Approved: 2/19/08
Date

MINUTES OF THE HOUSE COMMERCE AND LABOR COMMITTEE

The meeting was called to order by Chairman Steve Brunk at 9:18 A.M. on February 12, 2008 in Room 784 of the DSOB.

All members were present except:
Brenda Landwehr- excused
Broderick Henderson- excused
Candy Ruff- excused
John Grange- excused
Lana Gordon- excused

Committee staff present:
Jerry Ann Donaldson, Kansas Legislative Research Department
Jill Wolters, Office of Revisor of Statutes
Renae Jefferies, Office of Revisor of Statutes
Stephen Bainum, Committee Assistant

Conferees appearing before the committee:
Stan R Ahlerich, President, Kansas, Inc.
Dr. Art Hall, Executive Director, Center for Applied Economics, KU School of Business

Others attending: See attached list.

The Chairman called for bill introductions. Representative Ruiz introduced a resolution for compensation to the Department of Labor. It was received without objection.

Stan R Ahlerich, President, Kansas, Inc. provided a written bill summary about the Kansas, Inc. proposal for Universal Expensing of Capital Investment in **HB 2751** and **SB 571** **(Attachment 1).** He made no comments about the proposal. His testimony continued with a single page written testimony about the Strategic Plan for Kansas, Inc. **(Attachment 2)**. A 92 page report called Leveraging our Foundations and Designing the Future: A Kansas Economic Renaissance, The 2007 Kansas Economic Development Strategic Plan dated January 2008 was distributed to the committee. It is available from Kansas, Inc.

Mr. Ahlerich said that Kansas, Inc. was charged with developing a strategic plan for a safe Kansas and doing research and benchmark work for understanding the dynamics of the Kansas economy. We have compiled what the business leaders in Kansas needed and wanted. We have come up with 43 strategies to improve the business climate in Kansas. The participants to the plan are listed on pages 2 through 6 of the report. Starting on page 7 the recommendations for each of the 43 strategies are listed. These strategies are broken down by business categories such as Manufacturing–Aerospace and General, Rural Development and Agriculture, Professional, Scientific, and Technical Services, Energy and Natural Resources, Bioscience and 5 other categories.

Representative Grant asked which was better, a hundred small businesses or one large business. Stan's answer was that it was better to go for the hundred small businesses because that gives more diversity and prevents some corporate headquarters somewhere pulling the business out of Kansas.

Mr. Ahlerich continued his comments with Strategy 7, found on page 9, about the rural development of wireless coverage in Kansas. This is a new utility and is needed throughout Kansas, not just in the large cities. If we don't have high speed internet service throughout the state it will prevent some companies from locating here. He commented on the training for employment that Kansas, Inc. does for workforce development.

Representative Huntington wanted to know if the subject of immigration was addressed in the plan. Mr. Ahlerich said that first and foremost we have to build capacity. That goes to all segments of the population. Immigration has to be a part of the plan but it has to be legal.

Representative Goico said that the estimate was that we have 75,000 unlawful immigrants in Kansas and most of them are employed. What policy do you have to develop legal workers if the unlawful immigrants are forced to leave? Mr. Ahlerich said that the policy has to be the same as it is and it has to be legal. Many of these decisions are made at the Federal level.

The next portion of testimony was presented by **Dr. Art Hall, Executive Director, Center for Applied Economics, KU School of Business (Attachment 3)**. He began his testimony with the Implementation of Expensing in Kansas. Kansas, Inc. has a motto that says, "Every business matters". To honor that theme they sought to do something that could benefit every business. They proposed an expensing as an automatic option in lieu of other, select investment tax credits. There are may good tax incentives in the Kansas tax code but most of them have restrictions on them. "Expensing" is automatic, the business can take this option if they choose to. Simply speaking, it is a tax deduction related to capital investment. It is not the granting of a new privilege, it is the removal of a penalty. The idea is not new. It is decades old. It has been offered at different times in the Federal tax codes.

Expensing allows business taxpayers the option between expensing and other investment-related tax credits available under Kansas law. It is a mutually exclusive option. The business can not take the tax credit and expensing both. While there are restrictions on what kind of business can take the tax credits there are no such restrictions on the expensing plan. Only about 130 companies are taking the most valuable tax credit in Kansas but expensing would apply to every business in Kansas.

