Report of the Special Committee on Taxation to the 2016 Kansas Legislature

CHAIRPERSON: Senator Ty Masterson

VICE-CHAIRPERSON: Representative Marvin Kleeb

OTHER MEMBERS: Senators Steven Abrams, Tom Holland, Julia Lynn, Jeff Melcher, and Greg Smith; Representatives Ken Corbet, Mark Hutton, Jerry Lunn, Marc Rhoades, Tom Sawyer, Kathy Wolfe Moore; and (substitute members) Steve Brunk and Steven Johnson.

STUDY TOPIC

- Review the policy, rationale, and justification for all exemptions and credits within the state's tax code; and establishing a potential time table to sunset many of those provisions.

2015 Special Committee on Taxation

Report

Conclusions and Recommendations

As Kansas transitions its tax policy from one that taxes income and production to one that taxes sales and use, as a means to tax consumption, the Committee finds it necessary for exemptions and credits to be evaluated. An evaluation and sunset process must be conducted by the standing taxation committees of the Senate and House.

The Committee recommends the standing tax committees develop a continual process to evaluate exemptions and credits, which would employ measurable goals and standards, and implement a sunset schedule for current and future tax exemptions, excluding those that are legally required, applicable to governmental entities, or which otherwise result in double taxation if repealed.

Proposed Legislation: None.

Background

The Legislative Coordinating Council (LCC) established the Special Committee on Taxation to review the policy, rationale, and justification for all exemptions and credits within the state's tax code; and to establish a potential timetable to sunset many of those provisions.

Committee Activities

The Committee met on November 5 and 6 and December 9, 2015.

History of Sales Taxation in Kansas

During the two-day meeting in November, Committee staff from the Legislative Research Department presented an overview of sales taxation in Kansas, which included the history of enactment, Depression-era concerns regarding equity, food tax issues, rates and tax base, exemptions, revenue elasticity, and selected information from a 1991 Interim study and a 2006 study from the Kansas Advisory Council on Intergovernmental Relations. Information about the sales tax rates and food exemptions for all 50 states was provided to the Committee.

Legal Issues Involving Sales Tax and Statutory Construction

Committee staff from the Office of Revisor of Statutes explained the legal issues involved with the sales tax. States are prohibited by the Commerce Clause of the *U.S. Constitution* and federal law from taxing the federal government or any of its instrumentalities. This includes the purchases made either directly by the federal government or by certain other entities on its behalf.

Kansas institutes a sales tax on the sale of all tangible personal property at retail, unless there there is a specific exemption listed in statute. The majority of these exemptions are located at KSA 2015 Supp. 79-3606. The taxation of services is treated differently, however. There is no general statute which taxes all services. Pursuant to KSA 2015 Supp. 79-3603, services are taxable only if the service is specifically listed in statute. Therefore, services do not have equivalent sales tax exemptions.

Legislative Audits Concerning Tax Exemptions and Credits

Staff from the Legislative Division of Post Audit (LPA) reviewed past audits concerning sales tax exemptions and tax credits. Part II of the 2010 audit evaluated whether Kansas has any sales tax exemptions that should be considered for elimination. Kansas had 99 sales tax exemptions at the time the audit was conducted, which cost the State an estimated $4.5 billion in FY 2011. These exemptions generally fell into three broad categories.

- **Exemptions required by federal law.** Six exemptions are required by federal law relating to interstate commerce or to purchases made under certain federal programs. These exemptions accounted for an estimated $33.6 million (less than 1 percent) in foregone tax revenues in 2011;

- **Exemptions needed to avoid double taxation or taxing governmental entities.** The reviewed tax policy literature generally concluded that such exemptions are necessary even if they are not required. Altogether, 21 of the 99 sales tax exemptions fit this category. These exemptions accounted for an estimated $3.7 billion (81 percent) of the sales tax revenue the State gave up in 2011; and

- **Exemptions enacted as a matter of public policy.** These exemptions cover a variety of entities or type of sale or activity. Together, they account for an estimated $835 million (18 percent) in foregone revenues in 2011. These exemptions included agricultural, business, consumer, charitable, religious, and benevolent exemptions, as well as exemptions for services, educational entities, and healthcare-related exemptions.

Within the last category, sales tax exemptions provide unequal treatment for similar types of taxpayers. The audit concluded the Legislature should review the following sales tax exemptions to determine what changes, if any, should be made: exemptions for specifically named organizations or narrowly defined activities; the exemption for coin-operated laundries; and exemptions for not-for-profit entities, but not their for-profit counterparts.

