

Approved January 21, 1987
Date

MINUTES OF THE Senate COMMITTEE ON Assessment and Taxation

The meeting was called to order by Senator Fred A. Kerr at
Chairperson

11:00 a.m. ~~8:30~~ on Wednesday, January 14, 1987 in room 519-S of the Capitol.

All members were present except:

Senator Leroy Hayden (excused)

Committee staff present:

Don Hayward, Revisor's Office

Chris Courtwright, Research

Tom Severn, Research

Sue Pettet, Secretary to the Committee

Conferees appearing before the committee:

Senator Dave Kerr

Shelby Smith, Secretary of Human Resources

Dr. Chuck Krider, Kansas University

Chairman Fred Kerr called the meeting to order and introduced Chris Courtwright of the Research Department and Sue Pettet, Committee Secretary. Both will be serving the Committee for the first time in 1987. Senator Salisbury introduced her intern, Brett Barry.

Chairman Kerr said that the agenda for the meeting is to brief committee members on the recommendations of the 1986 Economic Development Task Force on Capital Markets and Taxation which pertain to taxes. He said that Senator Dave Kerr, Chairman of the 1986 task force, Shelby Smith, member of the task force, and Chuck Krider, resource person for the task force, would present the briefing.

Senator Dave Kerr gave a synopsis of what the task force had researched. (See Attachment 1). He said that neither KTEC nor the Kansas Venture capital Company Act address local seed capital needs. He said that amendments to statutes should be considered so that seed capital formation would be encouraged. He said that the task force had further recommended that the tax credit for investing in Kansas Venture capital Company stock should be made universal. That is, an amendment should be passed so that if an entity has no Kansas income tax liability that it should be allowed to sell its credit to Kansas taxpayers. He said this would encourage Kansas investment.

Senator D. Kerr said that four prominent experts were consulted regarding taxation in general and the Kansas tax structure in particular. All of the experts agreed that businesses are not especially influenced on where to locate by being provided tax incentives, when on the other hand, the state's tax structure should be competitive. He said that one of the goals of the task force this summer was to see if Kansas had problems which made our state non competitive and he said that some such problems were identified.

Shelby Smith stated that tax structure is more important than tax incentive (See Attachment 2). He said that some corporations recently have chosen not to locate in Kansas after analyzing the tax structure of our bordering states. The Kansas Corporate income tax makes the effective rate higher than any of our neighbors, especially for larger companies. Kansas 6.75 percent rate for all corporations with KAGI of \$25,000 or more does not compare favorably with the 5% across the board rate of Missouri, Oklahoma and Colorado.

Mr. Smith said that the task force identified several areas in which the Kansas tax structure in business should be adjusted downward in order to become more competitive, however, in light of the state's budget problems, he said that the task force recommended only one of the concepts to be adopted in 1987. That recommendation would extend the sales and use tax exemption for manufacturing machinery and equipment to the entire state, rather than

CONTINUATION SHEET

MINUTES OF THE Senate COMMITTEE ON Assessment and Taxation,
room 519-S, Statehouse, at 11:00 a.m./~~p.m.~~ on Wednesday, January 14, 1987

current law, which allows this exemption only within enterprise zones. Because of the budget situation, he said that the task force recommended that the exemption be phased in over a four year period.

Chuck Krider stated that Kansas is the only state in this region with the machinery and equipment sales tax. Iowa, Missouri, Oklahoma, and Nebraska all have sales tax exemptions in this area. He said that the task force also considered incentives which may not be cost effective. One such incentive was identified to be the job expansion credit. In order to help reduce the impact of the recommended sales tax exemption, he said that the task force recommended that the job expansion credit be removed.

Tom Severn, who served as a staff resource person for the 1986 task force, outlined several technical changes to the committee which the task force felt should be made regarding last year's economic development legislation.

The minutes of the January 13 meeting were approved. The chairman said that the next committee meeting would be on Wednesday, January 21.

The meeting was adjourned.

THE LOCAL COMMUNITY SEED CAPITAL FUND

Need and Mission

Status. Seed capital is virtually nonexistent in Kansas' smaller, rural communities. At the moment, neither KTEC nor the Kansas Venture capital Company Act address local seed capital needs. KTEC's seed capital fund is designed to address risks tied to technological development. It does not address risks tied to the size, sector or location of small town firms. The 25 percent tax credit is targeted to pools of \$1.5 million or larger, amounts too large for any small town to raise.

