral relationship with the property, the definition, by its plain language, would likely include the sale of the oil refinery in *In re Frontier Oil Corp.* The installment sale of the refinery generates income, fulfilling the clause "income arising from transactions and activity."¹⁷⁷ Additionally, the oil refinery is a physical building used in its oil business, constituting an asset used in the operation of the taxpayer's trade or business. In this sense, the statute creates business income where *In re Frontier Oil Corp.* failed to do so. Under this interpretation, the plain language incorporates an installment sale gain

173. See discussion *supra* Sections II.C.1.i., II.C.2.ii.

174. Jensen, *supra* note 80, at 29, 45.

175. *Id.* at 30. At the time of *In re Frontier Oil Corp.*, K.S.A. § 79-3271(a) was written:

"Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes 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, except that for taxable years commencing after December 31, 1995, a taxpayer may elect that all income constitutes business income. The election shall be effective and irrevocable for the taxable year of the election and the following nine taxable years. The election shall be binding on all members of a unitary group of corporations.

2004 Kan. Sess. Laws (H.B. 2949).

176. See Jensen, *supra* note 80, at 30.

177. KAN. STAT. ANN. § 79-3271(a)(2) (2008).

from an asset in the transactional test that was not captured by the old statute. Because K.S.A. § 79-3271(a)(2) expands the baseline transactional test in the first definition, and from the prior statute, it is not mere surplusage.

In addition to the legislative history and the context of the 2008 amendment, an up-and-coming canon, the “belt-and-suspenders” canon, supports the idea that the additional language in K.S.A. § 79-3271(a)(2) expands the transactional test and is not surplusage. There is growing support among the courts for the belt-and-suspenders canon as a response to the canon against surplusage.¹⁷⁸ The belt-and-suspenders canon “consider[s] the possibility that the relevant legislatures whose work product was at issue wrote their statutes with features that were deliberately duplicative, redundant, and/or reinforcing [C]ourts have recognized that legislatures can draft statutes to be abundantly cautious rather than to be supremely concise.”¹⁷⁹ Under the belt-and-suspenders canon, K.S.A. § 79-3271(a)(2) is not surplusage because the legislature was trying to capture additional transactions in the transactional test listed in K.S.A. § 79-3271(a)(1) in “abundance of caution” after the Kansas Board of Tax Appeal’s holding in *In re Frontier Oil Corp.*

Although this analysis expands the transactional test definition, the statute still does not create the functional test because the text fails to create the relationships between the property and the taxpayer required by the functional test.

B. Legislative History of K.S.A. § 79-3271(a)

The evolution of K.S.A. § 79-3271(a) between 1991 and 2008 supports the textual argument that K.S.A. § 79-3271(a)(2) does not create the functional test. The reenactment canon describes that when the legislature amends a statute, “[i]t is presumed that an amendment is made to effect some purpose, which may be either to alter the operation and effect of earlier provisions or to clarify the meaning thereof.”¹⁸⁰ The

178. See generally Ethan J. Leib & James J. Brudney, *The Belt-and-Suspenders Canon*, 105 IOWA L. REV. 735 (2020).

179. *Id.* at 736–37.

180. *Est. of Soupene v. Lignitz*, 960 P.2d 205, 220 (Kan. 1998) (citation omitted). The Kansas Supreme Court supports and uses the reenactment canon. *Curless v. Bd. of Cnty. Comm’rs*, 419 P.2d 876, 880 (Kan. 1966) (“The historical background and changes made in the statute may be considered by this court in determining legislative intent.”). “The historical background and changes made in a statute are to be considered by the court in determining legislative intent for the purpose of statutory construction, and any changes and additions made in existing legislation raise a presumption that a change in meaning and effect is intended.” *Id.* at Syl. ¶ 2.

following discussion analyzes the evolution of K.S.A. § 79-3271(a) and applies the reenactment canon. Although the amendments were made in reaction to specific holdings, over time, the text has evolved further away from the uniform statute, and further away from the ownership and use relationships. As a result, the legislative history supports the argument that K.S.A. § 79-3271(a)(2) does not create the functional test.