Kansas provides exemptions for some not-for-profit organizations, but not all of them. Kansas had 18,200 entities registered under section 501 (c) of the Internal Revenue Service (IRS) Code in 2008. Current exemptions only partially cover charitable and educational organizations. Thirteen exemptions account for approximately 96 percent of the total cost of sales tax exemptions to the State. Recently, exemptions have been added to exempt "purchases made on behalf of" and "sales by" many entities. Regardless of the merits of granting exemptions to these entities, the practice reduces the control over whether the purchase is related to an organization's purpose and could lead to abuse.

LPA staff next presented the findings from part I of the 2010 audit, which evaluated the effectiveness of tax credits. At the time of the audit, Kansas had 47 tax credits and 2 tax refund programs, costing nearly $670 million in foregone revenues in 2007. The report recommended various tax credits for modification or repeal.

The 2010 audit concluded there are a number of legitimate reasons for allowing certain entities or transactions not to be taxed. However, the increased number of tax credits and exemptions has significantly reduced the State's possible tax revenues. Kansas lacks a strong system for reviewing and evaluating tax credits.

Earned Income Tax Credit—Temporary Assistance for Needy Families Maintenance of Effort

Staff from the Legislative Research Department explained the Earned Income Tax Credit and Temporary Assistance for Needy Families. States receive block grants and then design and operate individual programs to accomplish the program's goals. Currently, Kansas receives $102 million from the federal government. In order to receive the block grant, Kansas must spend a specified minimum amount of state funds, known as a maintenance of effort. The maintenance of effort for Kansas is $65.9 million annually. If a state fails to meet its maintenance of effort, the federal government assesses a penalty equal to the shortfall; the state would be required to increase spending back to the threshold level as well as pay the penalty. If the state did not meet the requirements, there would be additional penalties of up to 2 percent of the total block grant in subsequent years.

Review of Tax Exemptions and Credits

Staff from the Kansas Department of Revenue (KDOR) reviewed tax exemptions and credits. The sales tax was first enacted in Kansas in 1937 at the rate of 2 percent. Currently, 45 states plus the District of Columbia have enacted a sales tax. Nationwide, sales tax is estimated to provide approximately a third of total state tax collections. Sales tax is imposed on the gross receipts received from the retail sale of tangible personal property or certain taxable services. Use tax is imposed on the use, storage, or consumption of tangible personal property in the state. It applies to goods purchased outside the state. The use tax complements the sales tax. It was developed to safeguard sales tax revenues from erosion by purchases of goods outside the state, and to protect local merchants from loss of business to border and other states that either have no sales tax or whose sales tax rate is lower than that of the merchants' state. Counties and cities have had the option of imposing local sales taxes since the 1970s. Local use taxes have existed since 2003. The city sales tax cannot exceed 2 percent for general purposes and 1 percent for special purposes. The countywide sales tax cannot exceed 1 percent.

For FY 2015, the value of all sales tax exemptions totaled $6.507 billion. The top 14 sales tax exemptions totaled 96.5 percent of the total value of all exemptions.

States that have expanded their sales tax base on services generally have looked at categories such as cloud computing, digital downloading of photographs and video, and information software services.

KDOR staff next reviewed tax credits claimed in Tax Year 2012, which showed $57 million were claimed. There are $600 million in accumulated income tax credits due to the High Performance Incentive Program (HPIP), which are nonrefundable, meaning a taxpayer must generate tax liability sufficient to use the tax credit. The total number of HPIP filers (198) is a small percentage of the approximate 35,000 corporate taxpayers.

Bioscience Initiative

KDOR staff briefed the Committee on the Kansas Economic Growth Act, an initiative created by the 2004 Legislature to foster the growth of bioscience and to make the state a national leader in the industry. Bioscience is defined as the use of compositions, methods, and organisms in cellular and molecular research; development; manufacturing processes for such diverse areas as pharmaceuticals, medical therapeutics, medical diagnostics, medical devices, medical instruments, biochemistry, microbiology, veterinary medicine, plant biology, agriculture, industrial, environmental, homeland security applications of bioscience; and future developments in the areas mentioned above. Bioscience also includes biotechnology and life sciences. The initiative is funded by 95 percent of the Kansas withholding taxes in excess of 95 percent of the base year taxation (2003) from all bioscience companies and employees employed by state universities associated with bioscience research. Data were provided concerning bioscience distributions and the number of Kansas bioscience companies and employees.

The Legislature appropriated bioscience funds for specific projects in some cases, such as the $5 million for orthopedic research at Wichita State University.

Special Tax Districts

KDOR staff briefed the Committee on several types of special tax districts.

Community Improvement Districts. The Community Improvement District (CID) Act, enacted in 2009, provides authority to municipalities to set up local districts in which a CID tax is imposed on the sales by retail businesses located within those districts. The revenue is used to pay for the commercial development, certain business operations, or redevelopment projects in the district. A municipality may create a CID when petitioned by owners of 55 percent of the land within the boundaries of the proposed district. The petition is subject to a public hearing, and the municipality's governing body may create the district by ordinance or resolution, including the levy of the local sales tax to finance the project. The total number of CIDs has grown to 74 and will continue to grow, as this program is very popular with municipalities and developers. In FY 2015, the KDOR distributed $3.63 million in CID sales taxes.