Representative Grant inquired about revolving low interest loans for small business. Dr. Hall replied that Network Kansas was created as a micro loan organization. They are just getting up and running. The Kansas Business Center is also helping out with new information.

Dr. Hall continued with a comparison of tax credits and expensing. He presented a chart to show the different amounts of Kansas Tax Liability that would result with expensing or tax credits.

Representative Kiegerl said that in the long term expensing would increase tax receipts. Dr. Hall completely concurred. He said that the whole point of this was to make Kansas a more profitable place to invest.

Representative Brunk asked if it would then be profitable to borrow for investment. Dr. Hill said that yes it absolutely would be profitable. Representative Brunk wondered further what the initial impact would be to the state. Dr. Hill said the initial impact would be about 79 million dollars. There would be some transition cost to a new regime. What we expect is a growing economy.

Representative Huntington asked who would not like this in Kansas. Dr. Hill said it would be anybody who does not think that this is a transition cost to a superior tax economy. It is a long term investment environment. This is a way for Kansas to invest in every business in Kansas rather that pick and choose which ones to invest in.

Representative Tietze wondered if the Federal tax policy was using expensing. Dr. Hill said that they have used it off and on. The idea is decades old. It should be a permanent fixture of Kansas economy. Representative Tietze then asked why other states were not doing it. Dr. Hill said that many states have tax credit programs which are meant to accomplish the same thing but they are very targeted. What we are saying is that we are not playing favorites. This will be available to every business in Kansas.

Representative Huntington asked what it would do to revenue in the long term if we don't have the growth of business coming into Kansas. Dr. Hill said that we need to look at the incentives for business coming into Kansas. The state would make an investment in new business that would ultimately pay off. On average Kansas business growth has been 2 to 3% a year.

Representative Quigley asked on the example on page 3 what the deduction would be for years 2 through 8. if expensing was taken. Dr. Hill answered that they would be the same as in the example. This is an extra deduction made in the first year only on each investment. This is to make Kansas a better place to invest.

The meeting adjourned at 10:20 A.M. The next meeting is scheduled for February 13, 2008.

COMMERCE & LABOR COMMITTEE
DATE: 2-12-08

NAME	REPRESENTING
Stan Ahlerich	Kansas, Inc.
Art Hall	KU
Dennis Clements	Rep. Ruiz
Isaac Ferguson	Kansas Chamber of Commerce
Mari Tucker	Dept. of Commerce
John Dougherty	ESU
Karla Wiens	KSAJ
Trent Lebits	AFP
Derick Sontag	NFIB
Kent Cornish	KAB

A Bill Summary Corresponding to the
Kansas, Inc. proposal for Universal Expensing of Capital Investment
(HB 2751 and SB 571)

Scope

- All business taxpayers shall have an automatic option to expense (immediately write-off for the year placed in service) any eligible investment. The expensing procedure amounts to an additional income tax deduction in Kansas over and above the deductions available for federal income tax purposes.

  Definition of eligibility. The cost of any tangible asset, including fabrication and installation, that is, or under the federal internal revenue code will become, eligible for depreciation, amortization, or accelerated cost recovery (including Section 179) for federal income tax purposes.

- There are no restrictions or caps, given the definitions and implementation procedures outlined in the bill.

- Kansas business taxpayers may elect the Kansas expensing deduction on an asset-by-asset basis. The election cannot be revoked.

- As currently drafted, the Kansas expensing option applies only to new purchases of an eligible asset(s) initially placed in service for federal income tax purposes after December 31, 2008.

Procedures and Implementation

- The expensing procedure is intended as a mutually-exclusive option: a business cannot choose to expense a capital investment if it also participates in a Kansas income tax credit program related to the same investment.

- Calculation of the expensing deduction (see factor tables below).