1. The 1996 Amendment: Expansion of the Transactional Test

The first amendment to K.S.A. § 79-3271(a)(2) did not indicate a desire to create the functional test. Before the 1996 amendment, the Kansas statute was identical to the model language promulgated by UDITPA.¹⁸¹ The 1996 amendment is a reaction to *In re Appeal of Chief Industries, Inc.*, which held the statute only implied the transactional test for business income.¹⁸² Because the identical UDITPA language was unchanged by the amendment, that language¹⁸³ still carries the *In re Appeal of Chief Industries, Inc.* interpretation—that the uniform language only creates the transaction test.¹⁸⁴ The added language¹⁸⁵ creates an opt-in provision to an expansion of the transactional test.¹⁸⁶ This language

181. UDITPA, *supra* note 4, § 1(a) (“‘Business income’ means income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes 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.”); 1991 Kan. Sess. Laws Ch. 283 (S.B. 2492).

182. *In re Appeal of Chief Indus., Inc.*, 875 P.2d 278, 285 (Kan. 1994).

183. 1996 Kan. Sess. Laws Ch. 264 (H.B. 2038)

“Business income” means income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes 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, *except that for taxable years commencing after December 31, 1995, a taxpayer may elect that all income derived from the acquisition, management, use or disposition of tangible or intangible property constitutes business income. The election shall be effective and irrevocable for the taxable year of the election and the following nine taxable years. The election shall be binding on all members of a unitary group of corporations.*”

(showing, in italics, the language added by the amendment).

184. *Kirchner v. Kan. Turnpike Auth.*, 336 F.2d 222, 230 (10th Cir. 1964) (“Provisions of the original Act which are repeated in the body of the amendment, either in the same or equivalent words, are considered a continuation of the original law.”).

185. *Supra* note 185 and accompanying text.

186. While this Comment argues the 1996 amendment expanded the transactional test, other academics have briefly concluded the opt-in language created the functional test on an elective basis. Ryan Pace, *A Review of Kansas Tax Law Governing the Allocation and Apportionment of Income for*

does not assertively plant the statute in functional test territory.

In the first amendment, the language of the opt-in provision expands the transactional test in the UDITPA language rather than creating the functional test. The first amendment added language after the UDITPA language that allowed the taxpayer to opt-in to classify all their income “derived from the acquisition, management, use or disposition of tangible or intangible property” as business income.¹⁸⁷ The ordinary meaning of the opt-in language clearly indicated an expansion of the transactional test using the word “derived.” The term “derive” means “to take, receive, or obtain esp[ecially] from a specified source.”¹⁸⁸ This definition indicates the term “derive” creates a relationship between the tangible or intangible property and the taxpayer.

This relationship, however, expands the transactional test rather than stepping fully into the functional test. While the word “derive” represents the first step in the use relationship¹⁸⁹—which is required for the functional test—it fails to link the relationship to the trade or business. The link must be integral to the taxpayer’s regular trade or business.¹⁹⁰ The text of the opt-in language does not include any language that indicates the tangible or intangible property must be integral to the taxpayer’s trade or business. The first amendment in 1996 represents an opt-in-expansion to the transactional test rather than an opt-in to the functional test.

Additionally, the opt-in language indicates the legislature did not intend to import the expansion of the transactional test on all taxpayers. The use of “may” in “the taxpayer may elect” indicates the expanded transactional test is not mandatory for the taxpayer.¹⁹¹ Because the expansion is not mandatory for all taxpayers, the 1996 amendment indicates the legislature wanted to keep the transactional test in place, but provide an option for the taxpayer.

2. The 2003 Amendment: Diverging Further from the Functional Test

The second amendment in 2003 makes the statute even more

Multistate Corporations Doing Business in Kansas, 37 WASHBURN L.J. 703, 710 (1998) (“[T]he 1996 Kansas Legislature creatively side-stepped the court’s ruling by allowing taxpayers to apply the functional test on an elective basis.”).

187. 1996 Kan. Sess. Laws Ch. 264 (H.B. 2038).

188. *Derive*, MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY (11th ed. 2003).

189. See discussion *supra* Section III.A.1.i.

190. See discussion *supra* Section II.D..

191. Clark & Connolly, *supra* note 142 (“Generally, ‘shall’ signifies that certain behavior is mandated by the statute, while ‘may’ grants the agent some discretion.”).

disconnected from the functional test, and it is apparent the closest the statute was to the functional test was in 1996 and 1991. In 2003, the legislature amended the opt-in provision created in the first amendment in 1996 to remove the phrase, “derived from the acquisition, management, use or disposition of tangible or intangible property.”¹⁹² Removing these terms is the first step in K.S.A. § 79-3271(a)’s divergence from generally accepted functional test language. The words acquisition, management, and disposition are imperative to the ownership relationship required by the functional test.¹⁹³ Removing these words in addition to removing “derive” also removes any shadows the statute had of the functional test.¹⁹⁴ The second amendment removed the transactional test expansion from the first amendment and the statute is left with a simple opt-in provision to treat all income as business income. Because the amendment removed any slivers of the use or ownership relationships in the first amendment, K.S.A. § 79-3271(a) drifts further from the functional test; this divergence further demonstrates an intent to only retain the transactional test.

