

MINUTES OF THE HOUSE TAXATION COMMITTEE

The meeting was called to order by Chairman Kenny Wilk at 9:00 A.M. on February 5, 2008 in Room 519-S of the Capitol.

All members were present.

Committee staff present:

Chris Courtwright, Legislative Research Department  
Gordon Self, Office of Revisor of Statutes  
Ryan Hoffman, Legislative Research Department  
Scott Wells, Office of Revisor of Statutes  
Rose Marie Glatt, Committee Secretary

Conferees appearing before the committee:

Secretary Kerr, Kansas Department of Commerce (KDOC)  
Dr. Art Hall, Executive Director, Center for Applied Economics, KU School of Business

It was noted that minutes from the January 23, 24 and 25, 2008 meetings were sent electronically to the Committee on January 28 and, by consensus, approved on February 5, 2008.

The following bill introductions were requested.

Representative Whitham requested a bill be introduced that would provide standardization for the granting of sales and use taxes. Representative Carlson seconded. The motion carried.

Representative Wilk made a motion to introduce a bill which would treat commercial trucks the same for M & E exemptions as the rest of business machinery and equipment. Representative Carlson seconded. The motion carried.

On behalf of Representative Goyle, the Chairman requested a bill introduction changing the social security exemption from \$50,000 for household to an individual. Representative Carlson seconded. The motion carried.

The Chairman called attention to a copy of an article "Growth and taxes - Outmoded tax systems are undercutting the economic future of the states," published in "Governing - January 2008." He urged members to read the article as it is relevant to what is happening in Kansas today (Attachment 1).

The Chairman invited Secretary Kerr to the podium for a review of his proposal for the 2008 IMPACT program. On January 31, 2008, Secretary Wagon distributed information and reviewed details on the program. In response to questions regarding the criteria used for selection of applicants, he stated that the guidelines have not been finalized; however, he provided an outline from which they are working. Applicants would have a period of time to submit applications up until the end of October. All applications would be processed within thirty days and would be notified by November 1, 2008. They would have thirty days in which to accept or reject the cash refunds. That would allow the state time to reallocate any unused funds to other applicants. The Committee requested that Secretary Kerr provide copies of the criteria as they are finalized.

Secretary Kerr distributed a memorandum, from the Kansas Department of Revenue, on the Benefits and Requirements on Tax Incentive programs, current and proposed, that included (HPIP), Enterprise Zone Program, Business & Jobs Program, **SB 497** and the Differences (proposed vs. existing) Also distributed was a spreadsheet, from the Kansas Department of Commerce, with data on Investment Projects tied to HPIP qualification. The chart represented FY 05-08 and listed the number and average cost of projects (Attachment 2.)

Discussion followed regarding:

1. Difference in salaries between rural and metropolitan areas
2. Constitutional merit of the program
3. Timing of refund mechanism for businesses before they make an investment

CONTINUATION SHEET

MINUTES OF THE House Taxation Committee at 9:00 A.M. on February 5, 2008 in Room 519-S of the Capitol.

4. Fiscal note on tax credit program
5. Factors that determine the percentage of refunds a company will receive

In response to Committee's requests the following information was distributed (Attachment 3) :

1. Kiowa county Business Restoration Assistance Program, with application
2. Southeast Kansas Business Restoration Assistance Program, with application
3. NAICS included in proposed legislation

At the request of several committee members, Secretary Kerr distributed a map "Kansas-Core based Statistical Areas and Counties, referred to in **SB 497**. The map reflects the opportunity zones (rural areas that are economically disadvantages) (Attachment 4.)

The Chairman requested that the following issues regarding the Corporate Tax Structure be brought to the table in order for members to review all proposals, determine what they want to accomplish and how much they want to spend before they move into policy. He stated there are four major components. They are:

1. IMPACT
2. Tax Credit program (**SB 497**)
3. R & D sales tax exemption (**HB 2739**)
4. Corporate tax issues regarding business verses non-business (Interim Bill.)

The Chairman reviewed bills from last year, i.e., Corporate tax rate, Expensing (**HB 2751**), Unitary, etc.

Dr. Art Hall briefed the committee on the various components of "Implementation of Expensing in Kansas," a primer on the expensing proposal in the Kansas, Inc. Strategic Plan (Attachment 5.) He stated the tax policy matter is decades old; however, the current conversation comes from Kansas, Inc.'s Strategic Plan. All through the development stages, the theme "every business matters" was emphasized. He provided data on the number of businesses, large and small, located in Kansas. Key points of his presentation included:

1. Overarching goals of the program
2. Explanation of "expensing"
3. What is the Kansas, Inc. Proposal
4. How expensing compares with investment tax credits
5. A taxpayer perspective
6. Kansas, Inc's solution for implementing expensing
7. What is the fiscal note for the Kansas, Inc. Expensing proposal
8. Methodological points related to the fiscal note calculations

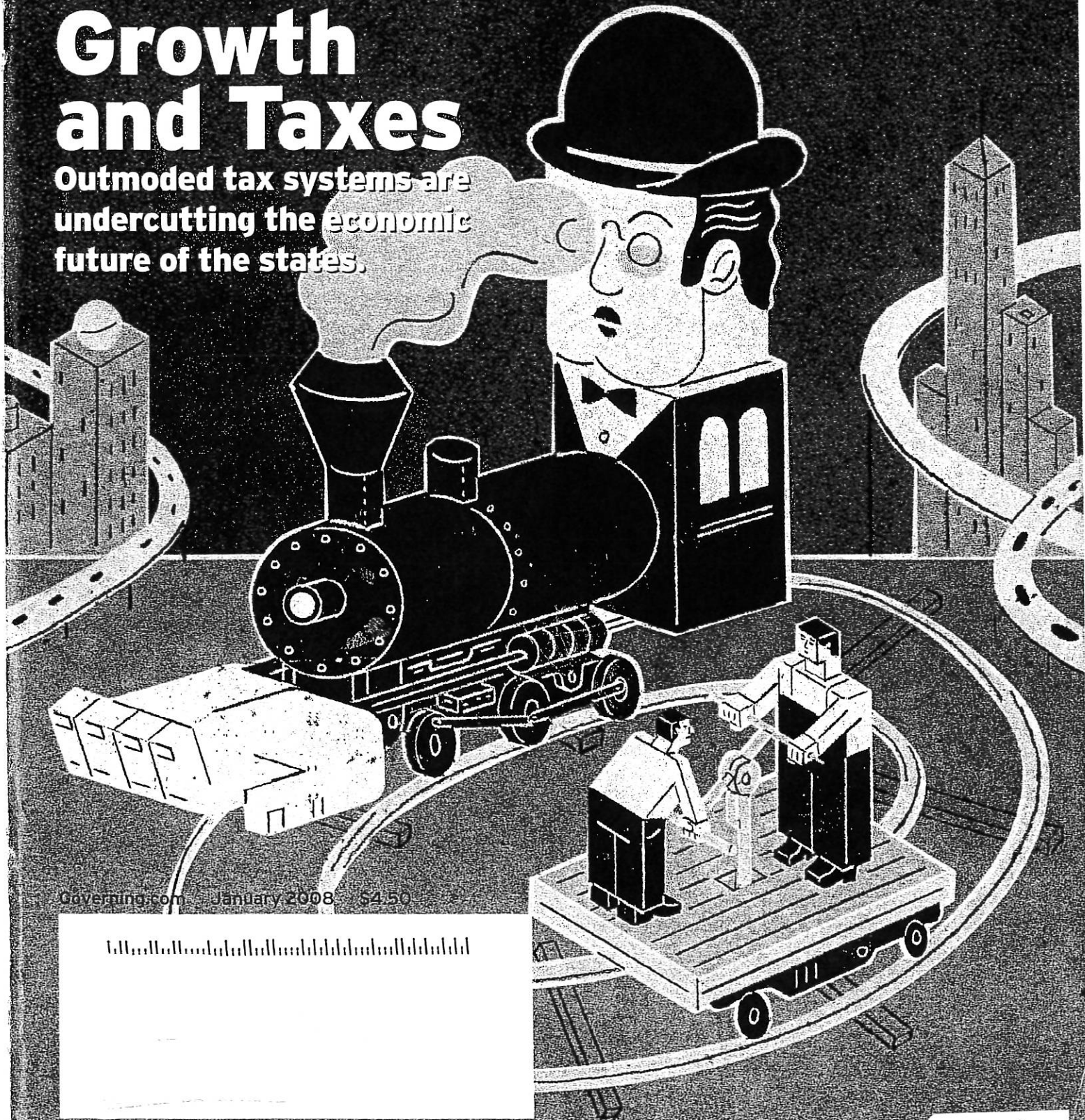
The overarching goal for expensing and all the tax credits proposed have the same policy goal, *to increase the expected rate of return on investment*, which in turn will attract private investors. Discussion followed on details of the proposal.

A memorandum regarding a Bill Summary corresponding to the Kansas, Inc., "Proposal for Universal Expensing of Capital Investment" as endorsed by the Joint Committee on Economic Development and an information brochure on "The Center for Applied Economics" (Attachment 6) were distributed.

The meeting adjourned at 10:30 A.M. The next meeting is February 6, 2008.

# Growth and Taxes

Outmoded tax systems are undercutting the economic future of the states.



Governing.com January 2008 \$4.50



# Taxes in the 21st Century

FOR 15 YEARS, Russell B. Long of Louisiana, the son of Huey, chaired the tax-writing Finance Committee in the U.S. Senate, a job he was uniquely qualified to handle. Long knew tax policy inside out, and it was he who famously said that what tax reform really means is, "Don't tax you, don't tax me. Tax that fellow behind the tree."

Indeed, for individuals, industries, professions and everyone in between, there is almost no

with each other but globally. Why are we taxing some industries, such as telecommunications, so heavily, and others, such as high-end professional services, hardly at all?

This is an ambitious report, designed to inform the debate about what different kinds of tax options will do for—or against—your economy. *Governing* can present this analysis in as interesting and understandable a way as possible, but



SCOTT J. FERRELL

area of public policy where the distinction between winners and losers is so keenly felt and strongly articulated as tax policy. One group's reform is another's burden.

That's why we decided to time our cover story on state tax policy for January, when most legislatures are reconvening. There has been a lot of activity in the tax area in recent months at both the state and local level, and more is likely. So we thought it was a good time to take a hard look at how tax policy can either help or hinder states' economies.

We've concluded that the existing tax systems in most states are outdated. But that's where this report really starts. We move on from there to examine what changes in tax policy are likely to improve economic vitality in various states, to make them more competitive not only

such an undertaking also requires the significant input of a number of experts in various aspects of tax policy.

Our partner in this effort is the Pew Center on the States, which is emerging as an important national think tank on state policy issues. Pew for years has underwritten our "Grading the States" effort on management (the next installment of which will appear in the March issue). But as the center builds capacity, more reports of various kinds are being planned.

I'm gratified that a major national foundation has decided to focus on the states, where policy change really is possible, rather than Washington, where everyone else is spending so much to do so little.

—Peter Harkness

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# GROWTH & TAXES

**Why  
outdated  
state tax  
systems  
undercut  
economic  
vitality,  
and what  
states  
can do  
about it.**

**BY KATHERINE BARRETT  
AND RICHARD GREENE**

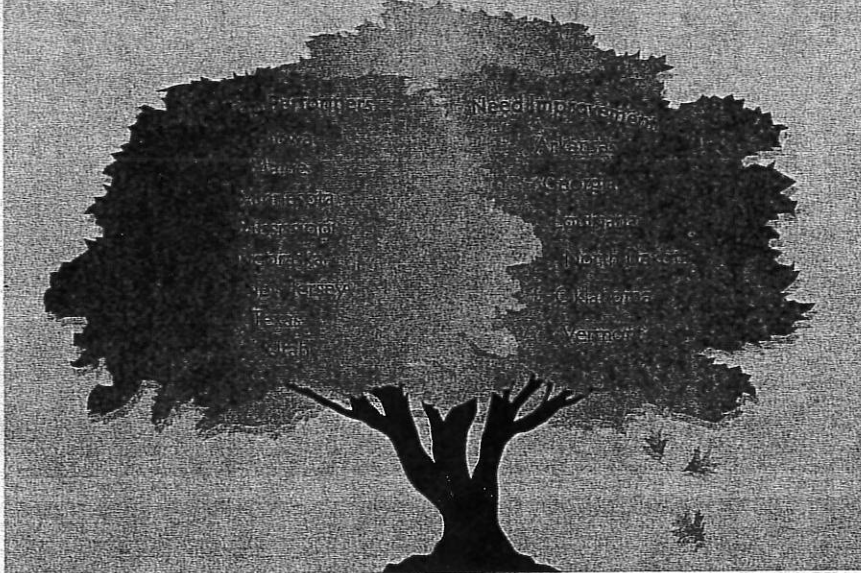
It's been known for a long time that obsolete state tax systems are not producing the revenue states need. But what's becoming clear today is that those tax systems are not only failing to keep up with the dramatic shifts in the U.S. economy. They are a drag on economic growth.

The new economy is more than a swing from manufacturing to services. Thanks to new technology and telecommunications, products can be purchased as easily from an outlet 3,000 miles away as from one down the block. Small businesses are increasingly vital—they now account for about a third of the value of U.S. exports. Moreover, the service economy is moving toward a further evolution: It's becoming increasingly knowledge-based. Where managerial and professional jobs accounted for roughly one-fifth of total employment in 1979, such jobs are now moving past the one-third mark.

And yet, state tax structures, developed at a time when computers—

## STATES OF CHANGE

States rated on presence of mechanisms for ongoing review of their tax systems in light of changes in the economy



Source: Pew Center on the States, based on data from the National Conference of State Legislatures, the Center on Budget and Policy Priorities, and state documents

“thinking machines”—were the stuff of science fiction, and the American economy flourished with the automobile industry, have failed to evolve. They are “completely inefficient,” says Ray Scheppach, executive director of the National Governors Association. They stifle economic vitality by creating an environment that’s inhospitable to businesses.

To take one example, there is the outmoded way in which telecommunications companies are taxed. A reliable, high-quality and affordable telecommunications system is essential to the economic competitiveness of states—to say nothing of the nation. And yet, these systems are subject to very high taxation rates in a number of states—by a tax approach set when the industry, dominated by one telephone company, was highly regulated. The result is a damper on the telecom industry. According to a 2004 report by the Council on State Taxation, the average effective rate of state and local transaction taxes for telecommunications services is around 14 percent, compared with about 6 percent for general businesses nationwide.

That’s not the only fallout from antiquated state tax systems. They are often unfair—undertaxing one portion of the economy at the expense of others. In many states,

for example, a number of services—including things such as tattoo parlors, car washes and gardeners—are free from any sales tax, while tangible goods—things such as pencils, cars and garden hoes—are subject to a higher tax rate to make up for the slack.

Over the past year, the Pew Center on the States has researched the question of how state tax systems can adjust to a new economy in which fundamental business rules have been changing. The report that follows looks not so much at the basic principles of taxation but at specific tax systems and practices that are critical to promote economic vitality.

Those tax systems are no longer a parochial matter of interest to each of the 50 states as an independent entity. That is, the battle for economic growth is not a civil war among the states anymore. It’s a world war. The U.S. is already at a huge disadvantage in competing internationally based on cost. Wages in India and China, for instance, are as much as 90 percent lower than those in the U.S. The competitive strengths in the U.S. are in innovation, productivity, marketing and entrepreneurship. All of these things can be either helped or hurt by the nature of the states’ tax systems—as can the revenue base, which states need to make the investments necessary to succeed.

“States are aware that their tax structures aren’t up to snuff,” says Michigan Governor Jennifer Granholm. “The question for us as the state of Michigan, is, ‘What is it that is going to make us competitive?’ If it’s not going to be price, then

## AT YOUR SERVICE

States that tax professional services and states that tax more than 55 of the roughly 143 different services susceptible to taxation



Source: Pew Center on the States, based on data from the Federation of Tax Administrators

perhaps it's going to be quality, and that means investing in your talent. If you have class sizes of 37, then you're going to be uncompetitive."

Since 2000, virtually every state has commissioned at least one major tax reform panel to study the issue and develop proposals for modernization. Seventeen states now have in place at least an informal mechanism for continuous review of their structures. Much of this action has been propelled by fiscal shortfalls or the realization that various revenue streams are declining relative to spending pressures. In more than a handful of states, the property tax—which has tended to rise inexorably to make up for some of these gaps—has led to citizen rebellions. Both Florida and New Jersey, for example, have been responding to public fury about the property tax by considering major tax restructurings.

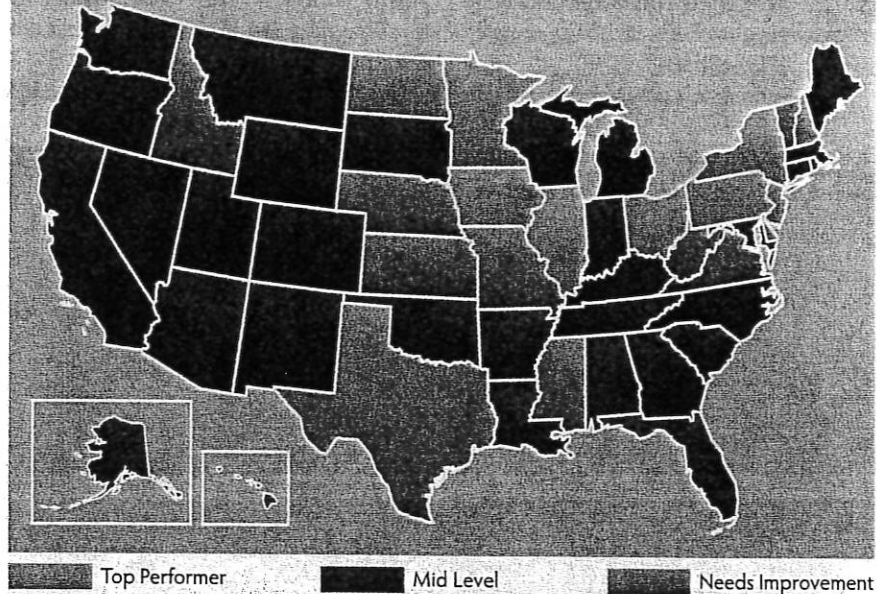
The tax questions the states will need to grapple with in coming decades are ones that lie at the heart of the new economy. How can states reshape and modify their tax systems to encourage greater interstate, federal-state and state-local cooperation—and still retain the autonomy of each level of government? In an age of globalization, how do states compete with other countries, yet minimize tax competition among the various levels of government? How do states generate revenues from the intangible products of knowledge-based firms? How do they capture business activity within state borders when borders are increasingly irrelevant in conducting business?

There's a shortage of proven solutions for dealing with a borderless, knowledge-based economy. But some good ideas have emerged—and are already being tested by some states—to deal with the most basic, underlying issue: creating a tax structure that encourages economic vitality.

The material in the pages that follow has been informed not just by predictions of the world to come but by respect for the deep-seated fundamentals of a solid tax system—one that is simple and transparent, with broad-based taxes that provide a balanced revenue stream, spread the tax burden fairly and heighten the chance of compliance.

## DOUBLE JEOPARDY

States rated on the reduction or elimination of corporate property taxes on inventory and tangible personal property and sales taxes on business inputs



Source: Pew Center on the States, based on data from Ernst & Young's Robert Cline, Council on State Taxation, Minnesota Taxpayers Association, Federal Reserve Bank of Boston, and state documents

Our research acknowledges the idea that some powerfully held beliefs about appropriate tax policy have little chance of prevailing. For example, some tax policy experts believe there should not be any corporate income taxes, because they raise a relatively small amount of money, are complex and end up being passed along to consumers anyway. Politically, however, it is unlikely that taxpayers will stand for an abolition of the corporate income tax. "Most economists come down saying corporate income taxes are really bad ideas for states," says William Fox, director of the Center for Business & Economic Research at the University of Tennessee. "But then they have to talk about the real world." Similarly, many people believe that tax incentives to corporations are a zero-sum game and potentially unproductive as an economic development tool. But incentives are not going away.

One cluster of questions addresses tactics that pertain to specifics of the new economy: the transition to services; the rapid growth of untaxed Internet sales; the need

to encourage newer high-tech industries while not overburdening old-time manufacturing; an adjustment of telecommunication tax rates and complexity to a world in which telecom companies are no longer monopolies; and strategies to tax multi-state and multi-national corporations in a fair way. Those tactics have grown increasingly critical in order to preserve any kind of equity between large multi-state or multi-national firms and smaller, in-state businesses.