  For simplicity of implementation, administration, and taxpayer compliance, the bill does not disturb the current-law procedures in Kansas related to starting-income definitions: federal taxable income for C-corporations and federal adjusted gross income for proprietorships, partnerships, and Subchapter S corporations. Federal depreciation deductions are already embedded in these starting-income definitions. To accommodate this situation, Kansas taxpayers will apply an adjustment factor to the investment amount eligible to be expensed:

  Kansas Expensing Deduction = Investment Amount x Kansas Adjustment Factor

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Attachment # 1

For example, suppose a $100,000 investment is classified as 7-year property for purposes of calculating a depreciation schedule for federal income tax. Further suppose that a business tax preparer chooses the 200% Declining Balance method. The expensing calculation would be:

Kansas Expensing Deduction = $100,000 x 0.223 = $22,300

This procedure gives the Kansas taxpayer the same economic value they would get if they expensed the whole $100,000 amount in the absence of federal depreciation deductions. Mathematically, each depreciation procedure available under federal law results in a unique adjustment factor that does not change with the dollar amount of the investment involved. A schedule of adjustment factors will be published and available for use by business tax preparers.

- Taxpayers may carry forward indefinitely unused deductions resulting from insufficient levels of taxable income in a given tax year.

- For businesses that must file income tax returns in more than one state, the Kansas expensing deduction will be directly allocable to Kansas income and not subject to apportionment.

- Firms with multiple legal entities will have access to the expensing deductions as a "unitary group" to reduce Kansas taxable income. This provision may require a slight modification of current Kansas tax forms.

- Change in the situs of an asset.

  If the change in the situs of a property results from a sale to an unrelated third party, K.S.A. 79-3276 applies. Otherwise, the bill intends for a recapture of value to take place with a change of property situs outside of the state of Kansas. The recapture amount shall be the lesser of (1) federal adjusted tax basis or (2) the Kansas expensing deduction allowed. For income tax purposes, the recaptured amount shall be directly allocated income to Kansas. The recaptured amount shall not be subject to apportionment. The recaptured amount shall not be treated as a deemed sale. The recaptured amount shall be added to the asset's basis for Kansas income tax purposes. Any subsequent sale of the asset to a third party after recapture shall be subject to K.S.A. 79-3276.

- Kansas basis for calculating gains or losses on sales.

  For purposes of calculating a gain or loss on the sale of an asset, Kansas taxpayers electing the Kansas expensing option shall reduce the tax basis in the expensed asset by the amount of the allowable expensing deduction for the asset in question. For income tax purposes, the difference between federal and Kansas gains or losses shall be directly allocable as Kansas income.

Factor Tables—The following tables illustrate how tax prepares might see Kansas adjustment factors in the law or in tax instruction published by the Kansas Department of Revenue. The asset lives correspond to the options listed in Internal Revenue Service Publication 946.

Table 1

	Factors		
Property Class	**Method A**	**Method B**	**Method C**
2.5-Year	*	0.118	0.140
3-Year	0.114	0.138	0.160
3.5-Year	*	0.154	0.175
4-Year	*	0.172	0.193
5-Year	0.174	0.201	0.224
6-Year	*	0.228	0.252
6.5-Year	*	0.241	0.265
7-Year	0.223	0.254	0.278
7.5-Year	*	0.266	0.291
8-Year	*	0.278	0.304
8.5-Year	*	0.290	0.315
9-Year	*	0.301	0.327
9.5-Year	*	0.312	0.339
10-Year	0.287	0.323	0.350
10.5-Year	*	0.333	0.361
11-Year	*	0.344	0.372
11.5-Year	*	0.353	0.382
12-Year	*	0.363	0.392
12.5-Year	*	0.372	0.402
13-Year	*	0.382	0.412
13.5-Year	*	0.391	0.421
14-Year	*	0.400	0.430
15-Year	*	0.417	0.448
16-Year	*	0.433	0.465
16.5-Year	*	0.441	0.473
17-Year	*	0.448	0.481
18-Year	*	0.463	0.497
19-Year	*	0.477	0.511
20-Year	*	0.491	0.525
22-Year	*	0.516	0.552
24-Year	*	0.540	0.576
25-Year	*	0.551	0.587
26.5-Year	*	0.566	0.603
28-Year	*	0.581	0.619
30-Year	*	0.599	0.637
35-Year	*	0.639	0.678
40-Year	*	0.673	0.712
45-Year	*	0.701	0.740
50-Year	*	0.724	0.764

Method A: General Depreciation System; 200% Declining Balance and Section 179 Elections for Property Classes of 10 Years or Less; Non-Farm 3-, 5-, 7-, and 10-Year Property Other than Residential and Nonresidential Real Property; Half-Year or Mid-Quarter Convention