Recommendations. It is necessary to encourage Kansas' communities to build seed capital funds which will invest in local start-ups.

Tools and Sources of Funds

Status. No mechanism exists within Kansas which encourages local communities to pool private resources for investments in the area.

Recommendation. The Commission recommends allowing private investments in local seed capital pools to be eligible for the 25 percent tax credit within the current total limitation of \$24 million eligible for the credit, and only if: (1) there are minimum private investments of \$250,000 into a given pool; (2) private investments are matched in kind at a ratio of 1:2 by federal community development grants, or other local government sources; (3) 100 percent of the pool's administration and operating overhead expansion be covered by sources other than the \$250,000 private and \$125,000 public minimum in-kind matching investments.

Accountability

Recommendation. Local pools should play a role within the risk capital system equivalent to that of Certified Development Companies and Small Business Development Centers in Kansas. They should be accountable to the state for the use of the tax-credit as provided for CDCs and SBDCs under the risk-capital system act.

— Sen. A & T

1/14/87

Att. 1

VENTURE CAPITAL

Universal Credit. The Commission recommends ensuring that the tax credit is truly universal -- available to every for-profit, not-for-profit, public, private, in-state, out-of-state, incorporated, unincorporated entity investing in Kansas venture capital company stock. If the entity has no Kansas income tax liability, it should be allowed to sell its credit to Kansas taxpayers.

- Denver, Kansas City, St. Louis, Minneapolis, and Dallas are all venture capital centers that surround Kansas. They may all wish to invest as a Kansas venture capital partner, but have no incentive to do so.
- Not-for-profit corporations in Kansas such as the Kansas University Endowment Association, the Wesley Medical Endowment Foundation and the Kansas Public Employees Retirement System (KPERs) may want to invest in Kansas venture capital companies.

THE RESEARCH AND DEVELOPMENT TAX-CREDIT

Legal Structure

Status. Although the research and development tax-credit will not be in effect until FY 1988, it is important to clarify how the Act applies to a number of particular situations. When the Research and Development Tax Credit Bill was being developed in the spring of 1986, the focus was on research and development investments by large corporations. There is, however, another important use for the tax-credit in terms of the Kansas economy. It pertains research and development investments by small firms and venture capital partnerships.

Recommendations The Commission recommends the following changes:

1. When a taxpayer invests in a R&D partnership which does not expend all the funds in the year of investment, the credit should be prorated based upon the taxpayer's share of the funds actually expended by the partnership during the taxable year.
2. When a taxpayer disposes of an interest in a partnership prior to expenditure of the funds by the partnership, the credit should be received by the partner holding the interest in the partnership at the time the funds are expended.

VENTURE CAPITAL CREDIT -- TECHNICAL

Expenditure of Funds Triggers Credit. The Commission recommends that an investor who borrows funds to purchase stock in a Kansas venture capital company be entitled to a tax credit on the full investment amount. The lender and borrower should be free to work out the details of the repayment agreement of the loan among themselves. The venture capital company should assign the full amount of the investment to the individual investor to the Secretary of the Department of Commerce.

Recapture. The Commission recommends that, absent decertification, if a taxpayer disposes of a portion of the investment, no portion of the credit would be recaptured. Only in case of decertification would the tax credit be recaptured. In that case, the original investor who benefited from the tax credit should be responsible for repayment.

The Tax Credit and Kansas Venture Capital, Inc.

Need and Mission

Status. The Kansas Statewide Risk Capital Act (1986 S.B. 756), is designed to address inefficiencies within Kansas' risk capital markets and seeks to meet a range of financing needs -- from seed to venture to mezzanine capital. The Kansas Statewide Risk Capital Act recognizes Kansas Venture Capital, Inc. to address these needs. KVCII's average return on investments will be lower than that of private venture capital companies -- around 15 percent, based on the experience of successful risk-capital mechanisms such as the Massachusetts Business Development Corporation (MBDC), the Massachusetts Capital Resource Company (MCRC), and others.

Recommendation. Separate, unambiguous guidelines should be established to govern the tax credits for investment in KVCII. Current law establishes certification guidelines for Kansas venture capital companies which are not fully appropriate for KVCII. While some of those guidelines are universal targeting mechanisms; others are regulatory measures specifically designed for organizations which only structure equity investments.

Tools and Sources of Funds

Status. Guidelines for KVCII investments in current law are ambiguous, and are not fully explicit in terms of KVCII's risk capital investments, function or SBIC status.