Four areas pertinent to vitality in the new economy are examined in the stories that follow. Fifty-state evaluations inform these articles on the transparency of tax incentives, the efficiency of tax collection, the stability of revenue streams and the tax flexibility states allow their localities—which provide many of the key services that support the new economy.

### The Rate Debate

Much of the argument over reform has tended to focus on the notion that a tax increase to any segment of the economy will

A nonprofit organization, the Pew Charitable Trusts applies an analytical approach to improve public policy and stimulate civic life. The Pew Center on the States (PCS) identifies and advances effective policy approaches to critical issues facing states. This series of articles on state tax systems is based on research by PCS. More data and analysis will be available at [www.pewcenteronthestates.org](http://www.pewcenteronthestates.org).

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drive away business, while a tax cut will do the opposite. This was the point Wisconsin state Senator Alan Lasee made during the 2006 campaign season. "High taxes," he told voters, "are driving our employees and businesses to move to other states for higher paying jobs and lower taxes."

Tax rates doubtless play some role in cre-

Dakota and Wyoming. As Tom Clark, executive vice president of the Metro Denver Economic Development Corp. and the Denver Metro Chamber of Commerce, puts it, "If low tax rates were the only factor, Wyoming would be the economic epicenter of the world."

It is theoretically possible to use low

Then there are investments in R&D at a time when innovation is key to economic development and in infrastructure, including broadband access, bridges, airports and, of course, roads.

## Taxing Services

One of the tectonic shifts that marks the new economy is the long-term transition to a service economy. In 2005, service industries accounted for some 68 percent of the total U.S. gross domestic product and 79 percent of growth in the GDP. Yet, only a handful of states tax more than 80 of the 143 or so common services, according to Federation of Tax Administrators' data. "We've ignored services in the past," says Tennessee's Fox. "But with all the new forms of technology available to expand the service sector, that's no longer a reasonable idea."

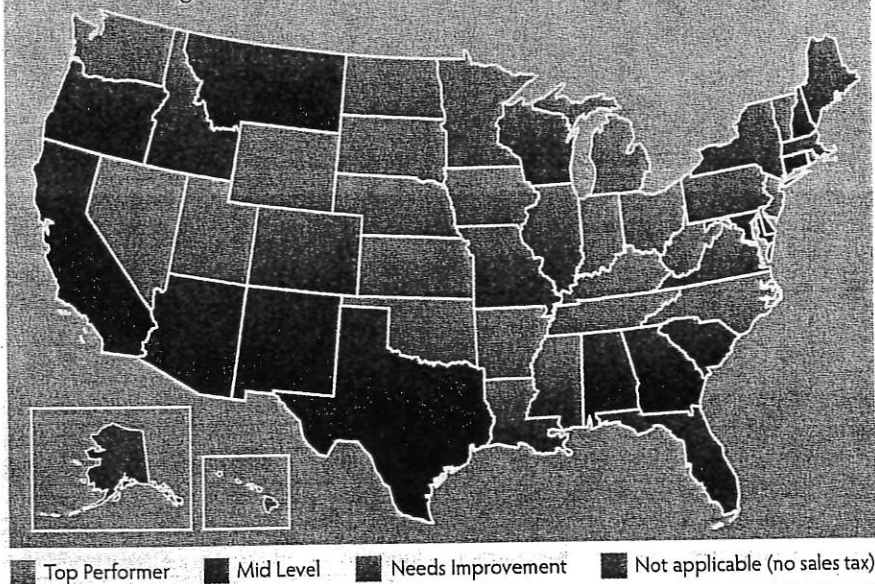
A number of obstacles stand in the way. The power of interested or affected parties is high on the list. They can and do lobby their legislators effectively. Last summer, a potentially forward-looking reform in Maine failed to pass the Senate largely because a slew of services—everything from haircuts to car towing—would become subject to tax. "Expanding the tax base to consumer services is good tax policy," says George Washington University professor David Brunori, "but the service providers rarely see it that way."

When it comes to the taxation of professional services—such as those provided by lawyers, accountants, financial advisers—things get even tougher. About 20 years ago, Florida attempted a bold experiment aimed at vastly broadening its taxation of services—to professionals and just about every service in the state's economy. When the state's newspapers and magazines realized that meant that advertising would be taxed, they mounted a full frontal assault. The state backed off, the governor suffered politically and ever since there have been very few states with the fortitude to move in the same direction at full force. Only last month, the Michigan legislature repealed a new service tax—mostly on business-to-business transactions but also on such things as manicures and ski lift tickets—just hours after it went into effect.

Even states that consider adding service taxes in a more marginal way have to deal with the knotty problem of taxing business

## TOLLS ON THE ELECTRONIC HIGHWAY

States rated on their compliance with the Streamlined Sales and Use Tax Act, the Multistate Tax Commission's efforts to advance uniformity, and model recordkeeping and retention regulations



Source: Pew Center on the States, based on data from the Streamlined Sales Tax Commission and the Multistate Tax Commission

ating a fertile economic climate—and if all other things were equal, businesses might choose to settle in lower-tax realms. But in the real world, all things are never equal. Some states have better-educated workforces, a better-developed network of roads or nicer public amenities. These elements, all of which require steady flows of tax revenues, are crucial to the equation.

There is now evidence that low tax rates by themselves are not a silver bullet. In his New Economy Index, Rob Atkinson, president of the Information Technology and Innovation Foundation, measures the progress of states in adapting to the new economy by looking at factors such as workforce creation, entrepreneurial activity and patent creation. Five of the eleven lowest-scoring states on his list are among those having the lowest tax burden: Alabama, Montana, Oklahoma, South

tax rates to drive economic vitality. Robert G. Lynch, chair of the Department of Economics at Washington College in Maryland, points out that academic studies on tax rates "suggest that state and local tax cuts and incentives may help economic growth, provided that government services are not reduced to pay for the tax cuts."

But as Lynch makes clear, in reality, lower taxes tend to lead to service reductions, some of which inevitably fall in areas that fuel economic vitality. Bruce Johnson, a former lieutenant governor of Ohio and head of economic development for that state, notes that "ground zero for economic development is a high-value workforce." That requires a considerable investment in education as well as in quality of life to enable states to compete effectively in the worldwide market for talent.



inputs. The issue is sometimes called pyramiding—at an extreme, a state could tax the services an accountant provides to a law firm, and then tax the services the law firm provides to a car manufacturer, which either builds those taxes into the price of a car or reduces its investments in the state. Most tax experts agree that that placing sales taxes on assets or services purchased by businesses is a form of double taxation and to be avoided.

States are making progress in reducing or eliminating the taxing of business inputs in an arena other than straightforward sales taxes. States that tax inventory and tangible personal property are dwindling in number. Ohio eliminated its taxation of tangible personal property, Indiana is on its way to doing so, and Michigan has enacted a 35-to-40 percent reduction in its tangible property tax.

Meanwhile, the rise of the high-tech and services-based economy has ushered in another trend: The reliance of corporations on customers who are remarkably mobile and geographically widespread. The steadily growing number of sales transactions over the Internet—Jupiter Research Online Retail Forecasts anticipates growth of 10 to 15 percent per year over the next decade—puts local retailers at a disadvantage. Those that sell their wares electronically often escape the sales tax. That, in turn, is contrary to the precept that taxes should be levied over as broad a base as possible so that states and localities can generate the revenue they need at the lowest possible rates.

The biggest obstacle to taxing Internet transactions has been the wide variety of sales tax structures used by the individual states (and their localities), which make it extremely difficult to coordinate a means of taxing them. The Streamlined Sales Tax Project is the clearest effort by states to deal with the complications of this world in which there are virtually no physical barriers to commerce. The ultimate goal of the project is to create an environment in which transactions conducted over the Internet could be easily taxed by states. The agreement would simplify state and local tax returns and the administration of exemptions; it would also provide for streamlined tax returns and a centralized electronic registration system for all member states. Nearly half of the states have made a commitment to either fully or par-

tially comply with the Streamlined Sales and Use Tax Act, which requires uniformity in state and local tax-based definitions and sourcing rules for all taxable transactions.

## Catching Corporate Dollars

Even as the technological complexity of the world has advanced, so too has the capacity of large companies to create business forms designed, in part, to shift tax burdens from high-tax states to low- or no-tax states. Many states allege that interstate income shifting amounts to little more than tax evasion, while corporations argue they are legally taking advantage of competing state tax systems. The state courts are divided on the issue, and the U.S. Supreme Court has yet to rule on it.

closes a loophole that many enjoy. In addition, there are potentially significant compliance costs for companies required to alter their bookkeeping. Despite these drawbacks, there is no evidence that the economies of combined-reporting states have suffered compared with those without combined reporting.

Among the states that don't use combined reporting is Iowa. "Our state," says Peter Fischer, professor of urban and regional planning at the University of Iowa, "loses a pretty big chunk of corporate taxes because of its unwillingness to take on combined reporting." Fischer thinks it may be that people who are simply anti-tax see it as a tax increase. Whatever the reason, it has been proposed in Iowa a num-

## THE BUCKS STOP HERE

States that use combined reporting for corporate income



Source: Pew Center on the States, based on data from the Center on Budget and Policy Priorities, Institute on Taxation and Economic Policy, and state tax databases and documents

As a remedy, states have been adopting combined reporting as a more comprehensive approach to curbing artificial interstate income shifting. Combined reporting forces corporate parents and their subsidiaries to add profits together. This enables the state to tax the percentage of an out-of-state subsidiary's profits that can legitimately be attributed to the corporation's in-state operations. Many big corporations, obviously, are not advocates of combined reporting. For one thing, it

ber of times, but the legislature has not moved on it.

An aligned area in which states are gaining some control is in taxing a growing array of new business structures. James Edward Maule, a professor at Villanova University's School of Law, was one of the first to study the tax treatment of limited-liability companies, limited-liability partnerships and S corporations. The new entities are similar to corporations but have a more flexible ownership

structure. His initial findings on the tax picture made Maule reflect that they were in a state of "chaos."

Take S corporations. The simple problem is that they pass all their profits through to shareholders and are essentially immune from corporate taxes. These profits are taxed by a state personal income tax imposed on the individual shareholders. There are now some 3.6 million S corporations in the United States. Obviously, this means that whenever a company elects to use this form, the state may lose some revenues—and the problem is even more intense for the nine states that don't tax income.

Like S corporations, limited-liability corporations and limited-liability partnerships are also "pass-through entities"—states generally don't impose tax at the corporate level but instead collect taxes by imposing the personal income tax (if they have one) on individual members and partners.

The chaos to which Maule refers came from states having no model for how to tax these various new business forms that aren't exactly corporations but aren't individuals, either. Without guidance, confusion reigned in the states over how to apply their tax structures to these alien new business forms. Until the states got a handle on the very concept of what these new business forms were, they couldn't properly capture taxes duly owed, if they captured any taxes at all. Fortunately, the states have gained a large measure of control in recent years. There is now a Model S Corporation Income Tax Act that provides states with a template for how to tax S corporations and is endorsed by both the American Bar Association and the Multi-state Tax Commission. It gives state lawmakers and tax administrators a way to think consistently about state tax treatment of pass-through entities.

As for LLCs and LLPs, one breakthrough came when states, en masse, determined that they would no longer allow the owners of these new business forms to elect to be classified as one type of entity for federal tax purposes but another for state taxation, which might have given them more favorable treatment. A number of states also now require LLCs and LLPs to withhold taxes on the distributive state share of nonresident members' and partners' earned income. This helps en-

sure that the taxes properly owed to the state don't slip away as they did in the past.

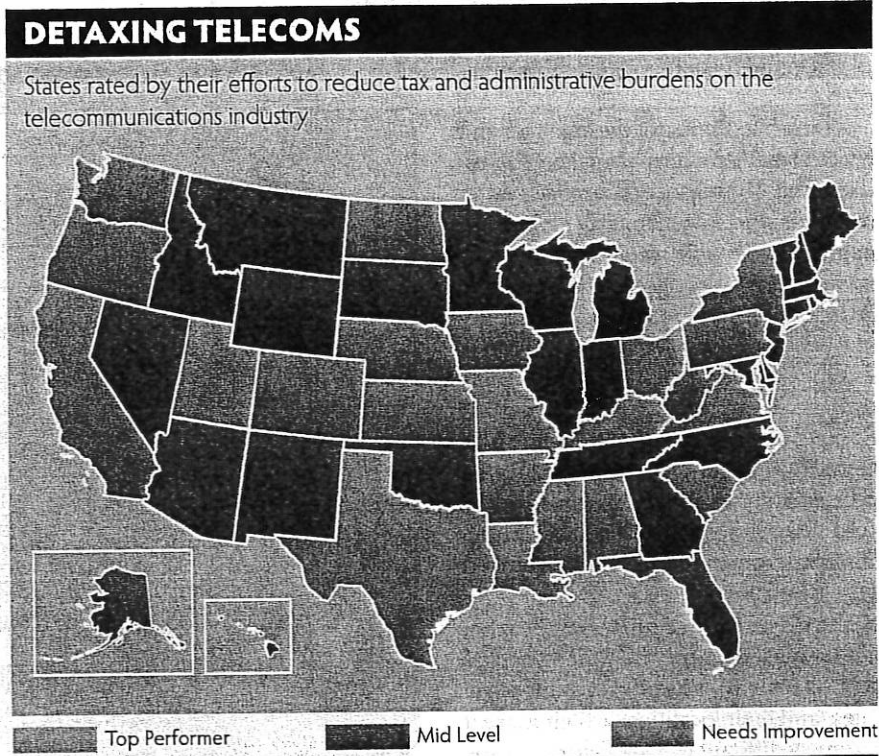
### Marconi's Legacy

Telecommunications was once an industry dominated by telephone companies that were monopolies—and states taxed them accordingly. This was a quid pro quo for the lack of competition.

But today's industry is totally different. Not only don't telecom companies have monopolies, there is bitter competition over a business that has changed dramatically from just supplying phone lines to one that permits transfer of data through a variety of technologies—technologies undreamt of when

local taxes—including local telecommunications taxes—to the state governments. The agreement also contains uniform telecommunications sourcing rules and definitions. And if the states succeeded in resolving nexus questions for Internet-based sellers, the change would, for the first time, put telecommunications companies on a level playing field with Internet-based companies that sell essentially the same products and services to customers.

These taxing issues are germane not only to the economic vitality of a state but to its compact with taxpayers—be they individuals or businesses. The way in which revenues are raised—the fairness and transparency—



Source: Pew Center on the States, based on data from the Council on State Taxation and state tax databases and documents

the codes were written. But states continue to apply the old, outdated tax regimes. Only a handful of states have undertaken telecommunications tax reform over the past decade, and in many of those states, the primary reform has been in centralizing return filing.

Telecommunications companies are also hampered by major administrative burdens. Many states still require telecom companies to file more than 500 returns. This area would be another beneficiary of the streamlined sales tax movement, which requires centralized filing and payment of

is fundamental to the trust constituents have in their government. Right now, most of the states need to modernize their tax policies to encourage growth, and to do that they need to look beyond immediate and purely political considerations. "The biggest problem we have is policy makers making decisions in a vacuum," says Utah state Senator Howard Stephenson. "Overcoming that is crucial to making good tax policy."

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# BREATHING ROOM

States that give localities greater leeway to raise revenue help create robust partners for investing in the future.

**O**n January 29, Florida's voters will decide whether to approve a constitutional amendment—sent to them by the state legislature—that would set sharp limits on what the state's localities can collect in property taxes. While end-of-year polling data suggest that the amendment is not likely to pass, the specter of losing \$2 billion for schools and yet more dollars for infrastructure, technology updates, public amenities and all the things that attract business, has been a constant worry for cities, counties and school districts.

Tax decisions are always a tradeoff. While the state's beleaguered homeowners would rejoice over any constraints on the much-loathed property tax, there's a downside to removing taxing power from localities: They come up short of money to invest in things that make an economy tick.

"Local governments are a key local economic actor—not just an extension of state government," says Michael Pagano, a dean at the University of Illinois at Chicago. "They need to be nimble in the face of economic circumstances—just like a company does."

Without flexibility, a locality is at the mercy of economic ups and downs and decisions made elsewhere. The locality can't even work with its local business commu-

nity and taxpayers to craft a system that might best meet all their needs.

Flexibility also is key to global competitiveness, working to attract companies from all over the world and to keep a highly mobile labor force in place. "Any restriction on their ability to raise the money to invest," says Barry Bluestone, director of the Center for Urban and Regional Policy at North-

## NOTHING IS SIMPLE

**Within the 50 state-local fiscal systems lie different sets of rules for cities, counties, towns, townships, villages—at which point the variation spreads from 50 states to 19,000 municipalities, 16,000 towns and villages and 3,000 counties.**

eastern University, "can harm them"—and, by extension, the home state as well.

Yet a number of states hold local revenue streams hostage, even though most state and local tax experts agree that giving localities greater flexibility or breathing room—with appropriate controls by the state, of course—is solid fiscal policy. They also agree that it can lead, as Bluestone

suggests, to more vibrant support for economic development.

## Control Room

When a locality has authority over its taxes, it can match its revenue-raising tools to the underlying economy. "If a state imposes a uniform revenue and tax structure on its localities," says Chris Hoene, head of research for the National League of Cities, "it ignores the variation of its localities' economic bases and their diverse spending needs." It is, course, up to each locality to figure out whether a particular revenue-raising tool is worth levying on its constituents—whether the administrative or transaction costs outweigh the amount of revenue the tax would raise.

At the same time, localities with a great deal of flexibility need to be cognizant of how their taxes and rates fit in with those the state is already levying—and make sure that the sum total doesn't create an unsupported tax burden. Or that different local variations on a single tax don't impose unfair strains on businesses in a state.

That said, flexibility is still key and one way states give cities or counties leeway is through a local option to control the tax rate and to use the revenues they raise as they see fit—that is, without state earmarks. Localities also can breathe better if they have a

range of taxes to use. For a locality to weather economic ups and downs, it can't be overly reliant on any one source of revenue.

Most states limit localities to the property and sales tax as a sources of revenue. A few keep their localities really short of breath, limiting them to one tax source. Cities, towns and counties in many New England states, for instance, have access only to a local property tax. "On its own, reliance on the property tax produces powerful inequities in development," Bluestone says. "Rich communities get rich because they can provide better schools and police protection than communities with stagnant and falling property values."

The intersection between local authority and revenue independence is what's known as "own-source capacity." That is, the extent to which fiscal policy decisions made by local government officials actually determine the fiscal direction of the locality. In addition to the tax revenue, there are fees and charges that localities set and that flow into the general revenue coffers. These add to the own-source capacity and enhance a locality's ability to pay for services it wants to provide. This is particularly important in localities that have the primary responsibility for their school funding.

There's another part of the equation, of

course. Some states that allow for minimal own-source capacity help to make up for the shortfalls with state aid. While too much state aid can make localities too dependent on the state—and create state budget problems—generally speaking, state aid increases the overall capacity of a local government. In many instances, it provides a level of equalization and base support for localities that may lack other resources. State aid to school districts, for example, often relies on an equalization formula to ensure that the state meets its constitutional responsibility of providing adequate support to schoolchildren.

In Massachusetts, which keeps its localities dependent on one tax, state aid has been used to keep the local communities from diverging dramatically, making up in large measure for whatever inequities are produced by reliance on the property tax.

### TEL Talk

Another way that local tax systems are constrained significantly is through tax and expenditure limitations—TELEs. There are two main types of TELEs: those that put restrictions on revenue raising and those that set limits for overall spending. Spending limits on localities are a good deal less common than tax limits.