Method B: General Depreciation System or Alternative Depreciation System; 150% Declining Balance and Section 179 Elections for Property Classes of More than 10 Years; All Classes of Property Other than Residential and Nonresidential Real Property; Half-Year or Mid-Quarter Convention

Method C: General Depreciation System or Alternative Depreciation System; Straight-Line; All Classes of Property Other than Residential and Nonresidential Real Property; Half-Year or Mid-Quarter Convention

Table 2

General Depreciation System or Alternative Depreciation Sysytem
Straight-Line
Residential and Nonresidential Real Property

Month Placed in Service	GDS Residential 27.5-Year Property	GDS Non-Residential 31.5-Year Property	GDS Non-Residential 39-Year Property	ADS Residential & Non-Residential 40-Year Property
January-March	0.602	0.640	0.697	0.703
April-June	0.610	0.647	0.703	0.709
July-September	0.618	0.654	0.709	0.715
October-December	0.626	0.661	0.715	0.721

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Kansas, Inc. Testimony
House Commerce and Labor Committee
February 12, 2008
Stan R. Ahlerich, President

Chairman Brunk, members of the House Commerce and Labor Committee, Kansas, Inc. appreciates the opportunity to share with you highlights from the 2007 Kansas Economic Development Strategic Plan, entitled *Leveraging our Foundations and Designing the Future: A Kansas Economic Renaissance*.

The framework for our testimony will highlight the vision, missions, strategies and recommendations formulated during the Strategic Planning process. This Strategic Plan is the result of a yearlong process, driven by sound, fundamental research and tested with business input throughout the state. Time permitting, we will cover as many aspects of this plan as possible today, and we would be glad to follow up on any part of this plan with your committee during the future. Also, Dr. Art Hall, with the Center for Applied Economics, University of Kansas School of Business is here to specifically address Strategy 24 and the expensing concept, which is brought forth in House Bill 2751 and Senate Bill 571.

Following the Strategic Planning process, this plan was designed to be both comprehensive and flexible. The strategies and recommendations outlined in this report identify policy options to build the consensus essential for concerted action on vital economic issues. Kansas, Inc. will continue to promote and educate all interested Kansans regarding the vision, missions, strategies and recommendations set forth in this plan.

This plan may require action in the form of legislation, executive order, agency collaboration, coordination, funding, research, marketing, benchmarking, and various other actions to fulfill the overall vision of the Kansas Economic Development Strategic Plan. As this plan was designed to be both comprehensive and flexible, Kansas, Inc. will provide ongoing benchmarking and analysis to ensure progress towards our overall economic development goals.

Again, thank you for the opportunity and we applaud the common sense approach of your Committee to build prudent policies for our future.

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Implementation of Expensing in Kansas:
A Primer on the Expensing Proposal in the Kansas, Inc. Strategic Plan

Prepared for Kansas, Inc. by
Art Hall, Executive Director
Center for Applied Economics, KU School of Business

Presented to the House Committee on Commerce and Labor
February 12, 2008

Overarching Goals:

- Every business matters—strive for inclusive policies and a level playing field among businesses of all types and sizes.

- Build on the pro-investment initiatives passed in recent legislative sessions—namely, the exclusion of business machinery and equipment from property taxation and the phase-out of the franchise tax. These policies apply to all businesses equally—and automatically.

- Minimize the cost and complexity of accessing pro-investment tax policies. Kansas, Inc. proposes expensing as an automatic **option** in lieu of other, select investment tax credits, which typically have restrictions or require application procedures with state agencies.

What is "Expensing"?

- Expensing is a procedure related to the calculation of business income tax. Whenever a business makes a capital investment (whether equipment or structure), it is allowed to take a deduction against income tax for the depreciation of the investment. Expensing is one form of depreciation deduction. Expensing allows for an immediate deduction of the full investment amount instead of requiring a prescribed schedule of smaller deductions over multiple years.

- Expensing is a pro-investment tax policy that has many desirable economic qualities:

    - Logical consistency; expensing, properly implemented, treats all businesses and all investments equally, given the tax rate faced by the business taxpayer

    - Expensing allows the taxpayer to perceive the same investment return that would exist if there were no income tax

    - Expensing does not grant a special tax privilege; it removes a tax penalty

    - The state can expect the same investment return as the taxpayer, demonstrating an authentic public-private partnership

    - The state, all else equal, will receive the same expected income tax revenue generated by the investment over the investment's lifetime

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What is the Kansas, Inc. Proposal?

