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November 2, 2012

ATTORNEY GENERAL OPINION NO. 2012-27

The Honorable Jean Schodorf
State Senator, 25th District
3039 Benjamin Ct.
Wichita, KS 67204

Re: Constitution of the United States—Amendments to the U.S. Constitution—
Due Process of Law; Retroactive Tax Legislation

Taxation—Income Tax—Kansas Adjusted Gross Income of an Individual;
Tax Basis of a Partner's Interest in a Partnership

Synopsis: Retroactive tax legislation proposed during the 2013 legislative session and affecting tax year 2013 is constitutional if the legislation is justified by a rational legislative purpose. The non-wage business income tax exemption provisions of Senate Substitute for House Bill 2117, passed during the 2012 legislative session, can be implemented in their current form. Cited herein: K.S.A. 2011 Supp. 79-32,117; U.S. Const., Amend. 5.

* * *

Dear Senator Schodorf:

You ask for our opinion on three questions regarding Senate Substitute for House Bill 2117¹ (S Sub HB 2117), passed during the 2012 legislative session, which amends various tax statutes. In your letter, you state that questions have been raised regarding certain provisions of the bill, and whether the bill can be implemented on January 1, 2013, its effective date. Specifically, you state that the bill is silent on how the gain or loss on a sale of full or partial ownership of a business will be treated in determining the tax basis. You further state that there has been some discussion about further

¹ L. 2012, Ch. 135.

amending tax statutes for the 2013 tax year during the 2013 legislative session, which has raised questions regarding the constitutionality of retroactive tax legislation.

We will address your specific questions in order.

1. *Could passing legislation to define the tax basis for the sale of business interests or shares during the 2013 legislative session result in an unconstitutional retroactive tax increase?*

In your letter, you specifically question whether S Sub HB 2117 adequately defines the tax basis of partnership interests. The tax basis of an asset determines how much tax a person will owe if the asset is sold. If the sale price of an asset exceeds its tax basis, the taxpayer is taxed on the gain from the sale. If the sale price of an asset is less than its tax basis, the loss on the sale is tax-deductible.

Your question relates to section 37(a) of S Sub HB 2117, which reads as follows:

For Kansas income tax purposes: (1) The basis of a partner's interest in a partnership formed prior to January 1, 2013, shall be determined by computing the basis as of January 1, 2013, in accordance with section 705² of the federal internal revenue code as in effect on January 1, 2013, and amendments thereto, and making any subsequent adjustments to the partner's interest as provided in section 733³ of the federal internal revenue code as in effect on January 1, 2013, and amendments thereto.

(2) The basis of a partner's interest in a partnership formed on or after January 1, 2013, shall be determined by computing the basis as of the date of formation of the partnership in accordance with section 705 of the federal internal revenue code as in effect on January 1, 2013, and amendments thereto, and making any subsequent adjustments to the partners' interest as provided in section 733 of the federal internal revenue code as in effect on January 1, 2013, and amendments thereto.⁴

Section 37(b) of S Sub HB 2117 defines the tax basis for S corporations in a similar fashion.⁵ Thus, the following analysis applies to the bill's definition of the tax basis for both partnerships and S corporations.

² 26 U.S.C. § 705.

³ 26 U.S.C. § 733.

⁴ Footnotes added.

⁵ Section 37(b) of S Sub HB 2117 states that the basis of each shareholder's stock and indebtedness in an S corporation shall be computed in accordance with section 1367 of the federal internal revenue code as in effect on January 1, 2013, and amendments thereto. Any subsequent adjustments to the shareholder's stock and indebtedness shall be made in accordance with section 1367(a)(2)(A) of the federal internal revenue code as in effect on January 1, 2013, and amendments thereto.

We note at the outset that this section 37(a) of the bill *does* provide a definition of the tax basis for a sale of a partnership interest: the basis of such interest as of January 1, 2013, with subsequent adjustments in accordance with Internal Revenue Code § 733. That section of the Internal Revenue Code provides that the basis of a partner's interest shall be decreased by the amount of money or property distributed to such partner.⁶ Section 37(a) limits adjustments to a partner's basis to those provided in Internal Revenue Code § 733, and thus does not include provisions by which to *increase* the tax basis of a partner's interest in a partnership if the partner contributes additional assets to the partnership or assumes more partnership liability.

The Kansas Department of Revenue (KDOR) advises us that any legislation proposed during the 2013 legislative session to amend S Sub HB 2117 would likely *decrease* affected taxpayers' tax liability, not increase it.⁷ However, for the reasons discussed below, we believe that any such legislation would be constitutional, even if the legislation resulted in increased income tax liability.

2. *Would eliminating tax credits and exemptions on 2013 taxes, or adjusting 2013 Kansas income tax rates upward during the 2013 legislature be an unconstitutional retroactive tax increase?*

The United States Supreme Court addressed the issue of retroactive tax increases in *United States v. Carlton*.⁸ In *Carlton*, the executor of an estate filed a refund action after the IRS disallowed a deduction claimed on the decedent's estate tax return, which was filed in December 1986, based on retroactive legislation passed in December 1987. The executor in *Carlton* argued that the 1987 legislation's retroactivity provision violated the due process clause of the Fifth Amendment of the United States Constitution, which states in relevant part: "nor shall any person . . . be deprived of life, liberty, or property, without due process of law"⁹ The crux of the executor's due process argument was that he had no notice that § 2057 would be retroactively amended, and that he had specifically and detrimentally relied on the pre-amendment version of § 2057.¹⁰

The Court stated that "the due process standard to be applied to tax statutes with retroactive effect . . . is the same as that generally applicable to retroactive economic legislation."¹¹ A retroactive tax statute's due process burden "is met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose."¹² Applying this standard, the Court found that the 1987 amendment was designed to cure a mistake in the 1986 provision that would have resulted in unanticipated revenue loss, and therefore was neither illegitimate nor arbitrary.¹³ The

⁶ 26 U.S.C. § 733.