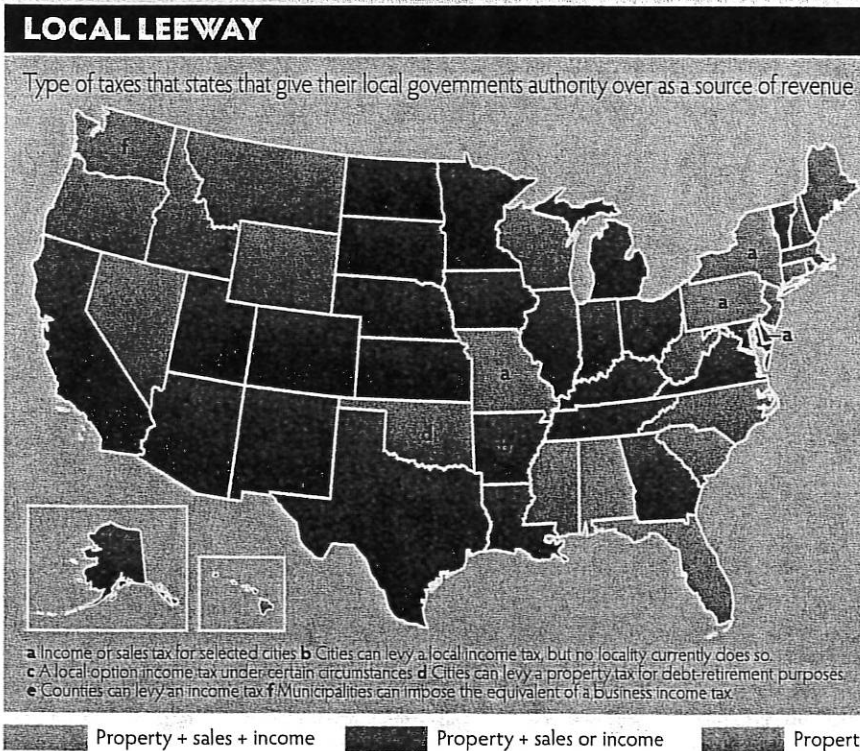
Sometimes, TELEs are imposed by voters. But state legislatures also do it or, as in Florida, ask voters to approve it. It can, however, be short-sighted. "There's an assumption at the state level," says Kevin O'Brien, former director of the Center for Public Management at Cleveland State University, "that every day is a sunny day and there are no extraordinary circumstances—that you won't need firefighters on the ridge."

For localities, the most common TELEs have to do with property taxes. California's Proposition 13 and Massachusetts' Proposition 2.5 are the uber-TELEs. They were imposed by voters, and they have made their mark. "Prop 13 turned California from a state that was among the best in primary and secondary education to a ranking in spending that was near the bottom," says O'Brien, who is currently executive director of the Great Lakes Environmental Finance Center. "That is the legacy of their TELE."

The Massachusetts TELE limits towns and cities from increasing the total property tax levy to no more than 2.5 percent of the community's total assessed value (the levy limit) and from increasing the tax levy to no more than 2.5 percent of the prior year's levy limit. "Homeowners felt they were paying enormously high property taxes," says Bluestone. "And that was because the property tax was essentially the only real source of local revenue."

The bottom line, though, is that the TELE makes it much more difficult for cities and towns to raise the revenue they need. "That you can't raise revenue by more than 2.5 percent on existing property is a powerful constraint," Bluestone says. Towns and cities in Massachusetts often ask voters for an override but these are increasingly unsuccessful, leading to cutbacks in schools and social services—"just when," Bluestone says, "these communities are competing like never before for jobs and investment."

For state policy makers, there are obvious policy levers to pull to improve the fiscal and economic vitality of local governments. More local tax authority is perhaps most obvious. Maintaining or increasing state aid levels, particularly where state aid reduces inequities, is another—but one that is often pulled in the opposite direction, particularly in response to economic downturns. Doing so, however, can harm the ability of the state and its localities to recover from the downturn.



Source: Pew Center on the States in coordination with Michael Pagano, University of Illinois at Chicago, and Chris Hoene, National League of Cities

# BAITING

Tax incentives will always be with us, but states are finally keeping tabs on what they're getting for their money.

# HOOKS

**T**ax incentives have long been endorsed as the highway to prosperity—attracting businesses, providing jobs and enriching the state. That's been conventional wisdom in most states and cities.

One problem: Most public finance experts consider them bad policy. Tax incentives that target specific companies create inequities, complications and inefficiencies—and they shrink the tax base. Meanwhile, there's little evidence that targeted incentives bring growth in good-paying jobs. In short, big-ticket targeted tax incentives fail the test of any investment: the presence of a clearly identifiable return.

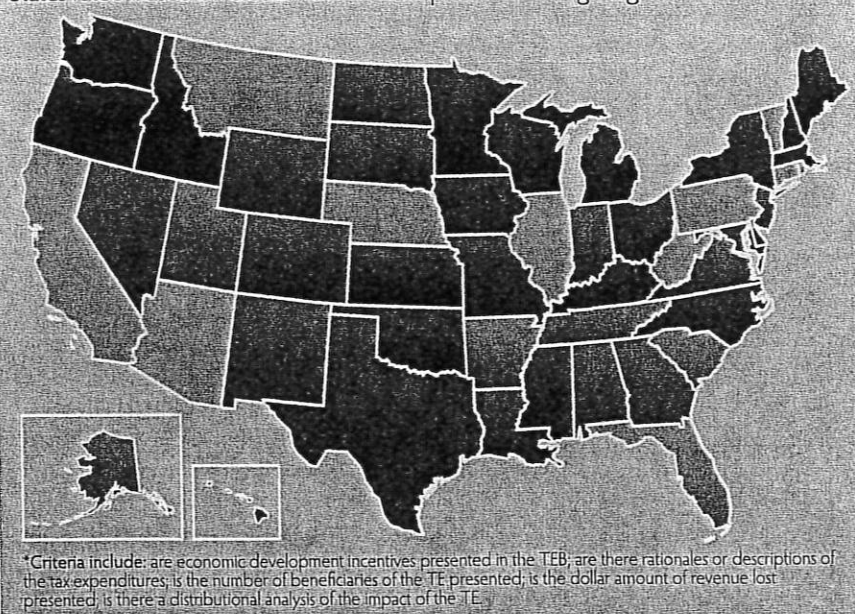
For some companies, they aren't a major factor. In 2006, when Honda decided to put a \$550 million automobile plant in Indiana instead of Ohio, it seemed at first blush that it was tax incentives that won the day for Indiana. In truth, Honda encouraged both states to stay away from pure cash tax incentives. "They needed a 100 percent check-off on what the states could provide in terms of water, sewer, environmental characteristics, roads, bridges and so on," says Bruce Johnson, former lieutenant governor and head of economic development in Ohio.

In the end, the deciding factor revolved around Honda's concern that settling in Ohio would have potentially driven up workforce costs for suppliers located there.

Many companies still seek incentives, and it's difficult for states to back away—particularly when there are lots of jobs involved. But there are questions states can

## MEASURING INCENTIVES

States rated based on assessment of Tax Expenditure Budget against select criteria\*



Legend:  Top Performer  Mid Level  Needs Improvement  No TEB available

Source: Pew Center on the States in coordination with the George Washington Institute of Public Policy, based on data collected directly from the states

focus on to mitigate the damage: Are the incentives transparent? Is there a look back to see if promises are met? Are there clawbacks—to retrieve the dollars spent if companies fail to hold up their end of the bargain?

Last November, New Jersey passed major legislation aimed directly at providing this kind of disclosure and transparency. Under terms of the new law, companies that receive a subsidy will have to report such things as their job-creation numbers, benefit rates on subsidized jobs, the number of current workers who get health insurance, and the number of subsidized employees represented by a union. "So many companies are more or less gaming the system," says state Senator Shirley K. Turner, one of the bill's sponsors. "This is our way of holding them to their commitments."

The Pew Center on the States, working in collaboration with the George Washington Institute of Public Policy, looked into the 282 tax incentive programs aimed at encouraging investment and job creation in the 48 states that offer tax incentives for economic development. (Alaska and Wyoming do not.) Some of the findings:

- In a dramatic change from a decade ago, every state that offers tax incentives for economic development undertakes one of three forms of incentive monitoring. Some states pre-certify: Before the recipient of an incentive can claim the tax break, it must prove that a level of investment or job creation has been met. In some states, recipients are allowed to begin taking advantage of the tax benefits before investment and job criteria are met, but they must file periodic reports with the state showing that progress on the criteria is being made. And in other states, the government conducts audits of recipients to determine if they are meeting their obligations.

- Eighty percent of states impose a penalty on recipients that do not meet their obligations. A decade ago, almost no states did so. Penalties include repayment of tax benefits received plus interest. In some states, there are fines and damages as well. Over the past two years, for instance, Pennsylvania took enforcement actions against 10 companies that received incentives from the state—recovering about \$2.3 million.

- Thirty-two states publicly disclose

information about tax incentive recipients—either identifying the recipients, identifying the amounts of tax dollars involved or both.

- Eighty percent of states have tax expenditure budgets, which provide data on the amount of potential tax revenue lost when exemptions or credits are granted. These reports provide information on the total cost, or fiscal impact, of all tax preferences, personal income tax deductions and sales tax exemptions. In practice, however, states vary widely in how much information they provide. California, Connecticut and Pennsylvania provide a great deal of useful

information; Florida, South Carolina and several others do not.

Building on the work of tax expert John Mikesell, the Pew-George Washington team categorized state tax expenditure budgets according to various characteristics, including whether the reports are available online and which taxes are included. They also asked questions such as whether there was a description of the tax expenditure, whether the dollar amount of revenue lost is presented, and whether there is a distributional analysis of the impact of the tax expenditure. These criteria were used to rank the states.

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# STAYING

volatile revenue streams and unpredictable taxes bring misery to everyone from state budgeters to businesses.

# STABLE

**W**e'd always take a tax cut, of course," says David Johnson, the former chairman of the Ohio Manufacturers' Association. Nothing surprising in those words, but the businessman—he heads a mid-sized tile company in Summitville, Ohio—doesn't stop there. Of even greater importance, he says, "is having a fixed code. If it's going to change every two years—even if it's a change for the better—it's confounding to business plans."

Johnson was deeply involved in a tax reform in Ohio in 2005. A major accomplishment was to replace the state's tangle personal property tax and corporate franchise tax—both of which were perceived as anti-business—with a broad-based, low-rate corporate activity tax, levied on taxable gross receipts from most business activities. Throughout the debate, one focus was on keeping that state's tax system as stable as it has been.

But not all states have been able to keep their focus on stability. The most significant concern for many corporations is the tendency for state legislatures, moved by a variety of causes, to alter their tax policies on a regular basis.

"People who run businesses success-

fully need to know what the variables are," says Bill Blazar, senior vice president for the Minnesota Chamber of Commerce. If a company wants to expand its factory in Minnesota, its planners would factor into that decision how much more the company would have to pay, say, in property taxes and sales taxes on equipment. "They want to write an equation that leads to profitability," Blazar says. "They have to have certainty that the equation will be true."

Meanwhile, a volatile revenue stream is a problem for governments. It makes it hard to maintain programs and invest for future growth. And that is a concern for taxpayers and the business community as well. "Instability in the revenue base obviously leads to difficult budgeting at certain times," says Michael Allen, director of economic research for Maine Revenue Services. "Government programs that businesses may depend on, such as job training or other economic development programs, can be susceptible to cuts."

Volatility is a close cousin of unpredictability. The distinction is that a highly volatile tax structure—one in which revenues bounce around a great deal from year to year—might be predictable if the fac-

tors driving those swings are well understood and are themselves predictable. For example, income taxes are driven in part by stock market capital gains, making them very volatile. They are not very predictable, though, because the market itself isn't and because taxpayers choose when to sell their stocks and realize gains.

One problem with reducing volatility is that the economy gets in the way. A downturn in the business cycle has a negative effect on receipts but rarely reduces the need or demand for government services and programs; an uptick opens the fiscal spigots. Some states are more affected by these cycles than others.

But the economy is just the beginning of the story. As Alison J. Grinnell and Robert B. Ward point out in one of their reports for the Fiscal Studies Program at the Neslson A. Rockefeller Institute of Government, "Even if growth affected all regions and states to exactly the same degree and at exactly the same time, the effect on state revenue would vary because the tax systems used by the states react differently to similar economic situations."

Whatever the cause, the bottom line is the same. "Volatility," says Don Boyd, an independent consultant affiliated with the Rocke-

feller Institute, "has negative effects, whether they're caused by underlying economic fluctuations or by a volatile tax structure."

## Taming the Wild Ride

States have tools available to tamp down tax revenue volatility and to ease its impact. They can reduce the overall revenue ups and downs by building a diversified portfolio of taxes, relying not just on a single tax or on a single industry but instead using several taxes, such as an income tax, a sales tax and selective excise taxes. Such a diversified base can sometimes draw a large portion of its revenues from sales taxes, which are themselves diversified among various areas of consumption. Individual taxes imposed on different bases almost never move in lockstep, even in recessions and booms, so their instabilities tend to offset each other partially, reducing the volatility of total tax collections.

In the last recession, many states were clobbered by the sudden downward swing in personal income tax receipts. As the stock market and other investments declined, income tax collections collapsed much faster than the economy, creating large holes in the budget of almost every state with an income tax—even in states such as New York and Colorado that have had moderate tax volatility on average over the long term. Colorado's real per-capita state government tax revenue fell by 12.1 percent in 2002 and by another 7.6 percent in 2003. New York's fell by 5.7 percent and 4.7 percent in these years—despite a tax increase. "Both states rely on very high-income taxpayers for a disproportionate share of their income tax revenue, with highly variable capital gains income and other forms of non-wage income," Boyd points out. "With the right kind of economic conditions, these states have extremely volatile revenue."

The design of individual taxes matters, too. A broad-based tax usually is more stable than one that is narrowly based, and progressive tax rate structures tend to be more volatile than flatter taxes. Choices such as these, made in the interest of tax stability, often conflict with other tax policy goals. One way to stabilize revenue from the income tax, for instance, is to broaden its base and make it less progressive. A flat tax tends to ease volatility. But that stability comes at a cost to low-income taxpayers. With flat-tax proposals, notes Ray Nelson of Brigham

# THE BROAD BEAM

The states of Montana and Washington are near the extremes of volatility versus stability. The difference has little to do with the states' economies and plenty to do with policy decisions. Montana relies on severance taxes and they can swing wildly depending on the price of natural resources. It also leans more heavily on the property tax—which it uses for state funding of schools—than does the typical state. It has no sales tax, and it depends on the income tax about as much as the typical state does.

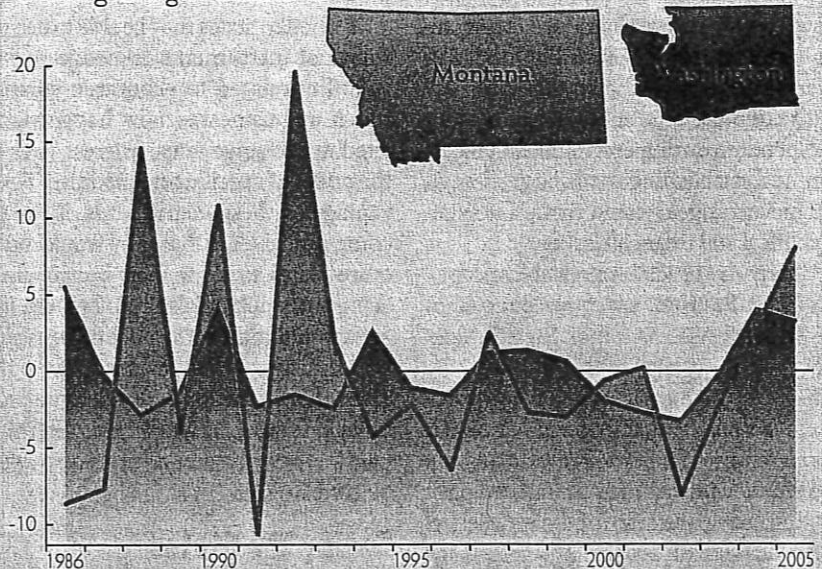
Washington, by contrast, has no income tax and relies disproportionately on the state sales tax. Although this lack of diversity can be seen as a shortcoming for the state's structure—and critics complain that sales taxes weigh too heavily on low-income groups—sales taxes tend to be far more stable than income taxes.

Both states are heavily dependent on a single kind of tax. But Montana is narrowly focused on all the natural resources that back up its slogan, "The Treasure State." Washington's sales tax, on the other hand, is broad-based.

Many of the steepest variations in Montana's revenues occurred in the early 1990s and were related in part to changing choices about how to finance schools. So, the state's revenue streams aren't as unpredictable as they used to be, although they are still more dicey than Washington's.

## A TALE OF TWO STATES

Annual percentage change in state-only taxes, adjusted for population, inflation and long-term growth trend



Source: Pew Center on the States in coordination with Boyd Research, based on U.S. Census Bureau data

Young University in his paper, "State Income Tax Revenue Volatility Causes and Effects," revenue volatility is largely dependent on the definition of taxable income while progressive taxes are dependent on many factors that lead to volatility, such as exemptions, deductions and phase-outs, to say nothing of broader tax brackets.

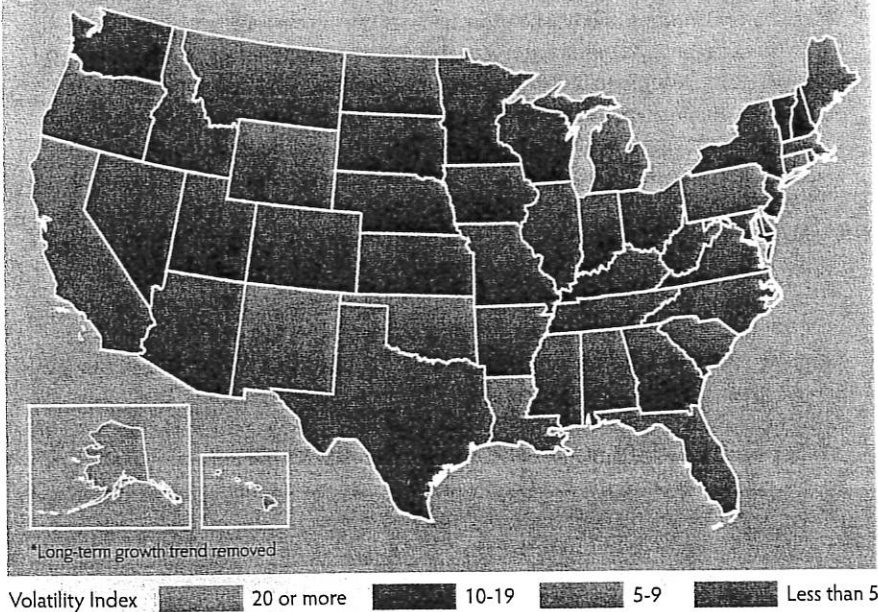
States have other ways to manage revenue volatility that need not conflict with other tax policy goals, but those, too, have shortcomings. Take rainy-day funds, which are supposed to help states weather the swings in the business cycle. States can withdraw money from the funds during a downturn to help stabilize services and

1-14



## SWINGING REVENUES

Standard deviation of year-to-year percentage changes in real per capita state government tax revenue, 1986 to 2005\* (larger values indicate more volatility)



Source: Pew Center on the States in coordination with Boyd Research, based on U.S. Census Bureau and U.S. Bureau of Economic Analysis data

allow orderly policy changes. During recoveries, they can replenish the fund. But several studies have shown that rainy-day funds rarely are large enough to fully stabilize spending during even a modest recession, and establishing funds large enough to achieve this goal would create a new set of political and financial issues.

"Rainy-day funds are great in concept," says Scott Pattison, executive director of the National Association of State Budget Officers, "but rarely are they funded adequately to make a material difference beyond a few projects in any given year." That was certainly the case in Maine during the 2000-01 downturn. The state burned right through its \$140 million fund, says Michael Allen, director of economic research for Maine Revenue Services. As to the current fund, Allen says he doesn't "envision that it would be able to solve the problem entirely. It might lessen it."

There's one other problem with a robust rainy-day fund. "Tax collections high enough to allow states to build rainy-day funds large enough to address the falling revenues experienced in the last recession," says Ron Snell of the National Conference of State Legislatures, "would lead to demands for substantial tax cuts."

Someday, states may be able to use pure financial instruments to hedge revenue volatility related to economic volatility, much as businesses now hedge risk related to exchange rates, interest rates and the prices of specific commodities. The advantage of these instruments, if they become available, is that they would not require states to skew their tax policies to achieve stability goals. This benefit, however, would come at the price of, in essence, purchasing a revenue insurance policy. Then if revenue (or the underlying economy) performed as expected, the money paid for the equivalent of premiums would be gone forever.

### Rating the States

Volatility results in large part from state policy choices. Since sharp shifts in policy can be a deterrent to economic activity, they have been included in the volatility index for assessing the states on the stability of their revenue.