Recommendations for KVCII. The Commission recommends that:

1. KVCII's investments be made solely in-state.
2. KVCII's investments be required to be structured as equity or as unsecured subordinated debt with warrants convertible to equity.
3. All of the \$1.5 million already invested in KVCII that is reinvested should be classified as new investments and credited towards the \$10 million requirement for the investment of state idle funds.
4. The state invest in KVCII preferred stock only after the full \$10 million has been raised.
5. The ceiling of \$10 million investment eligible for the tax credit remain unchanged for FY 1987. The Task Force recognizes that if there is an oversubscription on the original \$10 million, it should be honored. After FY 1987, and after the initial \$10 million has been raised, the ceiling is subject to review and should be negotiable upon availability of additional, unused tax credit.
6. While KVCII's investment standards are of a higher order than those set by SBIC regulations, they must not jeopardize KVCII's SBIC license. In case of an apparent conflict between SBIC guidelines and KVCII's statute, the Secretary of the Kansas Department of Commerce should be

given authority to interpret KVC's statute in ways which do not jeopardize the SBIC license at the same time that the Legislative intent of S.B. 756 is maintained.

7. Any firm located within Kansas should qualify as a "Kansas business" under the tax credit bill, regardless of the owner's residence.

Recommendation for Private Venture Capital Companies. The Commission recommends retaining the 60-40 provision for private Kansas venture capital companies in order to maximize the number of venture capital investments within the state. The Commission's recommendation is backed by four compelling reasons:

1. The provision will allow Kansas venture capital companies to import more capital into the state by forming joint-ventures with leading national and international venture capitalists.
2. Natural market areas extend beyond political boundaries. Economic activity in Kansas City, Missouri, is intertwined with economic activity in many Kansas cities and towns. Similarly, the natural economic market of St. Francis spills over the Nebraska and Colorado borders. Investments in Kansas City, Missouri start-ups are as likely to benefit Kansans as they are to benefit Missouri residents.
3. The entire history and nature of the venture capital industry does not allow capital to stray more than 200 miles from its source of origin.
4. The private venture capital industry in Kansas will be much more successful if it can spread risk to ensure its return. The rule that investors cling most avidly to is "don't put all your eggs in one basket." In order to secure reasonable rates of return at reasonable levels of risk for investors, venture capital companies need to diversify their portfolios. The 60-40 provision allows them to do so.

TAXATION

TAXATION AND TAX STRUCTURE IN KANSAS

After hearing testimony from a variety of businesses and business-location conferees, the Capital Markets and Taxation Task Force concluded that Kansas' tax structure and tax incentives should be viewed as an integral part of any successful economic development program. The Commission concurs with this conclusion. The ability of the state to appear competitive in its tax structure can send an important signal to outside firms and affect expansion plans of current Kansas businesses. Despite hearing testimony that most tax incentives are not cost-effective, the Task Force believes that Kansas should take steps to remove burdensome tax features and assure that the tax structure remains regionally competitive.

Some corporations recently have chosen not to locate in Kansas after analyzing the tax structure of bordering states. The Commission believes that this problem has arisen in part because of several features of Kansas' corporation income tax that make the effective rate significantly higher than any of its neighbors' effective rates, especially for large and very profitable corporations.

- Kansas' 6.75 percent rate for all corporations with KAGI of \$25,000 or more does not compare favorably with the 5 percent across-the-board rate in Missouri, Oklahoma, and Colorado.
- Of the 43 states with corporation income taxes, Kansas is one of 37 states that does not allow federal taxes paid as a deduction. Missouri is one of six states with corporation income taxes that does allow that deduction. This deduction lowers Missouri's effective rate under current law to 2.7 percent.
- Kansas and all of its neighboring states have adopted UDITPA, the Uniform Division of Income for Taxation Purposes Act. Three factors -- sales, payroll, and property -- are equally weighted when apportioning the amount of a corporation's income attributed to Kansas. Missouri, however, allows corporations the option of computing liability either under UDITPA or under a single-factor (sales) formula.

These distinctions in the states' corporation income taxes have combined to lead some publicly-held corporations, unable to justify payment of Kansas taxes, to locate in neighboring states, especially Missouri.