⁷ Richard Cram, Director of Policy & Research, Kansas Department of Revenue, Correspondence, September 27, 2012.

⁸ 512 U.S. 26 (1994).

⁹ U.S. Const., Am. 5.

¹⁰ 512 U.S. at 33-34.

¹¹ *Id.* at 30.

¹² *Id.* at 31 (quoting *Pension Benefit Guar. Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 729-30 (1984)).

¹³ *Id.* at 30.

Court also found that Congress acted rationally and promptly to cure the mistake in the 1986 provision, creating only a brief retroactivity period. Thus, the retroactivity period was not “so harsh and oppressive as to transgress the constitutional limitation.”¹⁴ Finally, the Court noted that neither the executor’s detrimental reliance on the 1986 version of § 2057 nor his lack of notice of retroactive legislation were sufficient to establish a due process violation.¹⁵ Accordingly, the Court held that the 1987 amendment’s retroactive application to the 1986 estate tax return did not violate due process because Congress reasonably acted to correct a mistake in the original provision.¹⁶

We assume that any constitutional challenge to curative legislation proposed in 2013 and affecting the 2013 tax year would be based upon the due process arguments advanced unsuccessfully in *Carlton*, namely, that the affected taxpayers lacked notice of retroactive legislation and that such taxpayers relied to their detriment on the language of S Sub HB 2117 as passed in 2012. In our opinion, those arguments would fail for the reasons outlined in *Carlton*. A legislative proposal during the 2013 session to amend the provisions of S Sub HB 2117 would likely be curative in nature and therefore serve a legitimate legislative purpose. Such proposed legislation, if passed, would create a limited retroactivity period that is neither harsh nor oppressive, and thus would not violate due process.¹⁷

3. *Is the absence of detail on the tax basis for the sale of business interests or shares a significant enough defect such that the provisions of S Sub HB 2117 that exempt non-wage business income from taxation cannot be implemented?*

The answer to this question is no. As background, we have been advised by KDOR that some tax professionals have questioned whether the partnership interest tax basis definition in section 37(a) of S Sub HB 2117 may result in the taxation of some partnership income intended to be excluded from Kansas income tax.¹⁸

This question concerns the effect of the partnership interest tax basis definition in section 37(a) of S Sub HB 2117 on section 12(c)(xx) of the bill.¹⁹ Section 12(c)(xx) states in relevant part that “net income . . . from . . . partnerships . . . as determined under the federal revenue code and reported on schedule E . . .” shall be excluded when calculating Kansas adjusted gross income. The question is whether income from

¹⁴ *Id.* (quoting *Welch v. Henry*, 305 U.S. 134, 147 (1938)).

¹⁵ *Id.* at 33-34.

¹⁶ *Id.* at 26.

¹⁷ *But see id.* at 38 (O’Connor, J., concurring) (“A period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise, in my view, serious constitutional questions.”); *id.* at 39-41 (Scalia, J., concurring) (“Retroactively disallowing the tax benefit that the earlier law offered, without compensating those who incurred expenses in accepting that offer, seems to me harsh and oppressive by any normal measure.”).

¹⁸ Richard Cram, Director of Policy & Research, Kansas Department of Revenue, Correspondence, September 27, 2012.

¹⁹ L. 2012, Ch. 135, Sec. 12(c)(xx), which amends K.S.A. 2011 Supp. 79-32,117.

the sale or liquidation of a partnership interest is intended to be excluded from state income tax.

Under the statutory scheme of S Sub HB 2117, if a partner sells her partnership interest, that partner's tax basis will be reduced by her income distributions, which include the net profit on the sale. If the sale price exceeds the partner's basis, then the amount in excess of the basis is taxable as gain income. It appears that this effect was intentional because section 12(c)(xx) of S Sub HB 2117 only allows income reported on IRS Schedule E to be excluded from Kansas adjusted gross income, and gains resulting from the sale of a partnership interest in excess of the partner's basis are not reported on Schedule E.

Section 37(a) of S Sub HB 2117 defines the tax basis for a partner's interest in a partnership as the basis as of January 1, 2013, computed in accordance with Internal Revenue Code § 705, with subsequent adjustments to the basis made in accordance with Internal Revenue Code § 733. Such definition may exclude other means of increasing or decreasing the tax basis of a partnership, but it does not lack sufficient detail to determine a partner's tax basis. Thus, the language of S Sub HB 2117 is sufficient to implement non-wage business income tax exemptions.

Conclusion

The *Carlton* court noted that “[t]ax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code.”²⁰ In our opinion, the Court's analysis in *Carlton* is applicable to any legislation passed during the 2013 legislative session that is made retroactive to January 1, 2013.

Sincerely,

Derek Schmidt
Kansas Attorney General

Sarah Fertig
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²⁰ 512 U.S. at 33.