Researchers generally have used several broad approaches to defining and measuring volatility, such as large or frequent year-to-year changes in tax revenue, large and persistent deviations in revenue from long-term trends, tax revenue that

changes rapidly in response to economic changes and tax revenue that deviates substantially from the amount predicted.

Overall, the assessment found that almost every state had at least a 15 percent reduction in volatility due to diversification of its taxes—the portfolio effect—and that three-quarters of them had a benefit of 26 percent or more. In Arizona, for example, the tax-by-tax volatility indices for the individual taxes were 6.8 for income tax, 3.3 for sales tax, 5.7 for nonproperty taxes. Yet, the state's overall tax volatility measure of 2.8 was about 50 percent lower than the tax-share weighted average—a nearly 50 percent reduction in volatility due to diversification.

A state such as Oregon, on the other hand, relied on the individual income tax for about 67 percent of its tax revenue over the time period examined—more than any other state. And it had the 7th most volatile state tax system with a volatility index of 7.0 compared with the median of 4.3. Washington, meanwhile, relied on the sales tax for 60 percent of its tax revenue—more than any other state—compared with 32 percent for the median state. Yet over the 20-year period examined, Washington's state tax revenue was the least volatile in the nation. So despite the general rule that relying on a single tax can lead to great volatility, for this period, when income taxes were particularly volatile, Washington's sales tax-dependent revenue was relatively stable.

The general rule remains, however: A diversified tax base generally is more stable than a non-diversified base. In the wrong kind of recession, a state like Washington's revenue could be hit especially hard. Still, three of the other four states that relied on the sales tax for more than 50 percent of their tax revenue—Florida, Tennessee and South Dakota—had below-average tax volatility over the 1986 to 2005 period. Only Nevada, among the states heavily reliant on sales tax, had above-average volatility.

Even states with "low" volatility are likely to find in the next recession that they have far too much of it. The goal in crafting a tax structure is to put together one that works in tandem with other counter-cyclical fiscal devices. That will help a state weather broad economic downturns and take advantage of upswings. It will also help taxpayers, particularly business taxpayers, rely on the tax structure to plan for the future.

# PLUGGING

A tax policy is only as good as the systems that collect the taxes and make it simple for people to pay them.

# LEAKS

**F**ifteen years ago, when a new business tried to put down roots in Kansas, the business owner had to mail in a paper registration and wait to be assigned a registration number. "It would take two or three weeks," says Steve Stotts, the state's director of tax operations. Now, thanks to reforms in the administration of the tax system in Kansas, a start-up business can register in 15 minutes.

States have been trying various ways to simplify collection and lock in compliance. The basic kit comes with five important tools: the effective use of the audit process, interstate cooperation, e-service offerings, a timely and fair appeals process and taxpayer buy-in to the design of the system and its administrative procedures.

## Automating the Audits

Field audits of businesses can be unpleasant, especially for smaller firms with minimal access to professional tax guidance. The solution for many states is greater use of technology.

In some states, however, there's corporate resistance. In Mississippi, for instance,

about 60 percent of companies are willing to provide the information electronically but that's only "after discussion and assurance that we are going to protect their data and not mess up their system," says Shelton Vance, director of audit and compliance in

## DIGITAL DIVIDE

**One caution about the rush to e-service: There are taxpayers who don't have access to computers. "We can't leave those people and businesses too far behind," says Virginia's Tax Commissioner Janie Bowen.**

Mississippi. The other 40 percent make it difficult to obtain their information electronically or simply don't have their data in an electronic form.

Fortunately, there are ways for states to stretch their audit dollars by using so-called "limited audits," that look only at specific issues within an industry. Want to audit cash-related transactions? In Michi-

gan, auditors aim right at restaurants—an industry that is known to be particularly susceptible to cash skimming.

Pennsylvania is trying a different low-cost approach; moderating its tone. When taxpayers are alerted to an audit, the letters, says Robert Coyne, deputy secretary for compliance and collections in Pennsylvania, "let taxpayers know exactly what we're looking for. They are more descriptive as opposed to threatening." In addition, Coyne's office does outreach and education so taxpayers understand the requirements. The benefits have been tangible. "People who got letters, read them, understood them, became compliant," says Coyne.

## The E of Collection

Through one model or another, all the states are doing e-collection of taxes—even electronic filing for sales and business taxes are coming into their own. Six states—Nevada, New Jersey, New York, Pennsylvania, Tennessee and Virginia—already have fully electronic systems that assign, track, complete, review and transmit audits.

So is it time for most of the states to declare victory? Not likely, according to a 50-

state survey by the Pew Center on the States in collaboration with the Federation of Tax Administrators. Some states keep coming up with new and important improvements.

New York State's Online Tax Center has a system that allows taxpayers to use the Web and set up a pay plan, file a "no sales tax due" return, apply for a penalty waiver, look up rates, register for the sales tax, fill in forms and print out returns that can't be e-filed. "When you enter this tax center," says Pat Mitchell, chief financial officer of the New York State tax system, "we can customize it

cess to calls, e-mails, notice responses, electronic returns, and even hard copies of documents that have been scanned.

## Talking to Taxpayers

Is anybody listening out there? If not, a tax agency runs a high risk of repeating its mistakes or missing good ideas from the most knowledgeable sources of all—the companies and individuals who interact with the tax system on a daily basis.

Some states routinely sit down and have heart-to-heart talks with their taxpayers

ducted by a neutral party, as well as Small Business Forums. When the office learned that the due date for returns for monthly filers was difficult for taxpayers to meet, it moved the date to a more amenable one.

While several states favor focus groups, the ultimate listening tool may be monthly and quarterly forums set up with chambers of commerce, industry groups, taxpayer representatives and policy or audit advisory groups.

## Mutual Aid

With appropriate interstate cooperation, states can leverage their resources to address such multi-state issues as shared debtors or scofflaws.

New Mexico, for example, has partnered with the tax authorities from the Navajo Nation and the Arizona Department of Transportation to conduct joint audits on retail gas stations. While the audits are ongoing, the joint effort has been uncovering non-filers who would otherwise have slipped between the cracks.

New Mexico is also tackling regional issues by joining with Texas, California, Arizona, Oklahoma and the IRS to form the Border States Caucus. An independently organized team, it works with the Mexican government to deal with tax, motor vehicle and regulatory problems that flow out of the implementation of NAFTA.

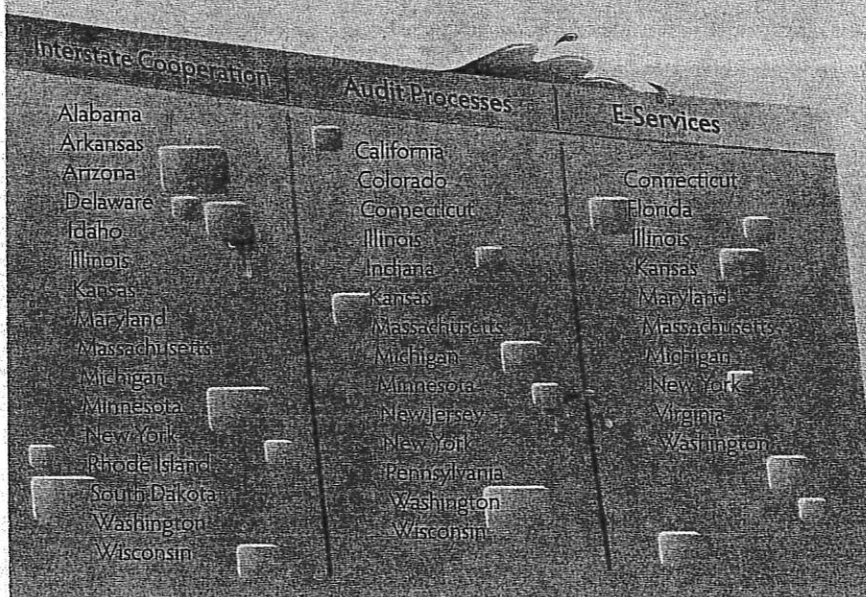
## An Appetite for Appeal

Much of compliance depends on giving taxpayers a fair shake at contesting decisions of the tax department. One of these is the ability to appeal without having to pay the assessment or a bond (called "pay to play"). This has been the subject of much reform. The other is ready access to a body that is independent of the tax administration agency.

A tax court or tribunal shouldn't report directly or indirectly to the department of revenue or to any subordinate executive agency. The logic here is pretty obvious: Executive branch agencies can be perceived as wanting to collect more taxes in order to balance the budget. Texas, for example, had placed responsibility for this function in the comptroller's office for years. Last year, the state moved it to an independent office of administrative hearings. "It is imperative," says Comptroller Susan Coombs, "to remove any appearance of bias and ensure that the integrity of the hearing process is beyond question."

## FINGERS IN THE DIKE

States rated as making superior efforts to collect the taxes due to them



Source: Pew Center on the States in coordination with the Federation of Tax Administrators

so it's all about you." The system can help taxpayers make estimated tax payments and access records and assessments that are due.

The ability of a taxpayer to work hand in hand electronically with a state tax department is the way some states are going. About one-third now allow taxpayers to send and sometimes receive an account-sensitive e-mail through a secured e-mail system, although sometimes the e-mail must originate through a state portal or agency Web site, for security reasons.

Virginia and Michigan not only put a great deal of information into taxpayers' hands, they do the same for state employees who assist taxpayers—from customer service agents to auditors. These employees have ac-

cess to what's working well and where they are falling short. Ohio hosts a large annual tax forum that covers both educational and administrative matters. North Dakota favors simple annual meetings with CPAs to discuss current matters.

North Carolina has reached out to neighborhoods. It used graduate students at Duke University to come up with recommended courses of action to improve compliance within North Carolina's immigrant community. The Department of Revenue then developed a strategy based on this work and hired a liaison to the Hispanic community.

Washington does a biennial taxpayer satisfaction survey, an independent study con-

| <b>Benefits</b>  | <b>HPIP<br/>(existing)</b>   | <b>Enterprise Zone Pgm<br/>(existing)</b>  | <b>Business &amp; Jobs Pgm<br/>(existing)</b>   | <b>SB 497<br/>(proposed)</b>  | <b>Differences<br/>(proposed vs. existing)</b>  |
|--|--|--|---|---|---|
| Opportunity Zones in rural areas, and also in disaster areas that are declared to be Opportunity Zones by Commerce | Not Defined  | Not Defined  | Not Defined   | Economically disadvantaged rural counties and also disaster areas designated as Opportunity Zones, where firms can earn enhanced invest & job credits                                 | Creation of new enhanced investment and job creation tax credits for businesses in disadvantaged areas  |
| Investment Tax Credit  | 10% investment tax credit for qualifying investment above \$50,000   | 1% investment tax credit for qualifying investment above \$50,000  | \$100 investment tax credit for each \$100,000 of qualifying investment, each year for 10 years (start of 10 year claim can be delayed 3 years)   | after \$300,000 minimum threshold is reached, 10% tax credit for all investment from first \$1 (\$50,000 threshold in Opportunity Zones)  | Higher threshold, but all qualifying investment earns credits; a one-time credit versus B&J method; Revenue Secretary reports annually on this  |
| Carry-forward of Unused Investment Tax Credits   | 10-year carry-forward; re-qualification is required in order to use any carry-forwards                                     | indefinite carry-forward until able to use   | Jobs must be maintained during the years in the 10-year claim period in which credits are claimed; unused credits are lost after the 10-year claim period   | 10-year carry-forward; requires re-certification (probably self re-certification) that program requirements are still satisfied   | Carry-forward 10 years compared to indefinitely for EZ and 10-year running claim for B&J; requires re-qualification to use  |
| Cash-in-lieu of investment credits   | not offered  | not offered  | not offered   | Up to 40% of investment credit value based on Commerce Secretary's evaluation; amount that exceeds tax liability to be refunded; remaining investment tax credits are forfeited       | New benefit; Commerce Secretary reports annually on this  |
| Sales Tax Exemption  | Available with program qualification   | Available with program qualification   | not offered   | Available with program qualification  | Same as for HPIP & Enterprise Zone  |
| Training Tax Credit  | Up to \$50,000 for training costs that exceed 2% of wage costs; no carry-forward   | not offered  | not offered   | not offered   | HPIP training tax credit is eliminated  |
| Job Creation Tax Credit  | not offered  | 2 minimum for "mfgrs" & "retailers"<br>5 minimum for "non-mfgrs"<br>20 minimum for "HQ"/"Anc. Support"<br>Job credit equals \$1,500 or \$2,500 depending on county strategic planning efforts; job creation must be associated with investment | Requires at least 2 new jobs associated with an investment; any NAICS is OK; \$100 per job can be claimed each year for 10 years (start 10-year claim can be delayed 3 yrs)                           | Normally requires 5 jobs (\$1,500/job) HQ/Anc.Support 20 jobs (\$1,500/job) Opportunity Zone 2 jobs (\$3,500/job) (Any NAICS category is OK for HQ, ancillary support & Op Zone jobs) | Job creation is de-coupled from investment requirement; minimum job thresholds have changed; there is a higher credit for Op Zone jobs in any NAICS category; also count employees who are effectively leased; Revenue Secretary to report annually |
| Job Credit Carry-forward   | not offered  | Indefinite carry-forward until able to use; if taxpayer does not maintain minimum required jobs all remaining carry-forward is forfeited   | Jobs must be maintained during the years in the 10 year claim period in which credits are claimed, or else credits cannot be claimed in that year; after 10-year claim period unused credits are lost | Indefinite carry-forward until able to use; if taxpayer does not maintain minimum required jobs all remaining carry-forward is forfeited  | No change from current Enterprise Zone Program requirements   |
| Credits offset income tax, privilege tax, premium tax  | 100%   | 100%   | 50%   | 100%  | SB 497 offers 100% same as HPIP & EZ, versus 50% for B&J  |
| Other benefits   | Priority consideration for other business programs; small cash awards for consulting costs to increase company growth rate | None   | None  | None  | SB 497 eliminates these two HPIP benefits   |

| <b>Requirements</b>                     |   |  |  |   |   |
|---|---|--|--|---|---|
| Pre-identification of investment        | To insure incentive function, investment must be pre-identified to Commerce before commitment   | no pre-identification requirement  | no pre-identification requirement  | pre-identification requirement  | To insure incentive function, investment must be pre-identified to Commerce before commitment   |
| Eligible Types of Businesses            | Worksite must be categorized by KDL in NAICS 221, 311-425, 481-721, 811-928, or else qualify as a headquarters or back-office (similar to an ancillary support operation) of a national or multi-corporation, in any NAICS code | "Manufacturers," "non-manufacturers," or any headquarters or ancillary support operation; also, for the sales tax exemption benefit only, "retailers" in communities of 2,500 or fewer | Retailers  | Worksite must be categorized by KDL in NAICS 112112, 221, 311-425, 481-624, 812-813, 922-928, or else qualify as a headquarters or ancillary support operation in any NAICS category, or be in any NAICS category in a disaster area that has been designated an Opportunity Zone | SB 497 adds NAICS 112112, deletes NAICS 711-721, 811, 814 & 921, eliminates EZ & B&J benefits for retailers, and disallows credits for regulated utilities with a guaranteed rate-of-return; Opportunity Zone firms in any NAICS category can earn job & invest credits; firms must be current in their Kansas taxes to earn benefits |
| Types of Businesses that Do Not Qualify | Generally ineligible are businesses whose decision about where to locate is not affected by tax incentives (retail, ag, construction, mining, etc.) and not-for-profits   | Most retailers & not-for-profits   | Businesses that are not retailers generally have access to larger tax benefits from other programs | Generally ineligible are businesses whose decision about where to locate is not affected by tax incentives (retail, ag, construction, mining, etc.) and not-for-profits   | Not applicable  |
| Wage Requirement                        | Worksite must pay an above-average wage based on NAICS/location/size  | No wage requirement  | No wage requirement  | Worksite must pay an above-average wage based on NAICS/location/size  | Same wage requirement as HPIP   |
| Training Requirement                    | Spend at least 2% of wages on training, or participate in KIT/KIR/IMPACT  | No training requirement  | No training requirement  | No training requirement   | SB 497 eliminates the HPIP training requirement   |
| Sources-of-Revenues Requirement         | Over half of worksite revenues must come from sales to Kansas manufacturers or out-of-state commercial/governmental customers (does not apply to manufacturers or if HQ or back-office site of a (multi)national)               | No sources-of-revenues requirement   | No sources-of-revenues requirement   | Over half of worksite revenues must come from sales to Kansas mfgs or out-of-state commercial/governmental customers (does not apply to mfgs, or to HQ/ancillary support worksites, or to disaster areas designated as Op Zones, or for job credits in Op Zones)                  | Nearly the same as HPIP (this filters out most companies whose decision about where to locate is unlikely to be influenced by tax benefits)   |
| Process to Access Benefits              | Submit application documenting satisfaction of certification criteria; re-certification process the same  | No application process   | No application process   | Submit application documenting satisfaction of certification criteria; simplified re-certification (probably self re-certification by the company)  | Nearly the same as HPIP for initial certification, then simpler re-certification (probably self re-certification by the company)  |
| Tax Credit Calculations on Tax Filings  | Complicated weighting methodology for investment tax credits  | Complicated investment tax credit and job credit calculations  | Complicated investment tax credit and job credit calculations                                      | Simplified investment tax credit and job credit calculations  | Simpler tax credit calculations, based on newly added investment that is in-service at year-end and newly added employees still working at year-end   |
| Sunset Provisions                       | no sunset   | no sunset  | no sunset  | Cash-in-lieu of investment credits in effect 01/01/08 through 12/31/12  | partial sunset  |

Kansas Department of Commerce

02/04/08

file = part of workpage 1 in 2005-2007 FY HPIP performance data.xls

| Investment Projects Tied<br>Tied to HPIP Qualification | FY 05       | FY 05          | FY 06       | FY 06          | FY 07      | FY 07          | FY 08 (Q1 & Q2 only) |                | All Years  |                |
|--|-------------|----------------|-------------|----------------|------------|----------------|----------------------|----------------|------------|----------------|
|  | # of Projs. | Average \$\$\$ | # of Projs. | Average \$\$\$ | # of Projs | Average \$\$\$ | # of Projs           | Average \$\$\$ | # of Projs | Average \$\$\$ |
| More than \$100 million                                | 3           | 406,887,523    | 2           | 155,868,224    | 4          | 245,049,000    | 4                    | 399,058,000    | 13         | 316,063,617    |
| \$50 - 100 million                                     | 1           | 58,652,679     | 3           | 59,646,733     | 1          | 77,367,068     | 2                    | 80,788,000     | 7          | 68,076,564     |
| \$25 - 50 million                                      | 6           | 32,992,750     | 10          | 34,467,729     | 13         | 35,932,942     | 2                    | 36,900,000     | 31         | 34,953,614     |
| \$10 - 25 million                                      | 10          | 14,190,873     | 12          | 14,547,308     | 13         | 14,017,274     | 6                    | 14,101,910     | 41         | 14,227,133     |
| \$1 - 10 million                                       | 62          | 3,249,004      | 55          | 3,596,008      | 64         | 3,619,635      | 27                   | 4,011,101      | 208        | 3,553,726      |
| \$50,000 - 1 million                                   | 39          | 363,491        | 49          | 429,053        | 74         | 354,015        | 46                   | 424,683        | 208        | 389,097        |
| Less than \$50,000                                     | 2           | 42,890         | 2           | 21,500         | 6          | 26,500         | 1                    | 17,000         | 11         | 27,707         |
| All Projects per FY                                    | 123         | 14,917,729     | 133         | 9,238,862      | 175        | 11,228,164     | 88                   | 23,228,086     | 519        | 13,627,456     |



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## KIOWA COUNTY BUSINESS RESTORATION ASSISTANCE PROGRAM

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| <a href="#">Your Vehicle</a>           |
| <a href="#">Your Business</a>          |
| <a href="#">Forms and Publications</a> |
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| <a href="#">Misclassification</a>      |
| <a href="#">Related Links</a>          |

The 2007 Kansas Legislature established the Kiowa County business restoration assistance program for the purpose of assisting businesses that were in operation in Kiowa County and damaged by the tornado and other severe weather in Kansas on May 4, 2007.