- Kansas, Inc. suggests that Kansas, as of date certain, offer business taxpayers the automatic **option** of choosing to expense capital investments made within the state. This policy change will make Kansas unique among the states (with income taxes).

- Kansas, Inc. suggests that the expensing proposal offer business taxpayers a **mutually-exclusive option** between expensing and other investment-related tax credits available under Kansas law. The table below lists those tax credits that a Kansas taxpayer could not take on a particular investment if they choose the expensing option for that investment.

Taxpayer Option: Automatically Expense an Investment or Take the Allowable Tax Credit(s)

Type of Credit	2004 Process Year		2006 Process Year	
	Returns	Dollars	Returns	Dollars
Alternative-Fuel Tax Credit (K-62)*	15	12,000	68	54,793
Business and Job Development Credit (K-34)	1,193	8,485,000	2,114	14,046,665
Cellulosic Alcohol Plant Credit (K-79)	n/a	n/a	n/a	n/a
Disabled Access Credit (K-37)**	9	2,000	6	1,321
Nitrogen Fertilizer Plant Credit (K-78)	n/a	n/a	n/a	n/a
High Performance Incentive Program Credits (K-59)	276	16,993,000	1,265	24,098,727
Integrated Coal Gasification Power Plant Credit (K-80)	n/a	n/a	n/a	n/a
Petroleum Refinery Credit (K-73)	n/a	n/a	n/a	n/a
Qualifying Pipeline Credit (K-77)	n/a	n/a	n/a	n/a
Research and Development Credit (K-53)***	154	554,000	223	833,891
Swine Facility Improvement Credit (K-38)	0	0	0	0
Environmental Compliance Credit (K-81)	New in 2007			
Electric Cogeneration Facility Credit (K-83)	New in 2008			
Storage and Blending Equipment Credit (K-82)	New in 2008			
Total	**1,647**	**26,046,000**	**3,676**	**39,035,397**

* Any business investment in a vehicle or fueling station would naturally fall under the procedures for expensing.
** Business property modifications would naturally fall under the procedures for expensing; household modifications would not. The dollar figure represents corporate returns only.
*** Expensing would apply to the machinery and equipment component of this credit only.

Source: Kansas Department of Revenue

Many Businesses in Growth Mode Apparently Do Not Seek Credits
Estimated Number of Kansas Businesses Starting Up or Expanding, 1994-2004

Year	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Average
Birth	13,644	8,603	13,229	8,894	10,835	8,843	11,860	18,028	14,984	8,780	9,502	11,564
Expand	2,831	5,051	5,576	6,230	6,699	7,370	4,669	5,779	4,980	5,213	6,067	5,497
Total	16,475	13,654	18,805	15,124	17,534	16,213	16,529	23,807	19,964	13,993	15,569	17,061

How Does Expensing Compare with Investment Tax Credits?

- Expensing is an "above the line" deduction from taxable income. The economic value of an income tax deduction equals the deduction amount times the tax rate.
- An investment tax credit is a "below the line" subtraction from income tax liability. The economic value of an income tax credit equals the investment amount times the tax credit percentage.
- All else equal, if a taxpayer faces an income tax rate of 10%, the expensing option and a 10% investment tax credit will have the same economic value.

Comparison of Expensing and Tax Credits
Hypothetical Business Operating Solely within Kansas

Assume a $100,000 Investment in 7-Year Property

Federal Depreciation (200% Declining Balance)								
Year	1	2	3	4	5	6	7	8
Dollars	14,290	24,490	17,490	12,490	8,930	8,920	8,930	4,460

Examples:
- Furniture and fixtures for a call center
- Agricultural machinery
- A new natural gas gathering pipeline
- Manufacturing equipment for many industries