Another area in which Kansas compares unfavorably is that it charges sales tax on manufacturing machinery and equipment. Such equipment has been subject to a refund of the sales tax when located within an enterprise zone. However, the value of the refund was diminished by the time lag between initial payment of the tax and receipt of the refund. Occasionally, this delay has proven to be a burden for some corporations. Beginning January 1, 1987,

such equipment installed within an enterprise zone will be exempt from sales taxes.

Table 2, below, compares some tax features of Kansas and neighboring states with respect to the characteristics mentioned above.

TABLE 2

Selected Tax Features for Kansas
and Neighboring States

	<u>Kansas</u>	<u>Missouri</u>	<u>Oklahoma</u>	<u>Colorado</u>	<u>Nebraska</u>
<u>Corporation Income Tax</u>					
Rates -- Maximum	6.75%	5.00%	5.00%	5.00%	6.65%
Rates -- Minimum	4.50%	5.00%	5.00%	5.00%	4.75%
Fed. Tax Deductible	No	Yes ¹	No	No	No
UDITPA	Yes	No ²	Yes	Yes	Yes
Credits --					
Job. Exp.	Yes	Yes	No	No	No
Investment	Yes	Yes	Yes	No	No
Relative Collections ³	\$ 65.17	\$ 31.93	\$ 31.66	\$ 31.46	\$ 30.49

Sales and Use Taxes

Rate	4.000%	4.225%	3.250%	3.000%	3.500%
Local Taxes	Yes	Yes	Yes	Yes	Yes
Exemptions --					
Manufacturing Mach.	No	Yes	Yes	Yes	Refund
Enterprise Zones	Yes	No	Yes	No	No

Notes:

- 1) This deduction lowers Missouri's effective rate under current law to 2.7 percent.
- 2) Missouri, although it has adopted UDITPA, allows the option of using only the sales factor.
- 3) FY 1985 collections per capita.

Source: Commerce Clearing House, State Tax Guide, 2d. Ed.

In order to make Kansas more competitive with surrounding states, the Commission believes that it is essential that all tax incentives be as cost-effective as possible for the state and local governments. The Commission, therefore, makes the following recommendations to the 1987 Legislature:

- Extend the sales and use tax exemption for manufacturing machinery and equipment to the entire state. The exemption currently exists only within enterprise zones. The Department of Revenue has estimated that this would cause a \$12-18 million reduction in State General Fund receipts. The Commission recommends that the exemption be funded in part by repealing the enterprise zones' enhancement of job expansion and investment credits, determined to be not cost effective by Task Force consultant, Charles Krider. The Department has estimated that receipts would increase by \$2-3 million in response to such legislation. Thus, the combined cost of the two elements of this recommendation would be \$9-16 million.
- The Commission believes that Missouri's allowing the single-factor apportionment option presents a serious problem for Kansas and that jobs have been lost because of it. While Kansas should not immediately abandon UDITPA, the Department of Revenue should study the business-location situation along the Kansas-Missouri border and make recommendations to the Legislature about how Kansas can respond.
- The Legislature should consider appropriate reductions in corporation income tax rates to make Kansas more competitive with neighboring states.

The Task Force also studied a number of other proposed tax changes that could enhance economic development in Kansas, including exempting the interest from general obligation bonds from the state income tax, adopting a single-factor apportionment option, and restoring corporate federal deductibility. However, given the realities of the state's fiscal situation, the Commission is not recommending these changes at this time.

The Commission wishes to place the highest priority possible on extension of the sales and use tax exemption for manufacturing machinery and equipment to the entire state. The Commission believes that this change would significantly improve the perception of the Kansas business climate. Economic activity would increase as a result of more manufacturing activity in Kansas. It is therefore imperative, particularly given the current economic situation, that this economic development initiative be enacted.

Adoption of these recommendations is also needed to stop an apparent trend of corporations choosing to locate elsewhere. A more competitive tax structure, coupled with an aggressive marketing strategy by the Department of Commerce to convince outside firms of the numerous advantages of locating in Kansas, can reverse the trend and serve as a crucial tool in Kansas' economic development strategy.

COMMISSION TAX RECOMMENDATIONS

FISCAL YEAR	CREDITS	SALES TAX EXEMPTION	Net FISCAL NOTE
88	\$250	(\$4,250)	(\$4,000)
89	500	(8,500)	(8,000)
90	750	(12,750)	(12,000)
91	1,000	(17,000)	(16,000)
92	1,250	(17,000)	(15,750)
93	1,500	(17,000)	(15,500)
94	1,750	(17,000)	(15,250)
95	2,000	(17,000)	(15,000)
96	2,250	(17,000)	(14,750)
97	2,500	(17,000)	(14,500)

Cross Reference File: 79.3606ee

MEMORANDUM

To: Harley T. Duncan

Date: October 29, 1986

Fr: Martha Carithers

Re: Exemption from Kansas Retailers Sales tax for new machinery and equipment.