The business restoration assistance program includes:

- Investment Assistance**  
 A grant of up to 10% of qualifying investment made to rebuild or replace a business facility in Kiowa County and the business machinery and equipment of a business that has been damaged or destroyed by the tornado or other severe weather that occurred on May 4, 2007.
- Job restoration assistance**  
 A grant of up to \$3,500 per qualifying job to a business damaged by the tornado and severe weather on May 4, 2007 that fills an employment position in Kiowa County, Kansas.

The Kansas Legislature has set aside \$5,000,000 for the investment assistance payment program and the job restoration assistance payment program. To apply for these assistance programs, a business must complete and submit a [Business Restoration Assistance application, Form PR-BRP](#). Applications received by August 31, 2007 will be considered for funding initially. Funding for this program is currently available. Please submit your application. [Policies and procedures for this program](#) are available here.

- Sales Tax Exemption**  
 A sales tax exemption is available for those businesses in Kiowa County that were damaged as a result of the tornado and other severe weather on May 4, 2007. This sales tax exemption will exempt all construction, reconstruction, materials and machinery and equipment to be incorporated into the business facility. Replacement of tornado damaged or destroyed fencing, the purpose for which is to enclose land devoted to agricultural use shall also be exempt from sales tax. As soon as the business has decided to rebuild, a [request for project exemption certificate \(Form PR-70BRP\)](#) should be submitted to the Kansas Department of Revenue. Applications will be accepted through June 30, 2008.

Questions may be directed to the Kansas Department of Revenue at (785) 296-3081 or to [kathleen\\_smith@kdor.state.ks.us](mailto:kathleen_smith@kdor.state.ks.us) (kathleen\_smith@kdor.state.ks.us).

**REQUEST FOR PROJECT EXEMPTION CERTIFICATE  
BUSINESS RESTORATION PROGRAM**

Kansas Department of Revenue  
Office of Policy and Research  
915 SW Harrison St., Room 230  
Topeka, KS 66612-1588

Telephone: (785) 296-3081  
FAX: (785) 296-7928

Date \_\_\_\_\_

It is requested that a Certificate of Exemption from sales tax be issued to the taxpayer for the following described project.

- (A) 1. Name of taxpayer: \_\_\_\_\_ Taxpayer EIN: \_\_\_\_\_  
Business type:  Corporation  L.L.C.  Limited Liability Partnership/Partnership  Individual  
 Other \_\_\_\_\_
2. Will the taxpayer on line (A)(1) lease this facility to a qualified business? Yes  No  If yes, please provide the lessee's name and business type on line (B)(1). If no, proceed to line (B)(2).
- (B) 1. Name and EIN of business that will operate the business facility (if different from the name listed on Line (A)):  
Name: \_\_\_\_\_ Business EIN: \_\_\_\_\_  
Business type:  Corporation  L.L.C.  Limited Liability Partnership/Partnership  Individual  
 Other \_\_\_\_\_
2. Location of business facility investment: \_\_\_\_\_  
Street Number and Address  
County: \_\_\_\_\_ City: \_\_\_\_\_ State: \_\_\_\_\_ Zip: \_\_\_\_\_
3. Mailing address of taxpayer (business) who will own and/or operate the business facility:  
\_\_\_\_\_  
Box Number and/or Street Number and Name  
City: \_\_\_\_\_ State: \_\_\_\_\_ Zip: \_\_\_\_\_
- (C) Are you rebuilding a business facility that was previously located in Kiowa County, Kansas prior to May 4, 2007 that was damaged by the May 4, 2007 tornado? Yes  No
- (D) Type of project:  Original construction of a new facility  Remodel or reconstruction of an existing facility  
 Addition to an existing facility  Additional machinery and equipment, not to include the purchase of a motor vehicle or trailer.  
 Fencing
- (E) **ATTACH** an explanation or list of improvements to be constructed, repairs or remodeling to be done, and machinery and equipment to be purchased.
- (F) Describe the type of business activity to be conducted by the taxpayer [name on Line (A)] at the business facility:  
\_\_\_\_\_  
\_\_\_\_\_
- (G) List the name(s) and address(es) of the general contractor(s): \_\_\_\_\_
- (H) Contract date: \_\_\_\_\_ (I) Contract No.: \_\_\_\_\_
- (J) Estimated project costs: Total \_\_\_\_\_ Construction costs: \_\_\_\_\_  
Machinery and equipment costs: \_\_\_\_\_
- (K) Estimated completion date (not to exceed two years): \_\_\_\_\_
- (L) **Would you like your project exemption certificate faxed rather than mailed to you?** Yes  No   
If yes, please provide your fax number: \_\_\_\_\_

\_\_\_\_\_  
Taxpayer (please type or print)

\_\_\_\_\_  
Name of Authorized Representative (please type or print)

\_\_\_\_\_  
Signature of Authorized Representative

\_\_\_\_\_  
Title

\_\_\_\_\_  
Phone Number



## INSTRUCTIONS

An exemption from sales tax is allowed on all sales of tangible personal property or services purchased for the construction, reconstruction, enlarging or remodeling of a business facility that was located in Kiowa County on May 4, 2007 and that was damaged or destroyed by tornado and other severe weather on May 4, 2007. The sale and installation of machinery and equipment purchased for the installation at the business facility as well as fencing that is used to enclose land devoted to agricultural use shall also be exempt from sales tax.

If this business facility will be leased by a qualified business, and both the lessor and lessee will incur expenditures to construct or reconstruct the facility and purchase machinery and equipment to be installed at the business facility, two applications will be submitted, one for the lessor and one for the lessee. If the lessor will incur expenditures, the lessor's application will have line (A)(1) completed with the lessor's name and EIN. Line (A)(2) will be checked to indicate that the facility will be leased. The lessor will insert the lessee's name, EIN and business type on line (B)(1). The lessee's application will have the lessee's name and EIN completed on line (A) and with an indication on line (B)(1) of any doing business as (DBA) name.

- Line (A)(1) Enter the name and EIN of the entity that will own and/or operate the business facility and claim the sales tax exemption, and check the appropriate box identifying the business type. This business entity must have been in operation providing goods or services within Kiowa County, Kansas, on May 4, 2007 and was damaged by the tornado and other severe weather on May 4, 2007.
- Line (A)(2) Indicate whether this business facility will be leased by a qualified business. A qualified business is a business that was in operation providing goods or services within Kiowa County, Kansas, which was struck by the tornado and other severe weather in Kansas on May 4, 2007.
- Line (B)(1) Enter the doing business as (DBA) name of the business, if it is different than line (A), above, and check the appropriate box identifying the business type.
- Line (B)(2) Enter the location (actual street address), including the county of the business facility where the investment is going to be made.
- Line (B)(3) Enter the complete mailing address of the entity (on line (A)(1)) who will own and/or operate the above referenced business facility. This is the address your project exemption certificate will be mailed to.
- Line (C) Indicate whether your business was located in Kiowa County on May 4, 2007 prior to the tornado. If your business was not located in Kiowa County on May 4, 2007, you will not qualify for the sales tax exemption.
- Line (D) Check the applicable box(es) that describe your project.
- Line (E) Briefly describe the purchases of materials, machinery, equipment, and services you will make for this project to qualify for exemption from retailers' sales tax. Inventory and property that leaves the facility, such as motor vehicles, will not qualify for exemption.
- Line (F) Describe specifically the type of business activity to be conducted by the taxpayer at the business facility.
- Line (G) List the name and address of the general contractor if available. If a general contractor does not exist for this project, please attach a list of all the contractors/subcontractors (if available) involved in performing labor services or supplying materials for the project. Include in this list, the estimated project costs, contract date, contract number, and the estimated completion date for each contract.
- Line (H) Enter the date of the contract.
- Line (I) Enter the applicable contract number if available.
- Line (J) Enter the estimated cost of the project. These costs should be separated between construction costs (materials and labor) and machinery and equipment costs.
- Line (K) Enter the estimated completion date for this project. The Department requests that this period not extend beyond two years from the application date.
- Line (L) Provide your fax number if you would prefer that your project exemption certificate be faxed to you rather than mailed.
- Signature The name of the taxpayer as well as the authorized representative requesting the exemption should be typed or printed in the area provided. The authorized representative must also sign the request and provide a phone number where they can be reached during business hours.

## BUSINESS RESTORATION ASSISTANCE PROGRAM

Kansas Department of Revenue  
Office of Policy and Research  
915 SW Harrison St., Room 230  
Topeka, KS 66612-1588

Telephone: (785) 296-3081  
FAX: (785) 296-7928

Date \_\_\_\_\_

- (1) Name of business: \_\_\_\_\_ EIN of business: \_\_\_\_\_  
Business type:  Corporation  L.L.C.  Limited Liability Partnership/Partnership  Individual  
 Other \_\_\_\_\_
- (2) Individual contact for business: \_\_\_\_\_  
Name \_\_\_\_\_  
Telephone Number \_\_\_\_\_ Fax Number \_\_\_\_\_
- (3) Mailing address of business: \_\_\_\_\_  
Box Number and/or Street Number and Name \_\_\_\_\_  
City: \_\_\_\_\_ State: \_\_\_\_\_ Zip: \_\_\_\_\_
- (4) Location of business facility on May 4, 2007: \_\_\_\_\_  
Street Number and Address \_\_\_\_\_  
County: \_\_\_\_\_ City: \_\_\_\_\_ State: \_\_\_\_\_ Zip: \_\_\_\_\_  
Parcel No: \_\_\_\_\_  
Approximate square footage of this business facility: \_\_\_\_\_
- (5) Did you own or lease your business facility on May 4, 2007? Owned  Leased
- (6) County appraised value of business real property: \_\_\_\_\_  
County appraised value of business tangible personal property: \_\_\_\_\_  
**Provide** a list of your business machinery and equipment and its fair market value that was in place on May 4, 2007.
- (7) Number of employees on May 4, 2007: \_\_\_\_\_ full-time \_\_\_\_\_ part-time \_\_\_\_\_ seasonal  
**Complete** attached employee worksheet and file with your business restoration assistance application.
- (8) Are you rebuilding a business facility that was located in Kiowa County, Kansas on May 4, 2007 that was damaged by the May 4, 2007 tornado? Yes  No
- (9) Proposed location of business facility: \_\_\_\_\_  
Street Number and Address \_\_\_\_\_  
County: \_\_\_\_\_ City: \_\_\_\_\_ State: \_\_\_\_\_ Zip: \_\_\_\_\_  
Parcel No: \_\_\_\_\_  
Approximate square footage of this business facility: \_\_\_\_\_

CONTINUE ON REVERSE SIDE

### FOR OFFICE USE ONLY

Application Received: \_\_\_\_\_ Log No.: \_\_\_\_\_  
Investment Assistance approved: \_\_\_\_\_  
Job Restoration Assistance approved: \_\_\_\_\_ Total Assistance approved: \_\_\_\_\_  
Approved by: \_\_\_\_\_ Date: \_\_\_\_\_

(10) Will you own or lease this proposed business facility? Own  Lease

(11) Describe specifically the type of business activity to be conducted by this business at the proposed business facility:

\_\_\_\_\_  
\_\_\_\_\_

(12) **ATTACH** an explanation or list of improvements to be constructed, repairs or remodeling to be done, and machinery and equipment to be purchased.

(13) Estimated project costs: Total \_\_\_\_\_ Construction costs: \_\_\_\_\_

Machinery and equipment costs: \_\_\_\_\_

(14) List the name(s) and address(es) of the general contractor(s): \_\_\_\_\_

Contract date: \_\_\_\_\_ Contract No.: \_\_\_\_\_

(15) Estimated completion date (not to exceed two years): \_\_\_\_\_

(16) Number of employees to be restored: \_\_\_\_\_ full-time \_\_\_\_\_ part-time \_\_\_\_\_ seasonal  
**Complete** attached employee worksheet and file with your business restoration assistance application.

(17) Has your business submitted a property loss claim to your insurer? Yes  No   
If yes, please **provide** a copy of the claim submitted and any supporting documents, the amount of reimbursement you have received and the amount of any reimbursement that is currently pending.

(18) **Provide** any additional documentation to evaluate the financial needs of your business.

I authorize the Secretary of Revenue or the Secretary's designee the ability to review business property records on file with the city or county.

I declare under the penalties of perjury that to the best of my knowledge this is a true, correct, and complete application.

\_\_\_\_\_  
Business Applicant (please type or print)

\_\_\_\_\_  
Name of Authorized Representative (please type or print)

\_\_\_\_\_  
Signature of Authorized Representative

\_\_\_\_\_  
Title

\_\_\_\_\_  
Phone Number

**EMPLOYEE WORKSHEET  
BUSINESS RESTORATION ASSISTANCE PROGRAM**

Employees employed on May 4, 2007

| Type of Position | Monthly Salary for Position Type | Was this position located in Kiowa County? | Full-time, part-time or seasonal |
|------------------|----------------------------------|--|----------------------------------|
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|                  |                                  |  |                                  |

Proposed positions to be filled

| Type of Position | Monthly Salary for Position Type | Will this position be located in Kiowa County? | Will this position be full-time, part-time or seasonal? | When will this position be filled? |
|------------------|----------------------------------|--|---|------------------------------------|
|                  |                                  |  |   |                                    |
|                  |                                  |  |   |                                    |
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## INSTRUCTIONS

The business restoration assistance program has been established for the purpose of assisting businesses that were in operation in Kiowa County, Kansas and that were struck by the tornado and other severe weather in Kansas on May 4, 2007. This program shall provide the following: (a) investment assistance payments shall be available for investment made to rebuild or replace the building or structure or to replace the business machinery and equipment; and (b) job restoration assistance payments for businesses that restore employees in Kiowa County.

Line (1) Enter the name and EIN of the business applying for assistance and check the appropriate box identifying the business type. If the business is a sole proprietorship, enter the SSN of the owner. This business entity must have been in operation providing goods or services within Kiowa County, Kansas, on May 4, 2007 and was damaged by the tornado and other severe weather on May 4, 2007.

Line (2) Print the name, telephone number, and fax number of the individual to be contacted regarding this application.

Line (3) Enter the complete mailing address of the business entity seeking assistance.

Line (4) Enter the address and parcel number of the location of the business on May 4, 2007, and the approximate square footage of the business facility prior to the tornado and severe weather. The parcel number may be obtained from the county appraiser.

Line (5) Indicate whether the business owned or leased their business facility on May 4, 2007 prior to the tornado and severe weather.

Line (6) Enter the appraised value of the real and tangible personal property this business had as of the most recent county appraisal.

Line (7) Indicate the number of full-time, part-time, and seasonal employees the business employed on May 4, 2007 prior to the tornado and severe weather. Full-time shall mean that an employee works at least 40 hours per week; part-time shall mean such person is customarily performing such duties at least 20 hours per week; and seasonal basis, shall mean such person performs such duties at least 20 hours per week for substantially all of the season customary for the position in which such person is employed.

**COMPLETE** the first half of the Employee Worksheet on page 3 of this application. Indicate the type of position (sales clerk, accountant, manager, etc.) this business employed on May 4, 2007 prior to the tornado and severe weather. Provide each positions monthly salary, whether that position was located in Kiowa County and whether that position was considered as full-time, part-time, or seasonal.

Owners, partners or shareholders of a business shall be considered in this worksheet when that individual performs duties in connection with the operation of the qualifying business on a full-time or part-time basis as defined above.

An independent contractor is not considered as a qualifying job.

Line (8) Check whether you are rebuilding a business facility that was located in Kiowa County, Kansas on May 4, 2007 prior to the tornado and severe weather. If you have checked no, you will not qualify for this business restoration assistance program.

Line (9) Enter the street address, county, city, zip and parcel number of the property you are proposing to rebuild upon as well as the approximate square footage of the proposed business facility. The parcel number may be obtained from the county appraiser.

Line (10) Indicate whether your business will own or lease the business facility you are proposing to locate to.

Line (11) Describe specifically the type of business activity to be conducted by this business at the business facility.

Line (12) **ATTACH** a scope of work, construction contract and description of the materials, machinery, equipment, and services you will make for this project.

Line (13) Enter the estimated cost of the project. These costs should be separated between construction costs (materials and labor) and machinery and equipment costs.

Line (14) List the name and address of the general contractor if available. If a general contractor does not exist for this project, please attach a list of all the contractors/subcontractors (if available) involved in performing labor services or supplying materials for the project. Include in this list, the estimated project costs, contract date, contract number, and the estimated completion date for each contract.

Line (15) Enter the estimated completion date for this project.

Line (16) Indicate the number of full-time, part-time, and seasonal employees the business is proposing to restore. Full-time shall mean that an employee works at least 40 hours per week; part-time shall mean such person is customarily performing such duties at least 20 hours per week; and seasonal basis, shall mean such person performs such duties at least 20 hours per week for substantially all of the season customary for the position in which such person is employed.

**COMPLETE** the second half of the Employee Worksheet on page 3 of this application. Indicate the type of positions (sales clerk, accountant, manager, etc.) this business is proposing to restore. Provide each positions monthly salary, whether that position will be located in Kiowa County, whether that position is considered as full-time, part-time, or seasonal, and when that position will be filled.

Owners, partners or shareholders of a business shall be considered in this worksheet when that individual performs duties in connection with the operation of the qualifying business on a full-time or part-time basis as defined above.

An independent contractor will not be considered as a qualifying job.

Line (17) Check whether your business has submitted a property loss claim to your insurer. If a property loss claim has been submitted, **PROVIDE** a copy of the claim and any supporting documents, the amount of reimbursement you have received and the amount of any reimbursement that is currently pending.

Line (18) Provide any additional documentation to evaluate the financial needs of your business.

Signature The name of the business as well as the authorized representative requesting the assistance should be typed or printed in the area provided. The authorized representative must also sign the request and provide a phone number where they can be reached during business hours.

Kansas Department of Revenue  
Policies and Procedures Manual  
for the  
Kiowa County Business Restoration  
Assistance Program

May 2007

The policies and procedures for the Kiowa County Business Restoration Assistance Program shall be in effect as of May 4, 2007 for Kiowa County, Kansas.

The 2007 Kansas Legislature established the county business restoration assistance program for the purpose of assisting businesses that were in operation in Kiowa County and damaged by the tornado and other severe weather in Kansas on May 4, 2007. This assistance program shall be administered by the secretary of revenue.

The county business restoration assistance program is comprised of three components:

- Investment assistance payment;
- Job restoration assistance payment; and
- Sales tax exemption.

The Kansas Legislature has set aside \$5,000,000 for the investment assistance payment program and the job restoration assistance payment program. To apply for these assistance programs, a business must complete Form PR-BRP. Applications for these two assistance programs should be submitted as soon as possible. Applications received by August 31, 2007 will be considered for funding initially.

A sales tax exemption is also available for those businesses in Kiowa County that were damaged as a result of the tornado and other severe weather on May 4, 2007. This sales tax exemption will exempt all construction, reconstruction, materials and machinery and equipment to be incorporated into the business facility (including fencing for land devoted to agricultural use). As soon as the business has decided to rebuild, a request for project exemption certificate (Form PR-70BRP) should be submitted to the Kansas Department of Revenue.

#### **INVESTMENT ASSISTANCE PAYMENT**

To the extent funding is available and depending on the factors described on page 4 under the Assistance Payment Process, the secretary of revenue may award an investment assistance payment of up to 10% of the qualifying investment made to rebuild or replace a business facility in Kiowa County and the business machinery and equipment of a business that has been damaged or destroyed by the tornado or other severe weather that occurred on May 4, 2007. The investment assistance payment shall be for the purpose of assisting the business in recovering from the damages sustained from the storm on May 4, 2007 and as an incentive to remain in Kiowa County.

Any business taxpayer that was operating in Kiowa County, Kansas on May 4, 2007 suffering damage, may be eligible for assistance.

The following definitions have been provided to implement this program:

**Business facility** means a permanent building or structure used in business or commercial operations located within Kiowa County, Kansas. It shall include any building or complex of buildings, including the land on which the facility is located and all business machinery and equipment located at or within the facility used in connection with the operation of the facility. For purposes of this program, commercial operations shall include medical facilities and mental health facilities.



**Business machinery and equipment** means the tangible personal property permanently and physically located at the business facility and used in the business operations. Trade fixtures, racks, shelving, office furnishings and computers are some examples of business machinery and equipment. It does not include (A) mobile equipment that leaves the business facility, such as motor vehicles, or (B) any items held for sale, such as business inventory.

**Qualifying business** means a business that was in existence and in commercial operations providing goods or services within Kiowa County, Kansas which was damaged or destroyed by the tornado and other severe weather on May 4, 2007.