Transportation Development District. The Transportation Development District (TDD) Act, enacted in 2003, provides authority to municipalities to establish TDDs for the purpose of financing transportation infrastructure improvements with up to 1 percent local sales tax imposed on retail sales occurring within that district, in connection with a commercial development or redevelopment project.

Sales Tax and Revenue Bonds. The Sales Tax and Revenue (STAR) Bond Financing Act provides authority to cities and counties, for certain development or redevelopment purposes, to acquire property and issue STAR bonds for financing an approved project. The city or county establishes a STAR bond project district. If the project is approved by the Secretary of Commerce, the city or county may issue STAR bonds, which are financed by the tax increment revenue from both state and local sales taxes generated by retail businesses located within the STAR bond project district.

The Committee received a list of the current CIDs, TDDs and STAR bond districts in place, along with the dates those districts were established, and amount of sales tax revenue distributed in FY 2015 per district.

Tax Increment Financing. Tax increment financing (TIF) is a tool that enables governments to fund infrastructure, land acquisition, and other public investments in private redevelopment projects within eligible redevelopment districts. It allows the financing of development costs with borrowing at generally lower interest rates. Kansas statutes permit only cities to create redevelopment districts. Cities must conduct public hearings and adopt ordinances with descriptions of proposed redevelopment districts. In most cases, TIF uses the increased property taxes generated by real estate development within a TIF district to pay for certain eligible costs associated with the development.

Selected Economic Development Programs

A deputy secretary of Commerce explained the Promoting Employment Across Kansas (PEAK) Program, HPIP, and the Job Creation Fund (JCF). PEAK encourages companies to relocate, locate, or expand business operations in Kansas. Participating companies may retain 95 percent of the payroll withholding tax of PEAK-eligible jobs for a period of 5 to 10 years. HPIP provides tax incentives to employers that pay above-average wages and have a strong commitment to skills development for their workers. According to the Department of Commerce, this program recognizes the need for Kansas companies to remain competitive and encourages capital investment in facilities, technology, and continued employee training and education. The JCF primarily helps attract new companies to Kansas, but it also may be used to entice Kansas companies to remain or expand in the state. Payments to companies from the JCF are typically made over three years as the companies meet certain benchmarks, such as creating jobs and making capital investments.

During the past three fiscal years, the Department has completed more than 500 successful projects that will result in more than 28,452 new jobs, $2.5 billion in payroll increases, and $4.12 billion in capital investment. Information was provided illustrating successful recruitment projects by type and industry in 2014 and 2015. Last year, LPA concluded its review of Kansas incentive programs. The performance audit found that the State's economic development programs generate excellent return on investment, including $57.00 of economic activity generated by every dollar of foregone revenue through PEAK and $56.20 for every dollar awarded through HPIP.

Tax and Economic Trends

The Secretary of Revenue remarked on tax trends for the State. The corporate tax stream is always volatile. There was an unanticipated $13.7 million refund in September, and there has been approximately $20 million of unanticipated refunds for the year. For seven of the past ten months, there has been an increase in the level of individual income tax receipts. Unemployment is down to 4.4 percent. According to the Department of Labor, well over 50 percent of those leaving the work force are retiring. Many areas of the state are now reporting a lack of people to fill jobs. Sales tax revenues are down; however, the situation is not unique to Kansas. There is an overall concern about the economy, as consumers are paying off debt and increasing their level of savings. Online sales have increased significantly. Healthcare insurance premiums are increasing by as much as 50 percent.

Kansas data match the trends found by the National Retail Federation and the U.S. Census Bureau. A new migration report from the IRS shows significant in-migration from Missouri in 2013. There were 10,402 returns from the net migration, with an average income increase of approximately $27,000.

Johnson and Wyandotte counties have experienced the largest in-migration. KDOR estimates approximately $600 million shifted from Missouri to Kansas in 2013, and the persons coming into the state were making on average approximately $27,000 more than those persons leaving Kansas for Missouri. The flow of jobs out of the state is about equal to the number coming to Kansas; however, the inflowing jobs pay more than those leaving the state.

In 2013, there were 8,666 new small business tax filers in Kansas, bringing $468.7 million of new income to the state. Johnson, Wyandotte, and Sedgwick counties have benefited the most from the new tax policy. The average net income of those new small businesses was less than $25,000. Since 2011, 76,111 new private sector jobs have been created in Kansas.