It is roughly estimated that exemption of new machinery and equipment could decrease state revenues by about \$27 million annualized for FY 1988.

There is no real way to determine the revenue loss if these purchases are exempt. The 1982 Census of Manufacturing shows \$443.7 million in capital expenditures for new machinery and equipment for Kansas, up from \$250.0 million in 1977, for an average gain of \$38.74 million year ($\$443.7 - \$250.0 / 5$). Increasing the expenditure by the same amount for each year and holding growth constant, the estimate for FY 1988 is \$676.14 million in new expenditures, for a tax at 4% of about \$27 million.

This estimate is consistent with that for the impact of 1986 House Bill 3121, which exempts materials, machinery and equipment, which are purchased by qualifiers for income tax credit within an enterprise zone, when constructing, reconstructing, enlarging or remodeling (K.S.A. 79-3606ee).

copy: Dan Walstrom
Steve Stotts

Tom: 1/3 of estimate is attributable to

increases extrapolated from 1982-1987 considering

lower inflation and real growth, along w/ Enterprise zones,

I would suggest a range of \$12-18 million annually

AD

Manufacturers' Shipments - Capital Goods Industries

1982	327,990	
1983	337,497	
1984	386,980	
1985	411,381	
1986	385,000 *	420,000*
1987	385,000 *	430,000*

* estimate

Source: Business Statistics 1984

1.31

$$443.7 \times 131\% = \$581.7 \text{ m.}$$

$$@ 4\% \Rightarrow \$23.3 \text{ m.}$$

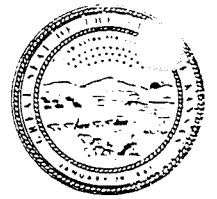
$$\times 75\% \Rightarrow \$17.45 \text{ m.}$$

FISCAL EFFECTS OF PROPOSED CHANGES IN CORPORATION
INCOME AND FINANCIAL INSTITUTION PRIVILEGE TAX

Lower Rate to:	Corps	Banks	S & Ls	DomInsCos	Total
6.00% (rate)	\$15,822,174	\$886,277	\$195,526	\$0	\$16,903,977
5.50% (rate)	26,370,290	2,067,980	325,877	0	28,764,147
5.00% (rate)	36,918,406	3,249,683	456,228	0	40,624,317
6.00% (surtax)	\$13,946,061	\$837,546	\$190,411	\$0	\$14,974,018
5.50% (surtax)	23,243,434	1,954,274	317,351	0	25,515,059
5.00% (surtax)	32,540,807	3,071,002	444,291	0	36,056,100
Lower Rate by:	Corps	Banks	S & Ls	DomInsCos	Total
0.75% (rate)	\$15,822,174	\$1,772,554	\$195,526	\$48,000	\$17,838,254
1.25% (rate)	26,370,290	2,954,258	325,877	80,000	29,730,425
1.75% (rate)	36,918,406	4,135,961	456,228	112,000	41,622,595
0.75% (surtax)	\$13,946,061	\$1,675,092	\$190,411	\$48,000	\$15,859,564
1.25% (surtax)	23,243,434	2,791,820	317,351	80,000	26,432,605
1.75% (surtax)	32,540,807	3,908,548	444,291	112,000	37,005,646

NEWS

JOHN CARLIN
GOVERNOR OF KANSAS



Michael Swenson, Press Secretary The Statehouse, Topeka 66612 (913) 296-2716

FOR IMMEDIATE RELEASE: January 8, 1987

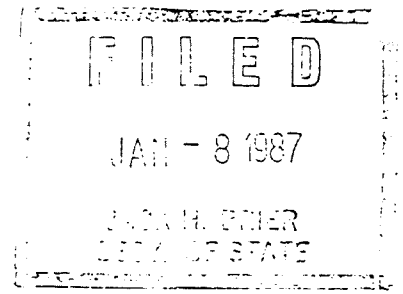
Governor John Carlin today issued Executive Order Number 87-91,
directing the Kansas Secretary of Revenue to implement procedures
excluding foreign dividends and gross ups from the state corporate tax
base. The purpose of this executive order is to create a more favorable
business climate for investors considering a Kansas location and those
companies currently doing business in Kansas.