**Qualifying investment** shall mean the value of real and tangible personal property permanently and physically located at the Kansas business facility, except inventory, or property held for sale to customers in the ordinary course of the taxpayer's business, which constitutes the business facility or which is used by the taxpayer in the operation of the Kansas business facility. Investment, such as rolling stock and motor vehicles, that leaves the business facility, shall not be considered as qualifying investment.

Only that real and tangible personal property that rebuilds or replaces what was in place prior to the severe weather on May 4, 2007 shall be considered as qualifying investment. The investment must be made between May 4, 2007 and June 30, 2008 to be considered as qualifying investment.

The value of such property shall be (1) its original cost if owned by the business and purchased after May 4, 2007; or (2) actual lease payments made after May 4, 2007 through June 30, 2008, if leased by the business.

For those lessors that choose to rebuild their business facility which will then be leased to a qualifying business, assistance for investment made in the facility is available. For this program, the property shall be valued at its original cost in determining investment assistance to the lessor. The lease payments that are made by a lessee to rent the business facility will not be considered as qualifying investment.

The lease payments made by a qualifying business after May 4, 2007 through June 30, 2008 to replace business machinery and equipment may be included in qualifying investment.

Qualifying investment shall be determined by calculating the value of the investment that has been placed into service at the taxpayer's business facility in Kiowa County, Kansas after May 4, 2007 through June 30, 2008.

#### **JOB RESTORATION ASSISTANCE PAYMENT**

To the extent funding is available and depending on the factors described on page 4 under the Assistance Payment Process, the secretary of revenue may award a job restoration assistance payment of up to \$3,500 per qualifying job to a business damaged by the tornado and severe weather on May 4, 2007 that fills an employment position in Kiowa

County, Kansas. The purpose of the job restoration assistance program shall be to assist the business in recovering from the damages sustained from the storm on May 4, 2007 and as an incentive to the business to restore jobs within Kiowa County, Kansas.

**Qualifying job** means a job employed by a qualifying business in Kiowa County that was lost as a result of damage sustained by the tornado and other severe storms that struck Kansas on May 4, 2007, that is restored in the county between May 4, 2007 and June 30, 2008, and shall not include any part-time or seasonal job that provides the employee with less than 20 hours per week of paid employment.

A qualifying job shall mean a person employed by the business in the operation of the qualifying business. A person shall be deemed to be so engaged if such person performs duties in Kansas in connection with the operation of the business on: (A) a regular, full-time basis; (B) a part-time basis, provided such person is customarily performing such duties at least 20 hours per week; or (C) a seasonal basis, provided such person performs such duties for substantially all of the season customary for the position in which such person is employed.

Owners, partners, and shareholders of a business may be considered as a qualifying job, if that individual performs duties in connection with the operation of the qualifying business on a full-time or part-time basis as defined above.

An independent contractor will not be considered as a qualifying job.

#### **ASSISTANCE PAYMENT PROCESS**

Eligible businesses applying for the assistance programs must complete Form PR-BRP (see Appendix A). Applications for assistance that are submitted to the Kansas Department of Revenue by August 31, 2007 will be considered for funding initially. It is very important that applications be received within this time frame as not more than \$5,000,000 can be expended from the state emergency fund to provide assistance payments through the investment assistance program and job restoration assistance program. Applications received after August 31, 2007 will be considered for assistance if funding is available.

Applications will be accepted by the Department of Revenue by fax (785-296-7928), through e-mail (kathleen\_smith@kdor.state.ks.us), or through mail (Kansas Department of Revenue, Office of Policy and Research, 915 SW Harrison St., Room 230, Topeka, KS 66612-1588).

Applications will be reviewed and evaluated based upon the following factors:

- Commitment to rebuild business facility in the community, financial need, timeframe to rebuild, and amount of investment in the community, in comparison to investment prior to May 4, 2007;
- Number of employees business is proposing to rehire in the community, in comparison to employment level prior to May 4, 2007; and

- Salary level and hours or duration of proposed jobs in the community, in comparison to salary levels, hours and duration of jobs prior to May 4, 2007.

Upon review of the application, the Department of Revenue will provide a proposed investment assistance payment and/or job assistance payment for which the applicant is eligible. (The Kansas Legislature has set aside \$5,000,000 for this assistance payment program. Therefore, allocations based on this cap and the number of eligible businesses applying will be made.) A letter will be mailed to the applicant indicating the proposed assistance.

Once the investment is placed into service and/or the jobs are employed, the applicant will certify to the Department and document the actual amount of investment made and/or the number of jobs hired by completing Form PR-Assist. The Department of Revenue will review this documentation and determine if the conditions for payment assistance have been met. If those conditions have been met, the Department will issue a letter to the applicant identifying the amount of the assistance payment to be made. The amount of the assistance issued may not exceed the amount that was previously approved. The assistance payment will be mailed shortly after the approval letter.

#### **Conditions for Payment Assistance**

The investment assistance will be issued to the applicant in the determined amount after the applicant has completed the investment, the business facility is operational and placed in service, and the applicant has provided the required documentation to the Department of Revenue for the qualifying investment expenditures.

The jobs assistance payment will be issued to the applicant in the determined amount after the applicant has hired employees to fill the positions for which payments were sought, such employees have been employed for at least 3 months, and the applicant has provided the required documentation to the Department of Revenue that these positions have been filled.

#### **SALES TAX EXEMPTION**

An exemption from sales tax shall be allowed on all sales of tangible personal property or services purchased for the construction, reconstruction, enlarging or remodeling of a business facility that was located in Kiowa County, Kansas on May 4, 2007 and that has been damaged or destroyed by tornado and other severe weather on May 4, 2007. The sale and installation of machinery and equipment purchased for installation at any such business facility shall be exempt as well. Replacement of fencing damaged or destroyed by the tornado, the purpose for which is to enclose land devoted to agricultural use, shall also be exempt from sales tax.

Any business constructing, reconstructing, enlarging or remodeling a business facility that was located in Kiowa County, Kansas and was damaged on May 4, 2007 shall make application for a project exemption certificate. Businesses shall complete form PR-70BRP (Appendix B) and submit to the Kansas Department of Revenue prior to June 30,

2008. Applications will be accepted by the Department of Revenue by fax (785-296-7928), through e-mail (kathleen\_smith@kdor.state.ks.us), or through mail (Kansas Department of Revenue, Office of Policy and Research, 915 SW Harrison St., Room 230, Topeka, KS 66612-1588).

Any person that was leasing a business facility to a qualifying business in Kiowa County, Kansas that was damaged or destroyed on May 4, 2007, and wishes to rebuild the facility may also be eligible to obtain a project exemption certificate. The lessor may obtain a project exemption certificate for the facility construction or reconstruction if the facility will be occupied by a business that was previously located in Kiowa County, Kansas.

The Department shall review the application and issue a project exemption certificate if approved. The project exemption certificate will be effective for a period of two years. The project exemption certificate shall be furnished to the contractor to purchase materials for incorporation into the project. The business shall use the certificate to purchase any business machinery and equipment to be installed at the facility. The contractor shall furnish the certificate to all suppliers from whom such purchases are made, and the suppliers shall execute invoices covering the same bearing the number of such certificate.

Upon completion of the project, the contractor shall furnish to the person that obtained the exemption certificate, a sworn statement, on a form to be provided by the director of taxation, that all purchases so made were entitled to exemption. All invoices shall be held by the contractor for a period of five years and shall be subject to audit by the director of taxation.

Any contractor or any agent, employee or subcontractor thereof, who shall use or otherwise dispose of any materials, machinery or equipment purchased under such a certificate for any purpose other than that for which the certificate is issued without the payment of the sales or compensating tax otherwise imposed thereon, shall be guilty of a misdemeanor and, upon conviction therefore, shall be subject to the penalties provided for in subsection (g) of K.S.A. 79-3615, and amendments thereto.



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## SOUTHEAST KANSAS BUSINESS RESTORATION ASSISTANCE PROGRAM

A Southeast Kansas (SEK) business restoration assistance program has been established for the purpose of assisting businesses with less than 50 employees that were in operation in one of the affected counties and damaged by the flooding and other severe weather in Kansas that began on June 26, 2007. The counties included in this SEK business restoration assistance program are: Allen, Anderson, Bourbon, Butler, Chautauqua, Cherokee, Coffey, Cowley, Crawford, Edwards, Elk, Franklin, Greenwood, Harper, Labette, Linn, Miami, Montgomery, Neosho, Osage, Pawnee, Wilson, and Woodson

The business restoration assistance program includes:

- Investment Assistance**  
 A grant of up to 10% of qualifying investment made to rebuild or replace a business facility within the same community in one of the affected counties and the business machinery and equipment of a business that has been damaged or destroyed by the flood or other severe weather that began on June 26, 2007.
- Job restoration Assistance**  
 A grant of up to \$3,500 per qualifying job to a business damaged by the flood and other severe weather that began on June 26, 2007 that restores an employment position within the same community in one of the affected counties.
- Rental Assistance**  
 An assistance grant for the rent paid by a qualified business to lease a temporary business facility within the same community while the permanent facility is being rebuilt. Rental assistance will be granted for a period of up to six months and may not exceed a total of \$1,500.

The State Finance Council has set aside \$5,000,000 for the investment assistance, job restoration assistance, and rental assistance program. To apply for these assistance programs, a business must complete and submit a Business Restoration Assistance application, Form PR-SEK. Applications received by September 30, 2007 will be considered for funding initially. Funding for this program is currently available. Please submit your application. [Policies and procedures for this program are available here.](#)

Small businesses that have damage due to the flood are encouraged to attend one of the informational meetings on August 16, 2007 regarding this program. [Locations for these informational meetings are available here.](#)

Questions may be directed to the Kansas Department of Revenue at (785) 296-3081 or to [kathleen\\_smith@kdor.state.ks.us](mailto:kathleen_smith@kdor.state.ks.us) ([kathleen\\_smith@kdor.state.ks.us](mailto:kathleen_smith@kdor.state.ks.us)).

3-115

# SOUTHEAST KANSAS BUSINESS RESTORATION ASSISTANCE PROGRAM

Kansas Department of Revenue  
Office of Policy and Research  
915 SW Harrison St., Room 230  
Topeka, KS 66612-1588

Telephone: (785) 296-3081  
FAX: (785) 296-7928

Date \_\_\_\_\_

(1) Name of business: \_\_\_\_\_ EIN of business: \_\_\_\_\_  
Business type:  Corporation  L.L.C.  Limited Liability Partnership/Partnership  Individual  
 Other \_\_\_\_\_

(2) Individual contact for business: \_\_\_\_\_  
Name  
Telephone Number \_\_\_\_\_ Fax Number \_\_\_\_\_

(3) Mailing address of business: \_\_\_\_\_  
Box Number and/or Street Number and Name  
City: \_\_\_\_\_ State: \_\_\_\_\_ Zip: \_\_\_\_\_

(4) Location of business facility on June 26, 2007: \_\_\_\_\_  
Street Number and Address  
County: \_\_\_\_\_ City: \_\_\_\_\_ State: \_\_\_\_\_ Zip: \_\_\_\_\_  
Parcel No: \_\_\_\_\_  
Approximate square footage of this business facility: \_\_\_\_\_

(5) Did you own or lease your business facility on June 26, 2007? Owned  Leased

(6) County appraised value of business real property: \_\_\_\_\_  
County appraised value of business tangible personal property: \_\_\_\_\_  
**Provide** a list of your business machinery and equipment and its fair market value that was in place on June 26, 2007.

(7) Number of employees on June 26, 2007: \_\_\_\_\_ full-time \_\_\_\_\_ part-time \_\_\_\_\_ seasonal  
**Complete** attached employee worksheet and file with your business restoration assistance application.

(8) Are you rebuilding a business facility that was located in one of the affected counties on June 26, 2007 that was damaged by the flooding and other severe weather that began on June 26, 2007? Yes  No   
If yes, is the business facility you are rebuilding within the same community where the business facility was located at the time of the flood? Yes  No

(9) Proposed location of business facility: \_\_\_\_\_  
Street Number and Address  
County: \_\_\_\_\_ City: \_\_\_\_\_ State: \_\_\_\_\_ Zip: \_\_\_\_\_  
Parcel No: \_\_\_\_\_  
Approximate square footage of this business facility: \_\_\_\_\_

**CONTINUE ON REVERSE SIDE**

## FOR OFFICE USE ONLY

Application Received: \_\_\_\_\_ Log No.: \_\_\_\_\_  
Investment Assistance approved: \_\_\_\_\_  
Job Restoration Assistance approved: \_\_\_\_\_ Total Assistance approved: \_\_\_\_\_  
Approved by: \_\_\_\_\_ Date: \_\_\_\_\_

(10) Will you own or lease this proposed business facility? Own  Lease

(11) Describe specifically the type of business activity to be conducted by this business at the proposed business facility:

\_\_\_\_\_  
\_\_\_\_\_

(12) **ATTACH** an explanation or list of improvements to be constructed, repairs or remodeling to be done, and machinery and equipment to be purchased.

(13) Estimated project costs: Total \_\_\_\_\_ Construction costs: \_\_\_\_\_  
Machinery and equipment costs: \_\_\_\_\_

(14) List the name(s) and address(es) of the general contractor(s): \_\_\_\_\_  
Contract date: \_\_\_\_\_ Contract No.: \_\_\_\_\_

(15) Estimated completion date (not to exceed two years): \_\_\_\_\_

(16) Number of employees to be restored: \_\_\_\_\_ full-time \_\_\_\_\_ part-time \_\_\_\_\_ seasonal  
**Complete** attached employee worksheet and file with your business restoration assistance application.

(17) Will you be leasing a temporary business facility while your permanent facility is being repaired or rebuilt? Yes  No   
If yes, please provide the location of the temporary business facility.

Location of temporary facility: \_\_\_\_\_  
Street Number and Address

County: \_\_\_\_\_ City: \_\_\_\_\_ State: \_\_\_\_\_ Zip: \_\_\_\_\_

(18) If you will be or are leasing a temporary business facility, enter the monthly rental payment and the date the rent payment commenced. Monthly rent payment \_\_\_\_\_ Date rent commenced \_\_\_\_\_  
**Provide** a copy of the executed rental agreement.

(19) Has your business submitted a property loss claim to your insurer? Yes  No   
If yes, please **provide** a copy of the claim submitted and any supporting documents, the amount of reimbursement you have received, and the amount of any reimbursement that is currently pending.

(20) **Provide** any additional documentation to evaluate the financial needs of your business.

I authorize the Secretary of Revenue or the Secretary's designee the ability to review business property records on file with the city or county.

I declare under the penalties of perjury that to the best of my knowledge this is a true, correct, and complete application.

\_\_\_\_\_  
Business Applicant (please type or print)

\_\_\_\_\_  
Name of Authorized Representative (please type or print)

\_\_\_\_\_  
Signature of Authorized Representative

\_\_\_\_\_  
Title

\_\_\_\_\_  
Phone Number

## INSTRUCTIONS

The Southeast Kansas business restoration assistance program has been established for the purpose of assisting businesses with less than 50 employees that were in operation in one of the affected counties and damaged by the flooding and other severe weather in Kansas that began on June 26, 2007. The counties included in this Southeast Kansas business restoration program include: Allen, Anderson, Bourbon, Butler, Chautauqua, Cherokee, Coffey, Cowley, Crawford, Edwards, Elk, Franklin, Greenwood, Harper, Labette, Linn, Miami, Montgomery, Neosho, Osage, Pawnee, Wilson, and Woodson. This program shall provide the following: (a) investment assistance payments shall be available for investment made to rebuild or replace the building or structure or to replace the business machinery and equipment; (b) job restoration assistance payments for businesses that restore employees in one of the affected counties; and (c) rental assistance payments to lease a temporary business facility while the permanent facility is being rebuilt. Applications received by September 30, 2007 will be considered for funding initially.

- Line (1) Enter the name and EIN of the business applying for assistance and check the appropriate box identifying the business type. If the business is a sole proprietorship, enter the SSN of the owner. This business entity must have been in operation providing goods or services within one of the affected counties, on June 26, 2007 and was damaged by the flooding and other severe weather that began on June 26, 2007.
- Line (2) Print the name, telephone number, and fax number of the individual to be contacted regarding this application.
- Line (3) Enter the complete mailing address of the business entity seeking assistance.
- Line (4) Enter the address and parcel number of the location of the business on June 26, 2007, and the approximate square footage of the business facility prior to the flood and severe weather. The parcel number may be obtained from the county appraiser.
- Line (5) Indicate whether the business owned or leased their business facility on June 26, 2007 prior to the flood and severe weather.
- Line (6) Enter the appraised value of the real and tangible personal property this business had as of the most recent county appraisal.
- Line (7) Indicate the number of full-time, part-time, and seasonal employees the business employed on June 26, 2007 prior to the flood and severe weather. In order to qualify for the job restoration assistance, your business must have employed less than 50 employees. Full-time shall mean that an employee works at least 40 hours per week; part-time shall mean such person is customarily performing such duties at least 20 hours per week; and seasonal basis, shall mean such person performs such duties at least 20 hours per week for substantially all of the season customary for the position in which such person is employed.

**COMPLETE** the first half of the Employee Worksheet on page 3 of this application. Indicate the type of position (sales clerk, accountant, manager, etc.) this business employed on June 26, 2007 prior to the flood and severe weather. Provide each positions monthly salary, whether that position was located in one of the affected counties and whether that position was considered as full-time, part-time, or seasonal.

Owners, partners or shareholders of a business shall be considered in this worksheet when that individual performs duties in connection with the operation of the qualifying business on a full-time or part-time basis as defined above.

An independent contractor is not considered as a qualifying job.

- Line (8) Check whether you are rebuilding a business facility that was located in one of the affected counties on June 26, 2007 prior to the flood and severe weather. If you have checked no, you will not qualify for this business restoration assistance program.
- Line (9) Enter the street address, county, city, zip and parcel number of the property you are proposing to rebuild upon as well as the approximate square footage of the proposed business facility. The parcel number may be obtained from the county appraiser.
- Line (10) Indicate whether your business will own or lease the business facility you are proposing to locate to.
- Line (11) Describe specifically the type of business activity to be conducted by this business at the business facility.
- Line (12) **ATTACH** a scope of work, construction contract and description of the materials, machinery, equipment, and services you will make for this project.
- Line (13) Enter the estimated cost of the project. These costs should be separated between construction costs (materials and labor) and machinery and equipment costs.





- Line (14) List the name and address of the general contractor if available. If a general contractor does not exist for this project, please attach a list of all the contractors/subcontractors (if available) involved in performing labor services or supplying materials for the project. Include in this list, the estimated project costs, contract date, contract number, and the estimated completion date for each contract.
- Line (15) Enter the estimated completion date for this project.
- Line (16) Indicate the number of full-time, part-time, and seasonal employees the business is proposing to restore. Full-time shall mean that an employee works at least 40 hours per week; part-time shall mean such person is customarily performing such duties at least 20 hours per week; and seasonal basis, shall mean such person performs such duties at least 20 hours per week for substantially all of the season customary for the position in which such person is employed.
- COMPLETE** the second half of the Employee Worksheet on page 3 of this application. Indicate the type of positions (sales clerk, accountant, manager, etc.) this business is proposing to restore. Provide each positions monthly salary, whether that position will be located within the same community of one of the affected counties, whether that position is considered as full-time, part-time, or seasonal, and when that position will be filled.
- Owners, partners or shareholders of a business shall be considered in this worksheet when that individual performs duties in connection with the operation of the qualifying business on a full-time or part-time basis as defined above.
- An independent contractor will not be considered as a qualifying job.
- Line (17) Enter the address location of the temporary business facility you are renting. In order to qualify for the rental assistance, the temporary business facility must be located within the same community and county as your original business facility at the time it sustained flood damage.
- Line (18) If you are leasing a temporary business facility, provide the monthly rental payment and the date the rent payment commenced. **ATTACH** a copy of the executed rental agreement.
- Line (19) Check whether your business has submitted a property loss claim to your insurer. If a property loss claim has been submitted, **PROVIDE** a copy of the claim and any supporting documents, the amount of reimbursement you have received and the amount of any reimbursement that is currently pending.
- Line (20) Provide any additional documentation to evaluate the financial needs of your business.
- Signature The name of the business as well as the authorized representative requesting the assistance should be typed or printed in the area provided. The authorized representative must also sign the request and provide a phone number where they can be reached during business hours.