The legislative context in which S.B. 284 was passed also indicates a retraction from the expansion of the transactional test. S.B. 285, the Kansas Certified Capital Formation Company Act, was passed in 2003.¹⁹⁵ The bill’s purpose was to attract venture capital in Kansas and modernize Kansas’ economy.¹⁹⁶ The bill’s purpose provides insight to the removal of the words “acquisition, management, use and disposition.” Both bills, 284 and 285, passed just one year after the California Supreme Court expanded its UDITPA language to a broader functional test.¹⁹⁷ Additionally, the Kansas courts had not ruled on the 1996 amended language and therefore still retained only the transactional test in the eyes of the courts.

192. 2003 Kan. Sess. Laws Ch. 158 (S.B. 284)

[E]xcept that for taxable years commencing after December 31, 1995, a taxpayer may elect that all income ~~derived from the acquisition, management, use or disposition of tangible or intangible property~~ constitutes business income. The election shall be effective and irrevocable for the taxable year of the election and the following nine taxable years. The election shall be binding on all members of a unitary group of corporations.

193. See discussion *supra* Section III.A.1.ii.

194. See *supra* note 187 and accompanying text. Removing the word “derive” removes any relationships between the property and the taxpayer in K.S.A. § 79-3271(a).

195. 2003 Kan. Sess. Laws Ch. 154 (S.B. 285).

196. *Id.*

197. *Supra* notes 110–12 and accompanying text (discussing the terms “acquisition,” “management,” and “disposition”).

To bring more nondomiciliary businesses to Kansas, a narrow view of business income is attractive. These venture capital firms would likely be *passive* investors; their property would not be used in the nature of the trade or business, would fail the transactional test, and be classified as nonbusiness income. Because these firms would generate nonbusiness income in Kansas, they would not have to apportion income to Kansas.¹⁹⁸ Classifying this income as nonbusiness income allows the taxpayer the opportunity to choose their commercial domicile and has the benefit of administrative ease because they would not have to apportion income to Kansas. Because the transactional test as a *sole* test of business income provides for these benefits, removing the words “acquisition, management, use, and disposition” from the definition indicates Kansas does not adopt the functional test—especially after the *Hoechst* holding. In context with S.B. 284, the legislature in 2003 indicated a retraction from the expanded transactional test, providing more evidence the current statute does not create the functional test.

3. The 2008 Amendment: An Unsuccessful Catch-all

In context with the previous two amendments, the third amendment indicates a catch-all attempt to create the functional test but fails to do so. While this Comment has already discussed textually why this amendment fails to create the functional test, what the legislature chose to add to the statute indicates it was not prepared to fully commit to the functional test. This is explicit in the third definition of business income created by the amendment.¹⁹⁹ After K.S.A. § 79-3271(a)(3) brings in a constitutional standard,²⁰⁰ it reads “except that a taxpayer may elect that all income constitutes business income.”²⁰¹ With the “except that” language, the legislature reveals an intent to preserve the opt-in language established with the first amendment in 1996. As discussed with the first amendment, the opt-in language does not place the statute firmly in the functional test.²⁰² Preserving the opt-in language creates a presumption that a receipt

198. KAN. STAT. ANN. § 79-3274 (1984) (“Rents and royalties from real or tangible personal property, capital gains, interest, dividends . . . to the extent that they constitute nonbusiness income, shall be allocated as provided in K.S.A. 79-3275 to 79-3278.”); KAN. STAT. ANN. § 79-3276(c) (1963) (“Capital gains and losses from sales of intangible personal property are allocable to this state *if the taxpayer’s commercial domicile is in this state.*”) (emphasis added).