The order also issues a clear definition of those factors that will
be used as an assessment for the issuance of any combined or unitary
assessment for reporting corporate income tax. The combined method will
be enforced only in situations where corporate functions are integrated
on an operational level, such as transfers between the corporation of
items, such as products, services, technical information, marketing
information, purchasing and intangibles, in a manner that substantially
affects the manufacture, distribution, production, extraction or sale of
their products or services. Management oversight, supervision or control
does not constitute functional integration at the operational level and
shall not be used as the basis for the issuance of any combined or
unitary assessment.

For both domestic and international corporations, these two measures
should continue to increase the pro-business image of Kansas and make the
state more competitive in attracting new investment.

For more information, contact Kansas Secretary of Revenue Harley
Duncan at 296-3041.

STATE OF KANSAS



OFFICE OF THE GOVERNOR
State Capitol
Topeka 66612-1590

John Carlin *Governor*

EXECUTIVE ORDER NO. 87-91

CONCERNING STATE DETERMINATION
OF UNITARY TAXATION

Executive Department
State House
Topeka, Kansas

WHEREAS, many states have instituted the requirement of combined reporting for corporations which have a unitary relationship; and

WHEREAS, a definitive determination and policy by the State of Kansas as to the criteria for unity will provide guidance to corporate taxpayers, aid them in their business decisions with regard to locating facilities in Kansas, and be beneficial to the continued economic growth and prosperity of both Kansas businesses and its citizens; and

WHEREAS, the question of including foreign dividends and gross-ups as defined in Section 78 of the Internal Revenue Code of 1954, as amended, in the state corporate tax base has been litigated by several states with those decisions resulting in no clear statement regarding the continued propriety of taxing such dividends and gross-up by the states.

NOW THEREFORE, in order to promote and encourage economic development in

John Carlin
Executive Order No. 87-91
Page Two

Kansas yet not compromise the authority of the Secretary of Revenue to enforce Kansas tax statutes and pursuant to the authority vested in me as Governor and chief executive of the State of Kansas, effective for all taxable years beginning after December 31, 1986 I hereby order and direct that any interpretation of K.S.A. 79-32,141, or any other related statutes requiring the combined method of reporting corporate income tax, be enforced only in situations where there is, between the members of the corporate group, functional integration at their operational level, such as transfers between or pooling among the corporation of items such as products, services, technical information, marketing information, purchasing and intangibles (patents, copyrights, formulas, processes, trade secrets) in a manner that substantially affects the manufacture, distribution, production, extraction, or sale of their products or services. Management oversight, supervision, or control does not constitute functional integration at the operational level and shall not, without more, be used as the basis for the issuance of any combined or unitary assessment.

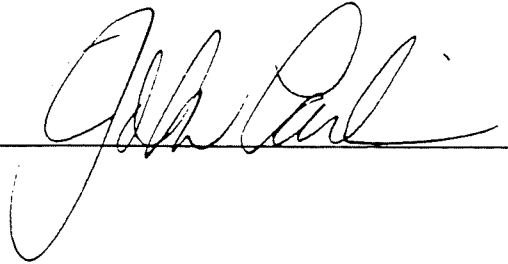
FURTHER, in order to further promote and encourage economic development in Kansas and eliminate any confusion regarding the proper treatment of foreign dividends and gross-ups as defined in Section 78 of the Internal Revenue Code of 1954, as amended, for state tax purposes, effective for all taxable years beginning after December 31, 1986 I hereby order and direct the Secretary of Revenue to implement procedures necessary to exclude from the state corporate tax base all foreign dividends and gross-ups as defined in Section 78 of the Internal Revenue Code of 1954, as amended.

John Carlin
Executive Order No. 87-91
Page Three

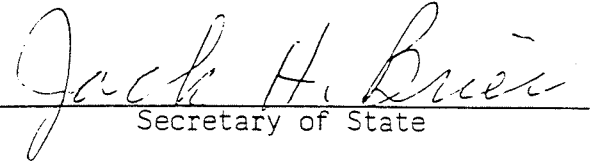
This document shall be filed with the Secretary of State as Executive Order No. 87-91 and shall become effective immediately.

THE GOVERNOR'S OFFICE

By the Governor



January 8, 1987



Secretary of State



Assistant Secretary of State