Kansas Department of Revenue  
Policies and Procedures Manual  
for the  
Southeast Kansas Business Restoration  
Assistance Program

August 2007

The policies and procedures for the Southeast Kansas Business Restoration Assistance Program shall be in effect as of June 26, 2007 for the following counties: Allen, Anderson, Bourbon, Butler, Chautauqua, Cherokee, Coffey, Cowley, Crawford, Edwards, Elk, Franklin, Greenwood, Harper, Labette, Linn, Miami, Montgomery, Neosho, Osage, Pawnee, Wilson, and Woodson.

A Southeast Kansas (SEK) business restoration assistance program has been established for the purpose of assisting businesses with less than 50 employees that were in operation in one of the affected counties and damaged by the flooding and other severe weather in Kansas that began on June 26, 2007. The counties that are included in this SEK business restoration assistance program are Allen, Anderson, Bourbon, Butler, Chautauqua, Cherokee, Coffey, Cowley, Crawford, Edwards, Elk, Franklin, Greenwood, Harper, Labette, Linn, Miami, Montgomery, Neosho, Osage, Pawnee, Wilson, and Woodson. This assistance program shall be administered by the secretary of revenue.

The SEK business restoration assistance program is comprised of three components:

- Investment assistance;
- Job restoration assistance; and
- Rental assistance.

The State Finance Council has set aside \$5,000,000 for the investment assistance, job restoration assistance, and the rental assistance programs. To apply for these assistance programs, a business must complete Form PR-SEK. Applications for these three assistance programs should be submitted as soon as possible. Applications received by September 30, 2007 will be considered for funding initially.

#### **INVESTMENT ASSISTANCE PAYMENT**

To the extent funding is available and depending on the factors described on page 4 under the Assistance Payment Process, the secretary of revenue may award an investment assistance payment of up to 10% of the qualifying investment made to rebuild or replace a business facility within the same community in one of the affected counties and the business machinery and equipment of a business that has been damaged or destroyed by the flooding and other severe weather that began on June 26, 2007. The investment assistance payment shall be for the purpose of assisting the business in recovering from the damages sustained from the storm and as an incentive to remain in the same community of one of the affected counties.

Any business taxpayer with less than 50 employees that was operating in one of the affected counties on June 26, 2007 suffering damage, may be eligible for assistance.

The following definitions have been provided to implement this program:

**Business facility** means a permanent building or structure used in business or commercial operations located within one of the affected counties. It shall include any building or complex of buildings, including the land on which the facility is located and all business machinery and equipment located at or within the facility used in connection with the operation of the facility.

**Business machinery and equipment** means the tangible personal property permanently and physically located at the business facility and used in the business operations. Trade fixtures, racks, shelving, office furnishings and computers are some examples of business machinery and equipment. It does not include (A) mobile equipment that leaves the

business facility, such as motor vehicles, or (B) any items held for sale, such as business inventory.

**Qualifying business** means a business with less than 50 employees that was in existence and in commercial operations providing goods or services within one of the affected counties, which was damaged or destroyed by the flooding and other severe weather that began on June 26, 2007 and is to be rebuilt or replaced at a location within the same community and county where such business was located when the flood damage was sustained.

**Qualifying investment** shall mean the value of real and tangible personal property permanently and physically located at the qualifying business facility, except inventory, or property held for sale to customers in the ordinary course of the taxpayer's business, which constitutes the business facility or which is used by the taxpayer in the operation of the qualifying business facility. Investment, such as rolling stock and motor vehicles, that leaves the business facility, shall not be considered as qualifying investment.

Only that real and tangible personal property that rebuilds or replaces what was in place prior to the severe weather that began on June 26, 2007 shall be considered as qualifying investment. The investment must be made between June 26, 2007 and June 30, 2008 to be considered as qualifying investment.

The value of such property shall be (1) its original cost if owned by the business and purchased after June 26, 2007; or (2) actual lease payments made after June 26, 2007 through June 30, 2008, if leased by the business.

For those lessors that choose to rebuild their business facility which will then be leased to a qualifying business, assistance for investment made in the facility is available. For this program, the property shall be valued at its original cost in determining investment assistance to the lessor. The lease payments that are made by a lessee to rent the business facility will not be considered as qualifying investment.

The lease payments made by a qualifying business after June 26, 2007 through June 30, 2008 to replace business machinery and equipment may be included in qualifying investment.

Qualifying investment shall be determined by calculating the value of the investment that has been placed into service at the taxpayer's business facility in one of the affected counties after June 26, 2007 through June 30, 2008.

#### **JOB RESTORATION ASSISTANCE PAYMENT**

To the extent funding is available and depending on the factors described on page 4 under the Assistance Payment Process, the secretary of revenue may award a job restoration assistance payment of up to \$3,500 per qualifying job to a business damaged by the flooding and severe weather that began on June 26, 2007 that fills an employment position in one of the affected counties. The purpose of the job restoration assistance

program shall be to assist the business in recovering from the damages sustained from the storm that began on June 26, 2007 and as an incentive to the business to restore jobs within the affected counties.

Any business taxpayer with less than 50 employees that was operating in one of the affected counties on June 26, 2007 suffering damage, may be eligible for assistance.

**Qualifying job** means a job employed by a qualifying business in one of the affected counties that was lost as a result of damage sustained by the flood and other severe storms that began on June 26, 2007. This job or position must be restored within the same community and county where such business was located when the flood damage was sustained between June 26, 2007 and June 30, 2008. A qualifying job shall not include any part-time or seasonal job that provides the employee with less than 20 hours per week of paid employment.

A qualifying job shall mean a person employed by the business in the operation of the qualifying business. A person shall be deemed to be so engaged if such person performs duties in Kansas in connection with the operation of the business on: (A) a regular, full-time basis; (B) a part-time basis, provided such person is customarily performing such duties at least 20 hours per week; or (C) a seasonal basis, provided such person performs such duties for substantially all of the season customary for the position in which such person is employed.

Owners, partners, and shareholders of a business may be considered as a qualifying job, if that individual performs duties in connection with the operation of the qualifying business on a full-time or part-time basis as defined above.

An independent contractor will not be considered as a qualifying job.

#### **RENTAL ASSISTANCE PAYMENT**

To the extent funding is available and depending on the factors described on page 4 under the Assistance Payment Process, the secretary of revenue may award a rental assistance payment to lease a temporary facility within the same community and county where the business was located at the time the flood damage was sustained, while the permanent facility is being rebuilt. Rental assistance will be granted for a period of up to six months and may not exceed \$1,500. The purpose of the rental assistance program shall be to assist the business in recovering from the damages sustained from the storm that began on June 26, 2007 and as an incentive to the business to remain in the same community of the affected county.

Any business taxpayer with less than 50 employees that was operating in one of the affected counties on June 26, 2007 suffering damage, may be eligible for assistance.

#### **ASSISTANCE PAYMENT PROCESS**

Eligible businesses applying for the assistance programs must complete Form PR-SEK. Applications for assistance that are submitted to the Kansas Department of Revenue by

September 30, 2007 will be considered for funding initially. It is very important that applications be received within this time frame as not more than \$5,000,000 can be expended from the state emergency fund to provide assistance payments through the investment assistance program, job restoration assistance program, and the rental assistance program. Applications received after September 30, 2007 will be considered for assistance if funding is available.

Applications will be accepted by the Department of Revenue by fax (785-296-7928), through e-mail (kathleen\_smith@kdor.state.ks.us), or through mail (Kansas Department of Revenue, Office of Policy and Research, 915 SW Harrison St., Room 230, Topeka, KS 66612-1588).

Applications will be reviewed and evaluated based upon the following factors:

- Commitment to rebuild business facility in the community, financial need, timeframe to rebuild, and amount of investment in the community, in comparison to investment prior to June 26, 2007;
- Number of employees business is proposing to rehire in the community, in comparison to employment level prior to June 26, 2007; and
- Salary level and hours or duration of proposed jobs in the community, in comparison to salary levels, hours and duration of jobs prior to June 26, 2007.

Upon review of the application, the Department of Revenue will provide a proposed investment assistance payment, job assistance payment, and/or rental assistance payment for which the applicant is eligible. (The State Finance Council has set aside \$5,000,000 for this assistance payment program. Therefore, allocations based on this cap and the number of eligible businesses applying will be made.) A letter will be mailed to the applicant indicating the proposed assistance.

Once the investment is placed into service, the jobs are employed, and/or the rents have been paid, the applicant will certify to the Department and document the actual amount of investment made, the number of jobs hired, and/or the actual rent paid for the temporary facility by completing Form PR-Assist. The Department of Revenue will review this documentation and determine if the conditions for payment assistance have been met. If those conditions have been met, the Department will issue a letter to the applicant identifying the amount of the assistance payment to be made. The amount of the assistance issued may not exceed the amount that was previously approved. The assistance payment will be mailed shortly after the approval letter.

#### **Conditions for Payment Assistance**

The investment assistance will be issued to the applicant in the determined amount after the applicant has completed the investment, the business facility is operational and placed in service, and the applicant has provided the required documentation to the Department of Revenue for the qualifying investment expenditures.

The job restoration assistance payment will be issued to the applicant in the determined amount after the applicant has hired employees to fill the positions for which payments

were sought, such employees have been employed for at least 3 months, and the applicant has provided the required documentation to the Department of Revenue that these positions have been filled.

The rental assistance payment will be issued to the applicant in the determined amount after the applicant has incurred the cost for the rental of the temporary facility, and the applicant has provided the required documentation to the Department of Revenue for the qualifying rental expense.



**NAICS included in proposed legislation (SB 497)**

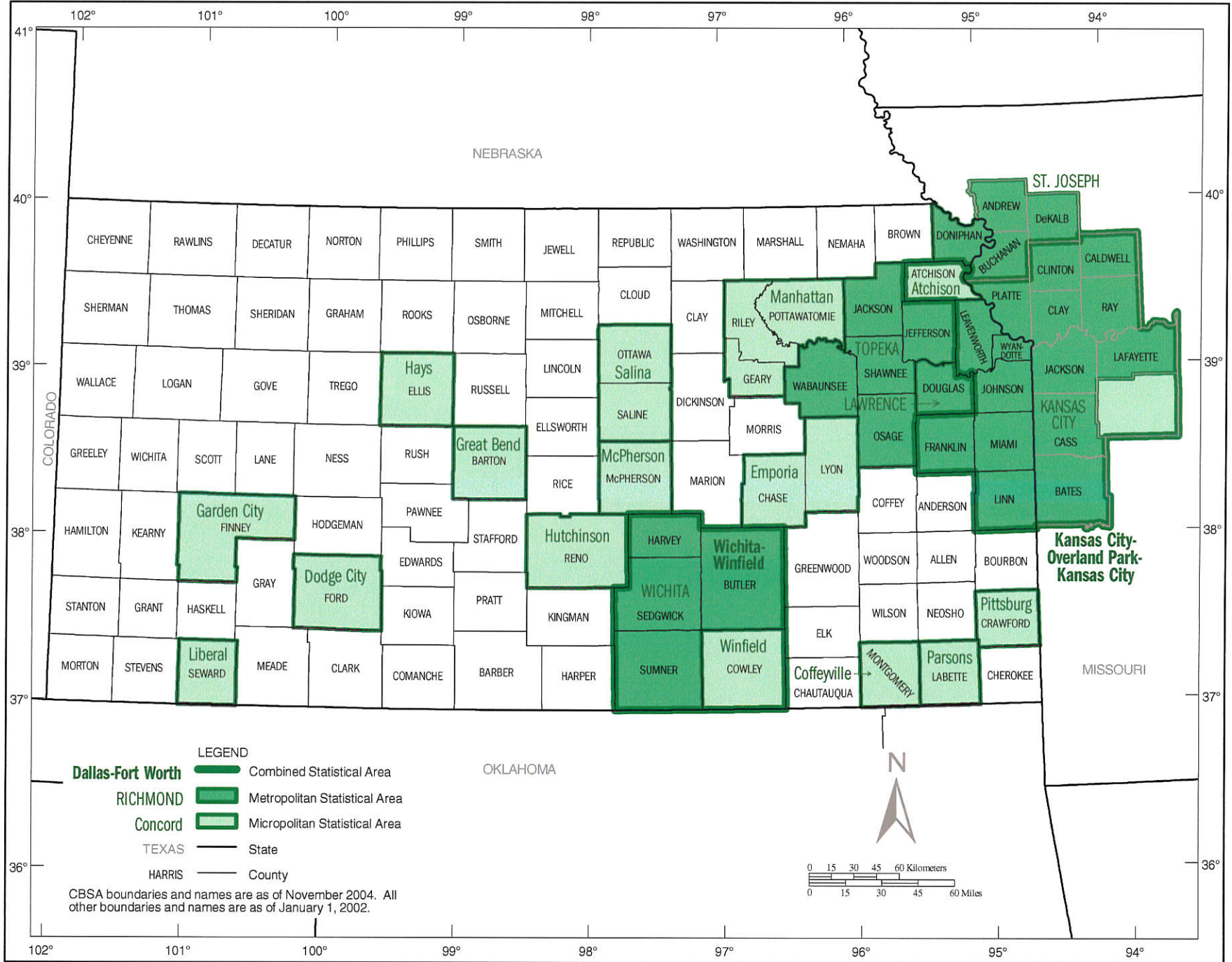
|  |
|--|
| 112112 Cattle Feedlots   |
| 221 Utilities  |
| 311-339 Manufacturing  |
| 311-Food Manufacturing   |
| 312-Beverage and Tobacco Product Manufacturing                   |
| 313-Textile Mills  |
| 314-Textile Product Mills  |
| 315-Apparel Manufacturing  |
| 316-Leather and Allied Product Manufacturing                     |
| 321-Wood Product Manufacturing                                   |
| 322-Paper Manufacturing  |
| 323-Printing and Related Support Activities                      |
| 324-Petroleum and Coal Products Manufacturing                    |
| 325-Chemical Manufacturing                                       |
| 326-Plastics and Rubber Products Manufacturing                   |
| 327-Nonmetallic Mineral Product Manufacturing                    |
| 331-Primary Metal Manufacturing                                  |
| 332-Fabricated Metal Product Manufacturing                       |
| 333-Machinery Manufacturing                                      |
| 334-Computer and Electronic Product Manufacturing                |
| 335-Electrical Equipment, Appliance, and Component Manufacturing |
| 336-Transportation Equipment Manufacturing                       |
| 337-Furniture and Related Product Manufacturing                  |
| 339-Miscellaneous Manufacturing                                  |
| 423-425 Wholesale Trade  |
| 423-Merchant Wholesalers, Durable Goods                          |
| 424-Merchant Wholesalers, Nondurable Goods                       |
| 425-Wholesale Electronic Markets and Agents and Brokers          |
| 481-493 Transportation and Warehousing                           |
| 481-Air Transportation   |
| 482-Rail Transportation  |
| 483-Water Transportation   |
| 484-Truck Transportation   |
| 485-Transit and Ground Passenger Transportation                  |
| 486-Pipeline Transportation                                      |
| 487-Scenic and Sightseeing Transportation                        |
| 488-Support Activities for Transportation                        |
| 491-Postal Service   |
| 492-Couriers and Messengers                                      |
| 493-Warehousing and Storage                                      |
| 511-519 Information  |
| 511-Publishing Industries (except Internet)                      |

|   |
|---|
| 512-Motion Picture and Sound Recording Industries   |
| 515-Broadcasting (except Internet)  |
| 516-Internet Publishing and Broadcasting  |
| 517-Telecommunications  |
| 518-Internet Service Providers, Web Search Portals, and Data Processing Services            |
| 519-Other Information Services  |
| 521-525 Finance and Insurance   |
| 521-Monetary Authorities-Central Bank   |
| 522-Credit Intermediation and Related Activities  |
| 523-Securities, Commodity Contracts, and Other Financial Investments and Related Activities |
| 524-Insurance Carriers and Related Activities   |
| 525-Funds, Trusts, and Other Financial Vehicles   |
| 531-533 Real Estate and Rental and Leasing  |
| 531-Real Estate   |
| 532-Rental and Leasing Services   |
| 533-Lessors of Nonfinancial Intangible Assets (except Copyrighted Works)                    |
| 541 Professional, Scientific, and Technical Services  |
| 551 Management of Companies and Enterprises   |
| 561-562 Administrative and Support and Waste Management and Remediation Services            |
| 561-Administrative and Support Services   |
| 562-Waste Management and Remediation Services   |
| 611 Educational Services  |
| 621-624 Health Care and Social Assistance   |
| 621-Ambulatory Health Care Services   |
| 622-Hospitals   |
| 623-Nursing and Residential Care Facilities   |
| 624-Social Assistance   |
| 812 Personal and Laundry Services   |
| 813 Religious, Grantmaking, Civic, Professional, and Similar Organizations                  |
| 922 Justice, Public Order, and Safety Activities  |
| 923 Administration of Human Resource Programs   |
| 924 Administration of Environmental Quality Programs  |
| 925 Administration of Housing Programs, Urban Planning, and Community Development           |
| 926 Administration of Economic Programs   |
| 927 Space Research and Technology   |
| 928 National Security and International Affairs   |

**NAICS not included in proposed legislation**

|  |
|--|
| 111-115 Agriculture, Forestry, Fishing and Hunting (except for 112112-Cattle Feedlots) |
| 111-Crop Production  |
| 112-Animal Production (except for 112112-Cattle Feedlots)                              |
| 113-Forestry and Logging   |
| 114-Fishing, Hunting and Trapping  |
| 115-Support Activities for Agriculture and Forestry                                    |
| 211-213 Mining   |
| 211-Oil and Gas Extraction   |
| 212-Mining (except Oil and Gas)  |
| 213-Support Activities for Mining  |
| 236-238 Construction   |
| 236-Construction of Buildings  |
| 237-Heavy and Civil Engineering Construction   |
| 238-Specialty Trade Contractors  |
| 441-454 Retail Trade   |
| 441-Motor Vehicle and Parts Dealer   |
| 442-Furniture and Home Furnishings Stores  |
| 443-Electronics and Appliance Stores   |
| 444-Building Material and Garden Equipment and Supplies Dealers                        |

|  |
|--|
| 445-Food and Beverage Stores                                     |
| 446-Health and Personal Care Stores                              |
| 447-Gasoline Stations  |
| 448-Clothing and Clothing Accessories Stores                     |
| 451-Sporting Goods, Hobby, Book, and Music Stores                |
| 452-General Merchandise Stores                                   |
| 453-Miscellaneous Store Retailers                                |
| 454-Nonstore Retailers   |
| 711-713 Arts, Entertainment, and Recreation                      |
| 711-Performing Arts, Spectator Sports, and Related Industries    |
| 712-Museums, Historical Sites, and Similar Institutions          |
| 713-Amusement, Gambling, and Recreation Industries               |
| 721-722 Accommodation and Food Services                          |
| 721-Accommodation  |
| 722-Food Services and Drinking Places                            |
| 811 Repair and Maintenance                                       |
| 814 Private Households   |
| 921 Executive, Legislative, and Other General Government Support |



**KANSAS - Core Based Statistical Areas and Counties**

# 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 Taxation  
February 5, 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

## 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       |                   |                   |                   |
| <b>Total</b>   | <b>1,647</b>      | <b>26,046,000</b> | <b>3,676</b>      | <b>39,035,397</b> |

\* 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                          | Kansas, Inc. | HPIP       |
|    |  | Expensing                     | Expensing    | 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

| <b>Expected Rate of Return on Identical Hypothetical Investments<br/>(7-Year Property, Full Value of Incentive Captured in Year 1)</b> |                                   |                                 |                                |
|--|-----------------------------------|---------------------------------|--------------------------------|
|  | <b>\$1 Million<br/>Investment</b> | <b>\$100,000<br/>Investment</b> | <b>\$50,000<br/>Investment</b> |
| 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%)                 |

| <b>Formulas for Calculating Taxpayer Value</b> |  |
|--|--|
| 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%) +<br>(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.

### An Example

- 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:  $\$100,000 \times 0.223 = \$22,300$ .