		Year 1 Income Tax Calculation: Full Expensing	Kansas, Inc. Expensing	HPIP Tax Credit
1	Gross Receipts	500,000	500,000	500,000
2	Less: Cost of Goods Sold	310,000	310,000	310,000
3	Less: Federal Depreciation (on above investment)	14,290	14,290	14,290
4	Equals: Net Profit (Federal Taxable Income)	175,710	175,710	175,710
5	Plus: Kansas Additions to Federal Taxable Income	0	0	0
6	Less: Kansas Deductions from Federal Taxable Income	0	0	0
7	Equals: Apportionable Business Income to Kansas	175,710	175,710	175,710
8	Less: Kansas Expensing Deduction	100,000	22,300 *	0
9	Equals: Kansas Taxable Income	75,710	153,410	175,710
10	Kansas Income Tax (at 4% + 3.35% Surtax over $50,000)	3,928	9,756	11,428
11	Less: HPIP Tax Credit (10%)	0	0	5,000
12	Equals: Kansas Tax Liability	3,928	9,756	6,428

* The adjustment factor is explained below: "What is the Kansas, Inc. Solution for Implementing Expensing?"

A Taxpayer Perspective:

The Investment Value of Expensing and Tax Credits

Expected Rate of Return on Identical Hypothetical Investments **(7-Year Property, Full Value of Incentive Captured in Year 1)**			
	$1 Million Investment	**$100,000 Investment**	**$50,000 Investment**
No Credit or Expensing	9.20%	9.20%	9.20%
Full Expensing (7.35% Tax Rate)	11.28%	11.28%	11.28%
Kansas Inc. Expensing (7.35% Tax Rate)	9.78%	9.78%	9.78%
HPIP Investment Credit	11.92%	10.60%	9.20%
Business& Jobs Credit (Rural, 5 Jobs)	9.20% (9.82%)	9.20% (13.14%)	9.20% (17.27%)

Formulas for Calculating Taxpayer Value	
Full Expensing	Investment Amount x Tax Rate
Kansas, Inc. Expensing	Investment Amount x Kansas Adjustment Factor x Tax Rate
HPIP Investment Tax Credit	(Qualifying Investment Expenditure - $50,000) x 10%
Business & Jobs Credit	(Qualifying Investment Expenditure x 1%) + (Number of qualifying employees x credit per employee)

What is the Kansas, Inc. Solution for Implementing Expensing?

Kansas, like many states, piggybacks on the procedures in the federal income tax code. This fact makes the implementation of expensing in Kansas slightly more complicated than it would be at the federal level. In brief, it would require a Kansas business tax preparer to spend about 5-10 minutes to perform one additional calculation.

The purpose of the additional calculation is to keep undisturbed the Kansas procedure of using federal taxable income as the starting point for Kansas corporate income tax calculations (and federal adjusted gross income as the starting point for proprietorships, partnerships, and S-Corporations). These starting-point measures of income already have federal depreciation built in. The Kansas, Inc. expensing proposal does not seek to double-count the federal deductions; it seeks to allow Kansas business electing the expensing option to capture the additional time value of money generated by expensing.

<u>An Example</u>

- Federal depreciation procedures rely on a set of prescribed rules.
- When a business taxpayer makes a capital investment, the tax preparer must make a decision about (1) how to classify the property for depreciation purposes and (2) what depreciation method to use. Once the tax preparer makes those decisions, all of the details about the depreciation schedule become known.
- Kansas, Inc.'s suggested implementation plan for expensing in Kansas relies on the decision that the tax preparer makes for federal depreciation purposes.

Acme Call Centers has a state-of-the-art facility in Hays, Kansas. Acme purchases $100,000 worth of new furniture to expand its call center. The CFO of Acme knows that furniture is classified as a 7-year form of property for federal depreciation purposes. She decides to use the 200% Declining Balance depreciation method (employing the half-year convention).

Acme Call Centers' Federal Depreciation Deduction Schedule								
Year	1	2	3	4	5	6	7	8
Amount ($)	14,290	24,490	17,490	12,490	8,930	8,920	8,930	4,460

- Kansas expensing amount if there were no federal depreciation rules: $100,000
- Kansas expensing amount under Kansas, Inc. proposal: <u>$100,000 x 0.223 = $22,300</u>.

The Kansas, Inc. proposal would provide Acme an additional $22,300 income tax deduction—<u>in Year 1 only</u>. That amount captures the time value of money difference between the federal depreciation schedule and the full expensing amount of $100,000.

Where did the 0.223 number come from? It was (hypothetically) published by the Kansas Department of Revenue. It was calculated by taking the difference between the investment amount ($100,000, in this case) and the discounted present value of the federal depreciation schedule (years 2-8) using an interest rate of eight percent (8%). Mathematically, the adjustment factor of 0.223 remains invariant for any investment in 7-year property that a taxpayer depreciates using the 200% Declining Balance method under the half-year convention.