Past Audits Concerning Economic Development

LPA staff provided an overview of part I and part III of the Performance Audit Reports titled "Economic Development: Determining Which Economic Development Tools are Most Important and Effective in Promoting Job Creation and Economic Growth." Part I answered what economic benefits have been realized as a result of PEAK and HPIP and whether the Department of Commerce adequately enforces performance clauses for incentive programs. Part III analyzed whether the implementation of major Kansas economic development programs has been successful.

Tax Issues Related to Agriculture

An assistant secretary for the Department of Agriculture provided an overview of each of the major sales tax exemptions in the agricultural industry, the estimated impact of each on profitability, and sales taxes paid by agricultural producers.

According to data from the U.S. Department of Agriculture and the Bureau of Economic Analysis, the farm-gate value, meaning the value of unprocessed crops and livestock, produced in Kansas in 2014 was approximately $17.5 billion. Given Kansas' gross regional product of $146 billion, this figure implies that agriculture contributes 12 percent to the economy. However, this number encompasses only the farm value. Additional industries are present in the state that support agricultural production or add value to the commodities. For example, sectors such as meat processing, flour milling, and ethanol production are considered manufacturing, not agriculture. If the 66 sectors (out of 532) directly related to agriculture are taken into account, then the output is $46 billion (32 percent) of the economy, contributing a total of $63 billion (43 percent) of the economy when accounting for all impacts.

Tax Issues Related to Insurance

The Director of Governmental Affairs for the Kansas Insurance Department explained insurance-related tax issues. Insurance premiums currently are taxed at 2 percent. The taxes on insurance premiums raise substantial revenue for the State. As premiums have increased, revenue has increased. Prior to 1997, the premiums collected by domestic insurance companies were taxed at a lower 1 percent rate, resulting in a pricing advantage for Kansas companies and the consumers who purchased policies through these companies. However, a 1985 U.S. Supreme Court case, *Metropolitan Life Insurance Co. v. Ward*, declared this type of disparate tax treatment was unconstitutional. The 1997 Legislature was faced with the task of equalizing this tax policy by either increasing the premium tax on policies sold by domestic companies, or reducing the premium tax on policies sold by non-domestic companies. The Legislature chose to increase the premium tax to a uniform 2 percent but to allow companies to offset a portion of the premium tax based on salaries paid to Kansas employees. This resulted in thousands of jobs being maintained in or moved to Kansas.

According to the conferee, the Insurance Commissioner works to assure that Kansas citizens have numerous choices available when purchasing insurance products. A key component to reaching this goal is a tax policy that brings insurance companies to Kansas, creates jobs, and encourages the development of new insurance products. The salary premium tax credit is a sensible policy that continues to yield excellent results.

Public Testimony on Tax Credits and Exemptions

Several dozen conferees explained how property, sales, and income tax exemptions and credits affect the lives and operations of various individuals and stakeholders.

Additional Information

At the December meeting, staff from the Department of Revenue provided the Committee with information it requested concerning other states' processes for periodic reviews of exemptions and tax credits. Information came from Arizona, California, Illinois, Indiana, Iowa, Massachusetts, Michigan, Minnesota, Nebraska, New Mexico, Ohio, Oklahoma, Oregon, South Dakota, Washington, West Virginia, and Wisconsin. Several states require tax expenditure reports, which KDOR does annually.

Two new Oklahoma laws were highlighted. The Incentive Evaluation Act (62 O.S. SS 7001-7005) creates a commission to evaluate tax expenditures at least once every four years. The Act, which went into effect on November 1, 2015, establishes evaluation criteria and provides a timeline for implementation. Second, under 46A O.S. S 62, any economic incentive provision enacted after January 1, 2016, is required to include measurable goals. "Incentive" is defined as any provision available to a business entity in the form of a credit, exemption, deduction, or rebate pertaining to a state tax liability of any kind; any grant, loan or financing program offered by the state or a state-beneficiary public trust; or any program for incentive payments from the state.

KDOR staff also provided the Committee with other requested information pertaining to corporate income taxes, sales tax exemptions, and bioscience companies.

Conclusions and Recommendations

As Kansas transitions its tax policy from one that taxes income and production to one that taxes sales and use, as a means to tax consumption, the Committee finds it necessary for exemptions and credits to be evaluated. However, the Committee recognizes that not all exemptions and credits are created equal. Those that are legally required or which would have an adverse effect on the growth of the Kansas economy if repealed should remain. All other tax expenditures must be scrutinized to determine whether they are likely candidates for sunset.

An evaluation and sunset process must be conducted by the standing taxation committees of the Senate and House because those committees have the most legislative expertise in identifying the various interacting consequences of tax policy.

The Committee recommends the standing tax committees develop a continual process to evaluate exemptions and credits, which should employ measurable goals and standards, and implement a sunset schedule for all current and future credits and exemptions, excluding those that are legally required, applicable to governmental entities, or which otherwise would result in double taxation if repealed.