199. The third definition of business income is referenced by K.S.A. § 79-3271(a)(3).

200. See discussion *infra* notes 216–19 and accompanying text.

201. KAN. STAT. ANN. § 79-3271(a)(3) (2008).

202. See discussion *supra* Section III.B.1.

is not business income. The opt-in language creates a presumption that undermines the legislature's attempt to create the functional test in K.S.A. § 79-3271(a)(3).

Arguably, the legislature's purpose was to create the functional test. Because the legislature amended K.S.A. § 79-3271(a) two out of three times in reaction to cases that only held the statute to include the transactional test, this could indicate an intent to create the functional test. In fact, non-binding documentation²⁰³ that describes the potential effects of the bill stated as such.²⁰⁴ Although the documentation does not establish legislative intent, the documentation does indicate what legislators believed when they went to vote on the bill. However, the text of the statute governs when a statute is ambiguous,²⁰⁵ and this Comment has discussed at length how the text of the statute does not create the functional test.

C. *Pass-Thru Interests and K.S.A. § 79-3271(a)*

Based on the textual analysis of K.S.A. § 79-3271(a)(2) above, the Kansas definition of business income does not create the functional test. Under this analysis, the nonresident entity's gain on a sale of pass-through interest would have to meet the transactional test in K.S.A. § 79-3271(a)(1)²⁰⁶ to be classified as business income in Kansas. Assuming the nature of the nonresident entity's regular trade or business is not that of buying and selling subsidiaries,²⁰⁷ the gain would not be part of the taxpayer's regular course of business and would not pass the transactional test in K.S.A. § 79-3271(a)(1).

The reasoning behind the unitary business principle as well as the

203. The footnote of the committee report states, "Conference committee report briefs are prepared by the Legislative Research Department and do not express legislative intent." *Conference Committee Report Brief Senate Substitute for House Bill No. 2434*, LEGIS. RSCH. DEP'T (2008), <https://www.kansas.gov/government/legislative/supplemental/2008/CCRB2434.pdf> [<https://perma.cc/4MBQ-GP72>].

204. A conference committee report prepared by Legislative Research Department, a nonpartisan agency within the legislature that supports the legislative process, summarized the bill as follows: "New language would provide for greater apportionment of business income, effective in tax year 2008, by authorizing the state to use the functional test." *Id.*

205. See *supra* notes 120–22 and accompanying text.

206. See discussion *supra* Section III.A.

207. In *Noell Industries*, the court discusses the district court's analysis that "the gain arising from a holding company's sale of a subsidiary can qualify as business income [under the transactional test] if the holding company regularly engages in the buying and selling of subsidiaries; however a one-time sale does not qualify." *Noell Indus., Inc., v. Idaho State Tax Comm'n*, 470 P.3d 1176, 1183 (Idaho 2020).

language (or lack thereof) used in K.S.A. § 79-3271(a)(2)–(3) prevents the sale of a pass-through entity interest from being taxed as business income in Kansas. This Comment has discussed in depth that K.S.A. § 79-3271(a)(2) fails to create the functional test. The failure to create the functional test in turn prevents the classification of pass-through interest as business income. States that hold the gain on sale of interest is business income root the analysis in the phrase “disposition of property” in the individual state statutes.²⁰⁸ Their analyses, however, apply the functional test’s requirement that the disposition of property must be integral to the taxpayer’s trade or business.

As discussed, K.S.A. § 79-3271(a)(2) lacks any semblance of the phrase “acquisition, management, and disposition of property.”²⁰⁹ To classify the gain on sale of pass-through interest as business income, “transactions and activity” needs to convey “disposition.” The dictionary definitions of “disposition” are “the act or the power of disposing,” “transfer to the care or possession of another,” and “the power of such transferal.”²¹⁰ Based on the dictionary definitions alone, the ordinary meaning of “disposition” requires control over the property. Additionally, the California Supreme Court in *Hoechst* defined disposition as the “transfer, or . . . power to transfer”²¹¹ property. As discussed in the analysis of the functional test, K.S.A. § 79-3271(a)(2) lacks any semblance of the control or ownership.²¹² While a disposition is certainly a transaction,²¹³ a transaction does not convey the element of control required by a disposition. The ordinary meaning of K.S.A. § 79-3271(a)(2) does not classify such a disposition as business income.