The same procedure used in the Acme Call Centers example would apply for any investment made in Kansas. Different adjustment factors would apply to the several different combinations of property classifications and depreciation methods available to taxpayers under the federal tax rules.

What is the Fiscal Note for the Kansas, Inc. Expensing Proposal?

- The table below illustrates a likely range of revenue (tax liability) reductions that would result from implementing the expensing system suggested by Kansas, Inc.—*assuming that every business opted to expense its investments.*

- The calculations assume that a fully mature expensing system applied to the actual Kansas income tax data recorded for the years 2005 and 2004.

- The estimates do not include the revenue offsets that would result from replacing the tax credits specified above with the expensing option—about $39 million in 2006.

- The fiscal note related to expensing should be interpreted as a transition cost. Over time, the state will collect the same revenue from the income generated by a specific investment. The state will collect a greater sum of revenue to the extent that expensing expands profitable investment opportunities.

Estimated Fiscal Note for Kansas, Inc. Expensing Proposal
(Assumes a Fully Mature System Applied to Tax Years 2005 and 2004)

Dollars in Millions	**2005**	**2004**
KS Business Income Tax Collections	$474.4	$315.1
Fiscal Note Estimates*		
Low Range	44.1	34.5
Medium Range (Likely)	55.1	43.2
High Range	69.1	54.4

* Includes machinery and equipment investments only. If structures are also included, which Kansas, Inc. suggests, add to an estimate: $35 million for 2005 or $23.3 million for 2004.

Source: Center for Applied Economics, KU School of Business using data from the Kansas Department of Revenue, the U.S. Internal Revenue Service, the U.S. Census Bureau, and the U.S. Bureau of Economic Analysis. (The Kansas Department of Revenue reported income and privilege tax collections for corporations and financial institutions. The Center for Applied Economics estimated the income taxes paid by proprietorships, partnerships, and S-Corporations.)

Methodological Points Related to the Fiscal Note Calculations

- The calculations for machinery and equipment use data compiled for the U.S. by the U.S. Census Bureau's Annual Capital Expenditure Survey. This data is reported for many different industry sectors. Census categorizes capital expenditures as either Equipment or Structures.

- The U.S. Capital Expenditure Survey equipment data is allocated to Kansas, by industry sector, based on the Kansas share of U.S. gross domestic product in each industry sector. In effect, this procedure assumes that Kansas businesses invest at the U.S. average rate, based on value-added. (Note: Based on the data for structures reported by the Kansas Department of Revenue for property tax purposes, as discussed below, this is a conservative assumption, because Kansas invests substantially below what the average rate would suggest.)

- For structures, the fiscal note calculations rely on property tax data collected and reported by the Kansas Department of Revenue; specifically, the appraised value of new commercial and industrial real property placed in service in 2005 and 2004. The U.S. Capital Expenditure Survey data for structures was used to gross-up the new-property amount to account for business investment in "used" structures.

- Capital expenditure amounts are allocated to businesses based on reported income. Guided by IRS data, 5-15 percent of capital expenditure amounts are allocated to businesses with no *taxable* income, depending on industry sector.

- The fiscal note estimates explicitly ignore the limited expensing rules allowed by Section 179 of the federal tax code. Incorporating this element into the calculations would *reduce* the Kansas fiscal note associated with expensing. Public data is too imprecise to warrant including Section 179 elections in the analysis.

- Federal tax rules allow for several choices of depreciation method for equipment-like property. Further, equipment-like property is classified into several categories: 3-, 5-, 7-, 10-, 15-, and 20-years. There is less flexibility regarding structures.

  For the equipment calculation, the fiscal note used the 200% Declining Balance method. Under each scenario, utility property was assumed to be 15-year property for depreciation purposes. Otherwise, Low Range assumed 5-year property, Medium Range assumed 7-year property, and High Range assumed 10-year property.

  For structures, the fiscal note assumed the straight-line depreciation method. Structures related to commercial residential real estate used a 27.5-year life. All other structures assumed a 39-year life.

  A discount rate of eight percent (8%) applied to all adjustment calculations. In each case, year-1 depreciation deductions were not discounted to keep them time-consistent with the full-expensing option.