Even if the ordinary meaning argument discussed above does not convince a court that a disposition is not captured by K.S.A. § 79-3271(a)(2), the unitary business principle in conjunction with the statute says otherwise. By its text, K.S.A. § 79-3271(a)(3) adopts the unitary business principle.²¹⁴ Applying the unitary business income standard to

208. See, e.g., *Blue Bell Creameries, LP v. Roberts*, 333 S.W.3d 59, 66 (Tenn. 2011) (“[T]he determinative issue of the functional test is not whether the disposition of the property is an integral part of the taxpayer’s regular trade or business operations but whether the property being disposed of constitutes an integral part of the taxpayer’s regular business.”).

209. See discussion *supra* Section III.A.1.ii.

210. *Disposition*, MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY (11th ed. 2003).

211. *Hoechst Celanese Corp. v. Franchise Tax Bd.*, 22 P.3d 324, 338 (Cal. 2001).

212. See discussion *supra* Section III.A.1.ii.

213. See discussion *supra* Section III.A.1.ii.

214. KAN. STAT. ANN. § 79-3271(a)(3) (2008) (“income of the taxpayer that may be apportioned to this state under the provisions of the Constitution of the United States and laws thereof”).

pass-through interests, “the investor and investee must be engaged in a unitary business or the ownership interest in the pass-through entity must be part of the owner’s unitary business, which is demonstrated by its serving an operational function in the owner’s business.”²¹⁵

The unitary business requirement echoes the idea from the functional test that the asset at issue must serve an essential purpose in the investee’s regular trade or business. *MeadWestvaco* discussed the unitary business principle and held that it applies to situations where the asset is an intangible.²¹⁶ Bringing in the unitary business principle’s three “hallmarks” of a unitary relationship implies the integral relationship imported by the functional test. The three hallmarks of a unitary relationship are functional integration, centralized management, and economies of scale.²¹⁷ To be unitary, the investor’s interest must be integral to the three hallmarks of a unitary relationship. Each hallmark relates to the operations of the trade or business because each hallmark relates to the necessary requirements of a business. An interest in a pass-through entity, unless that investor has a say in the operations of management, is likely not integral to the business and would not be unitary under the unitary business principle. Under the unitary business principle, the asset must be essential to the business. K.S.A. § 79-3271(a)(3) imports the unitary business principle into the statute, but because pass-through interests in most cases are not essential to the business, they are not unitary and are not business income under K.S.A. § 79-3271(a).

215. Fenwick, McLoughlin, Salmon, Smith, Tilley & Wood, *supra* note 6, § 9.01.

216. Jordan M. Goodman, *U.S. Supreme Court Rejects Application of Operational Function Test in the Sale of a Division*, 18-SEP J. MULTISTATE TAX’N & INCENTIVES 46, 48 (2008) (“[I]n *MeadWestvaco* the Court reaffirmed that apportionability turns on the unitary business principle. . . . [W]hether it is a short-term bank deposit, a futures contract, or another business—will produce apportionable income as long as that asset is unitary with the taxpayer’s business.”). *MeadWestvaco* also holds that the operational function test is part of the hallmarks of unity, rather than its own independent test. *MeadWestvaco Corp. ex rel. Mead Corp. v. Ill. Dep’t of Revenue*, 553 U.S. 16, 29 (2008).

As the foregoing history confirms, our references to “operational function” . . . were not intended to modify the unitary business principle by adding a new ground for apportionment. The concept of operational function simply recognizes that an asset can be part of a taxpayer’s unitary business even if . . . a “unitary relationship” does not exist between the “payor and payee.”

(citations omitted).

217. *MeadWestvaco Corp.*, 553 U.S. at 30 (citing *Mobil Oil Corp. v. Comm’r of Taxes of Vt.*, 445 U.S. 425, 438 (1980)).

IV. CONCLUSION

In conclusion, the current version of K.S.A. § 79-3271(a) does not support the functional test of business income. The functional test requires the presence of two relationships: the use relationship and the ownership relationship. The statute's use of the word "used" fails to create the requisite use relationship because it does not rise to the level of "integral" while the phrase "arising from transactions and activity involving tangible and intangible property" fails to imply the control and conditions of ownership required by the ownership relationship. Additionally, the legislative history and statutory evolution proves the Kansas Legislature never intended to firmly plant K.S.A. § 79-3271(a) in functional test territory. Finally, applying K.S.A. § 79-3271(a) to a gain from sale of a nondomiciliary taxpayer's interest in a pass-through entity fails to create business income. Overall, K.S.A. § 79-3271(a) fails to create the functional test, which in turn fails to classify the gain from sale of a pass-through entity as business income in Kansas.