The Kansas, Inc. proposal would provide Acme an additional \$22,300 income tax deduction—in Year 1 only. 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.

| <b>Estimated Fiscal Note for Kansas, Inc. Expensing Proposal</b><br>(Assumes a Fully Mature System Applied to Tax Years 2005 and 2004)  |             |             |
|---|-------------|-------------|
| <i>Dollars in Millions</i>  | <b>2005</b> | <b>2004</b> |
| <b>KS Business Income Tax Collections</b>   | \$474.4     | \$315.1     |
| <b>Fiscal Note Estimates*</b>   |             |             |
| 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.

A Bill Summary Corresponding to the  
Kansas, Inc. proposal for Universal Expensing of Capital Investment  
as endorsed by the Joint Committee on Economic Development

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

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:

$$\text{Kansas Expensing Deduction} = \$100,000 \times 0.223 = \$22,300$$

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 preparers 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**

| Property Class | Factors  |          |          |
|----------------|----------|----------|----------|
|                | 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 System  
Straight-Line  
Residential and Nonresidential Real Property**

| Month Placed in Service | GDS                                  | GDS                                      | GDS                                    | ADS   |
|-------------------------|--------------------------------------|--|--|---|
|                         | Residential<br>27.5-Year<br>Property | Non-Residential<br>31.5-Year<br>Property | Non-Residential<br>39-Year<br>Property | Residential &<br>Non-Residential<br>40-Year<br>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   |

*Supporting Regional Economic Development through Analysis and Education*

## EXPENSING: A COMPETITIVE LEAP FOR KANSAS TAX POLICY

By Arthur P. Hall, Executive Director, Center for Applied Economics.

Kansas is on a roll when it comes to good tax policy. One simple, inexpensive step can sustain the momentum and produce a competitive leap in terms of bang for the buck: Permit all businesses to take an immediate income tax write-off for new investments made in Kansas. This step—called “expensing”—would complement the recent competitive reforms related to property and franchise taxation—and further distinguish Kansas as a go-to destination for capital investment, a key driver of high-wage jobs. As a bonus, expensing would make taxes fairer, because it results in equal tax treatment among businesses of all types and sizes.

The existence of an income tax makes the Kansas government a *de facto* silent partner in every Kansas business. In light of this partnership, the appropriate tax policy question is this: Does the government want to act like a partner that invests in the business or a partner that draws cash out of the business whenever possible?

Kansas income tax law, because it operates as an extension of U.S. income tax law, makes the Kansas government act like a cash-hungry partner rather than an investment-driven partner. Expensing would reverse the situation and turn the government into an investment-driven partner—for the economic benefit of all Kansans.

### **Economic Fundamentals**

Well-constructed tax policy does not interfere with taxpayers’ decision-making calculations. Economists refer to this outcome as “tax neutrality.” It represents a challenging goal for policymakers to attain. Most tax instruments influence economic decision-making.

Fortunately, policymakers can attain the goal of tax neutrality with regard to the income tax treatment of saving and investment. Unfortunately, most income tax systems in the U.S. do not attain this worthy goal. Instead, they create an inherent tax bias against saving and investment. No one intended this destructive outcome. It is a historical artifact that has endured from the economically misinformed structure of the first income tax laws.<sup>1</sup>

In the modern-day economy, saving and investment represent the same thing from different perspectives. Virtually all saving becomes an investment somewhere in the world. Few people—in developed economies, at least—store cash under their mattress. Saved funds tend to flow to where they earn the highest (risk-adjusted) rate of return.

From a business perspective, the income tax bias against investment is embedded in the (frequently arcane) rules associated with capital cost recovery—that is, the rules associated with the depreciation of capital investments. Expensing is a little used depreciation procedure (sometime called cash-flow depreciation) that removes the tax bias—and greatly simplifies income tax administration for both the taxpayer and the tax authorities.

### **The Bias of Double Taxation**

The income tax bias against saving and investment results from an inherent double counting—and, therefore, double taxation—that results from an economically flawed definition of taxable income. To grasp the mechanics of this double counting, focus on the equal sign in the present value formula shown in *Exhibit 1*. This formula is a foundational

element of finance. It indicates that the economic value of an investment can be represented in one of two equivalent ways—as a point-in-time value (*PV*) or as a flow-through-time value (*CFs*). The formula is embedded in financial calculators for analyzing investments, pricing financial products, or calculating loan payments.

### Exhibit 1: The Present Value Formula *The Foundation of Investment Analysis*

$$PV = \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \frac{CF_3}{(1+r)^3} + \frac{CF_4}{(1+r)^4} + \frac{CF_5}{(1+r)^5}$$

- The formula above depicts a 5-year investment. A 30-year investment would have 30 elements on the right-hand side of the formula.
- *PV* stands for “present value.” It represents the market value (or perhaps purchase price) of an investment, regardless of whether the investment is a machine, a building, a stock, or a bond.
- *CF* stands for “cash flow.” It represents the cash flow that an investment generates, like profits, dividends, interest, rent payments, or capital gains. Normally, investments are valued using free cash flow, the cash flow available to the investment owner after all investment-related costs have been paid, including taxes.
- *r* stands for the “discount rate,” which is often the interest rate or the expected rate of return on an alternative investment. The quantity  $(1+r)$  is raised to a power that represents time. A fundamental tenet of finance is that a dollar received immediately is more valuable than a dollar received in the future. Thus, future cash flows are “discounted.”
- Two basic types of investment analysis flow from the above equation: First, **net present value** equals *PV* (with an assigned value for *r*) minus the cost of an investment; if the result is positive, the investment will be evaluated positively. Second, **internal rate of return** equals the value of *r* that equates the estimated values of *CF* with the known (or estimated) cost of an investment. Investors typically want to make investments with the highest internal rate of return.

The mathematical equality represented by the present value formula means that double counting occurs when money represented on both sides of the equal sign counts as taxable income. The same economic value is taxed twice: double taxation. Taxing money represented by the left-hand side of the formula (the money paid for an investment) effectively means that the tax authority is pre-taxing money represented by the right-hand side of the equation (the money generated by the investment). Alternatively, taxing the money represented on right-hand side of the equation is effectively a deferral of taxation on the money represented by the left-hand side.

An example related to retirement saving will help make the double tax problem clearer, because U.S. income tax law has eliminated the problem for personal retirement investments, when channeled through approved procedures. In the United States, people typically save for retirement using individual retirement accounts (IRAs) and employer-sponsored retirement plans, like 401(k)s. Generally, people have a choice between two types of IRAs—traditional IRAs or Roth IRAs (named after the late U.S. Senator, William V. Roth). Both types of IRAs solve the double tax problem but in different ways (401(k)s solve the problem the way traditional IRAs do).

Suppose someone wanted to save for retirement by investing in a bond (or a mutual fund that offered the bond). Using the 5-year present value formula in *Exhibit 1*, if the interest rate is eight percent (8%) and the bond promised to pay \$1,000 at the end of each year, one bond would cost almost \$4,000. The money to make the investment came from salary or small business earnings, which is subject to income tax. A traditional IRA allows the saver to immediately write-off the \$4,000, eliminating tax on the left-hand side of the present value formula; the \$1,000 interest payments on the right-hand side will be taxed later. A Roth IRA does not allow for an immediate write-off, so it taxes the \$4,000 on the left-hand side of the present value formula; but the \$1,000 interest payment will never be subject to income tax. A person that buys the bond without using approved retirement saving procedures must pay income tax on the \$4,000 and the \$1,000 payments—a double tax on money used for saving.

Expensing operates just like a traditional IRA—for businesses. Expensing eliminates the double taxation of business investment by allowing for an immediate income tax



write-off of the money used for investment.<sup>2</sup> A business investment and the bond investment example described above have the same finance fundamentals. Of course, there are practical differences. The pay-off provisions of a bond are set by contract. The pay-off provisions of a business investment are risky and uncertain; businesspeople must estimate them based on experience and expectations.

### Expensing Removes Tax Bias: A Simple Example

The force of habit creates perhaps the biggest obstacle to acknowledging the bias of double taxation. The common way people think about the idea of income—encoded into the income tax laws a century ago—forces them to see IRAs and expensing as a grant of privilege rather than a liberation from penalty.

A different type of example further reveals the penalty-removal perspective of expensing. *Table 1* illustrates the cash flow of a hypothetical \$100,000 investment using two different income tax rules for capital cost recovery—straight-line depreciation and expensing. The example assumes that the investment will generate \$30,000 of free cash flow (pre-tax income) per year for five years. The income tax rate is seven percent (7%). *Table 1* also reports the rate of return on the investment—the internal rate of return, calculated using the present value formula in *Exhibit 1*—based on the different rules.

**Table 1**  
The Tax Implications of Depreciation versus Expensing

|                | No Tax   | Straight-Line Depreciation |           | Expensing |           |
|----------------|----------|----------------------------|-----------|-----------|-----------|
|                |          | Tax Owed                   | After Tax | Tax Owed  | After Tax |
| Investment     | -100,000 | 0                          | -100,000  | -7,000    | -93,000   |
| CF 1           | 30,000   | 700                        | 29,300    | 2,100     | 27,900    |
| CF 2           | 30,000   | 700                        | 29,300    | 2,100     | 27,900    |
| CF 3           | 30,000   | 700                        | 29,300    | 2,100     | 27,900    |
| CF 4           | 30,000   | 700                        | 29,300    | 2,100     | 27,900    |
| CF 5           | 30,000   | 700                        | 29,300    | 2,100     | 27,900    |
| Rate of Return | 15.24%   |                            | 14.24%    |           | 15.24%    |

Note the different rates of return reported in *Table 1*. This result captures the essence of the tax bias that results from current income tax rules. The straight-line depreciation rule results in a rate of return one percentage point lower than the no-tax and expensing scenarios. This differential measures the penalty (double tax) on investment. The expensing rule generates a rate of return equal to the no-tax

scenario; it generates income tax revenue for the government but attains tax neutrality. (An investment tax credit equal to seven percent (7%) has economic properties identical to the expensing scenario.)

The expensing rule—full tax write-off of the investment in the year in which the business makes it—attains tax neutrality because it does not tax the quantity on the left-hand side of the equal sign defining the present value formula. The straight-line depreciation rule (or any other depreciation rule that has guided U.S. income tax policy) permits taxation on both sides of the present value formula.

Expensing expresses a policy consistent with a government that wants to behave as an investment-driven silent partner. Depreciation expresses a policy consistent with a government that wants to behave as a cash-hungry silent partner. (Note that the government's tax stream under the expensing scenario generates a 15.24 percent rate of return, a rate identical to the taxpayer's, indicating a genuine partnership.)

*Table 1* illustrates this viewpoint in the "Investment" line. The economic value of any income tax write-off is the write-off amount times the tax rate ( $\$100,000 \times 7\% = \$7,000$ )—the government's participation in the investment. By not taxing the investment amount—that is, by effectively reducing the after-tax cost of the investment in a manner consistent with the taxation of future income—the expensing rule preserves the no-tax pattern of costs and benefits. The depreciation rule, even though it results in a lower annual tax liability, only crudely approximates the pattern of costs and benefits.

As a practical matter, the economic elegance of the expensing rule holds only if the taxpayer can realize the full benefit of the write-off in the investment year. Under standard administrative procedures related to deductions, this outcome will not prevail if the taxpayer has an insufficient level of taxable income in the investment year. However, in a real-world scenario of uncertain cash flows and graduated tax rates, providing for an unlimited carry-forward of unused deduction amounts offers a sound administrative solution.

### A Note on "Tax Expenditures"

Stanley S. Surrey, a U.S. Treasury official, coined the term "tax expenditure" in the 1960s. He wanted to draw attention to the many elements of the U.S. tax code that simu-

lated spending programs by reducing tax liabilities in exchange for engaging in specified economic activities. The Kansas Department of Revenue produces an annual report on Kansas tax expenditures.

The concept of tax expenditure is useful, but it can be misapplied. Many tax expenditure items in the income tax code manifest themselves as items that pervert the tax base from what people believe to be the proper definition of a comprehensive income tax base. The problem comes when people define as a tax expenditure (special tax preference) policy steps that correct the economically flawed concept of income built into the traditional definition of a comprehensive income tax base. For example, many tax analysts view the deductions allowed for contributions to individual retirement accounts as tax expenditures; but they actually represent the correct income tax treatment of saving. Likewise, many analysts will put the label of tax expenditure on expensing, because it deviates from the historical practices of capital cost recovery (see Appendix); but expensing (or economically equivalent tax credits) represent the correct income tax treatment of capital investment.

Here is an example relevant to Kansas. Kansas law grants a 10 percent investment tax credit to qualifying business taxpayers. The Kansas Department of Revenue identifies this credit as a tax expenditure. However, this identification is only partially correct.

Removal of a penalty should not count as a privilege. The expensing procedure eliminates a penalty—the inherent double tax on capital investment. The top corporate tax rate in Kansas is 7.35 percent (the top partnership and S-Corporation rate is 6.45 percent). The value of a deduction is equal to the tax rate times the deduction, so expensing is economically equivalent to a tax credit rate equal to a taxpayer's marginal tax rate. Accordingly, the tax expenditure component of the Kansas investment tax credit equals 2.65 percent of the investment for corporations (3.55 percent for partnerships and S-Corporations) not the full 10 percent.

### Appendix: A Brief History of Tax-Related Depreciation Accounting<sup>3</sup>

People have understood the income tax bias against saving and investment for a long time. They have also understood how certain capital cost recovery procedures (depreciation rules) can either exacerbate or mitigate the bias. That the

problem has endured for decades in light of this understanding offers a case study in how difficult it is to change complex administrative systems once they begin.

The tax-bias problem started largely as a result of historical accident, inexperience-based ignorance, and intellectual fashion at the time lawmakers codified the U.S. income tax. Kansas inherited the problem when it adopted the income tax in 1933. The federal system had functioned for about 20 years by then. Like most states, Kansas piggybacked (and continues to piggyback) on federal law.

Depreciation accounting, as a business practice, was not widespread before the implementation of the income tax. The advent of the income tax, which embraced the practice, helped codify it and accelerate its acceptance. This history helps explain why business people largely accepted the procedures promulgated by the Bureau of Internal Revenue (now the Internal Revenue Service) without giving much thought to the economic consequences of their actions. The income tax had operated for several decades before savvy business managers began to keep at least two sets of books—one for the tax authorities and one for business decision-making.<sup>4</sup>

Depreciation accounting generated a lot of controversy among accountants during the latter half of the 19<sup>th</sup> century. The theory and practice began developing in the 1830s with the advent of capital-intensive industry—particularly railroads and public utilities. In general, the controversy pitted those practitioners committed to the age-old practice of realization (booking income or expenditures when validated by an actual transaction) against those that wanted to reckon depreciation (wear and tear) as a bookkeeping operation. From the viewpoint of income tax administration, the tax bias against business investment might have not materialized if the realization side had prevailed.

The controversy over depreciation accounting generated a few lawsuits that made it to the Supreme Court. The Court decisions generally reflected the state of professional opinion at the time the cases were heard. The Court rejected the concept of depreciation accounting in cases heard in 1876 and 1878; opined that the concept deserved consideration in a case heard in 1899; and acknowledged the concept in a case heard in 1909. Somewhat coincidentally, in the same year, the concept became codified into U.S. tax law with the Corporation Tax Act of 1909—the same year

that Congress submitted to the states for ratification the 16<sup>th</sup> Amendment to the Constitution (which authorized an income tax).

Depreciation accounting became a feature of the Tariff Act of 1913—essentially, the beginning of the income tax in the United States. The Revenue Act of 1918 specifically stipulated, for the first time, that certain compliance procedures—depreciation accounting among them—must harmonize with generally accepted accounting procedures.

The authors of a 1989 U.S. Treasury study titled “A History of Federal Tax Depreciation Policy” nicely set up the relevance of accounting protocols for the economics of investment:

Depreciation controversies have most often centered on the suitability of depreciable lives [of tangible assets] and methods used by taxpayers. . . . Originally, taxpayers were given considerable discretion in the choice of depreciable lives, asset salvage values, and depreciation accounting methods. However, this policy ultimately placed a costly burden on the Bureau of Internal Revenue and taxpayers to verify the “reasonableness” of the deductions taken. Over time, administrative and statutory changes lessened this burden by creating more uniform depreciation rules. Today, most property is depreciated using a small number of recovery periods established by statute; salvage value is no longer a factor in the determination of depreciation deductions for most property; and the method of allocating deductions over recovery periods is prescribed by statute. Consequently, taxpayer discretion with respect to tax depreciation has been virtually eliminated.<sup>5</sup>

The creation of pre-defined rules and timetables may have reduced compliance costs, but they created economic distortions. It undermined the fundamental precepts of depreciation accounting, which sought to accurately match the time flow of wear and tear with income generation. The arbitrary timetables altered the economic analysis of cash flows. Expensing (sometimes referred to as cash-flow depreciation) represented a viable alternative that promised even greater administrative simplification without the economic distortions.

The federal government’s demand for tax revenue perhaps best explains the motive responsible for codifying pre-defined timetables—and promulgating the notion that expensing (or other accelerated depreciation methods) represented a tax preference rather than economically superior tax policy. Making depreciation timetables longer, under the rationale of better matching the “useful lives” of capital investments—created a larger business income tax base in the short run. The bias toward long depreciable lives became further entrenched when adherence to the pre-defined timetables became a regular feature of income tax audits. The burden of proof shifted to the taxpayer to demonstrate why a particular capital asset did not fit into the prescribed timetable. Disparities in administration—given auditor discretion—exacerbated the tax-bias problems.

By the mid-1950s, a growing number of tax scholars, business people, and lawmakers began to recognize the economic problems with the existing tax depreciation methods.<sup>6</sup> (Marginal tax rates of more than 50 percent made the problems much worse.) The legislative tendency was to grant businesses more operational latitude and faster depreciation methods. The Internal Revenue Code of 1954—the first major re-write of the income tax code—explicitly allowed for accelerated depreciation methods. The record shows that lawmakers consciously intended for the 1954 changes to improve the economics of investment.

Many sophisticated commentators began to argue that it made no sense to keep the timetable depreciation methods in place. Accelerated depreciation methods simply represented administratively complex measures to mitigate the negative economics of an anachronistic (and mistaken) set of rules. Expensing—100 percent acceleration of depreciation—offered the best economics (and the simplest administration). Economist Vernon L. Smith, native son of Wichita, Kansas and 2002 Nobel Laureate in Economics, argued in a scholarly journal in 1963:

The common practice is to permit capital costs to be written off or depreciated over time in accordance with some specified set of tax depreciation rules. We will show that this practice leads to bias in the form of investment decision rules different from those prevailing in the absence of a tax, that the bias is likely in the direction of delaying optimal investment timing, and that such biases can be

removed by expensing investment outlays in the computation of taxable income. . . . Our analysis suggests that the write-offs should be fully accelerated, not to give anyone an advantage, but to eliminate an existing disadvantage in the sense that investment decision rules are distorted.<sup>7</sup>

Yet lawmakers have never taken this compelling step. The system has remained wedded to depreciation timetables that will always produce some degree of distortion because of the inherent double tax on investment. The year before Smith published the findings quoted above, the Kennedy Administration enacted the first of a seemingly never-ending set of income tax reforms that have created complexity, uncertainty, and often self-contradictory policies related to investment.

The Revenue Act of 1962 liberalized depreciation rules and enacted the first-ever investment tax credit. The Tax Reform Act of 1969 sought to improve the economics of the depreciation rules on the one hand yet on the other hand further enshrined accelerated depreciation as a tax preference in the context of the Alternative Minimum Tax. The Tax Reform Act of 1981 enacted an entirely new set of accelerated depreciation measures, which were modified in 1982 and 1984. The Tax Reform Act of 1986 (such a significant set of reforms that it created the Internal Revenue Code of 1986) modified depreciation rules yet again and terminated the ever-varying investment tax credit. Depreciation issues surfaced again as a policy concern around 2000.<sup>8</sup> The only change to result from this concern was “bonus depreciation,” enacted in 2002.

Throughout history, expensing as a universally applicable cost recovery procedure has arisen as a logically consistent alternative only in the context of radical tax reform. There is one *ad hoc* exception—the (capped and limited) expensing provisions for small businesses embodied in Section 179 of the Internal Revenue Code. Kansas law conforms to Section 179.

## Endnotes

- 1 For a detailed discussion of the issues involved, see Arthur P. Hall, “Competing Concepts of Income and the Double Taxation of Saving,” Technical Report 05-0926, Center for Applied Economics, School of Business, University of Kansas, September 2005. Available at: <http://cae.business.ku.edu>
- 2 A responsible discussion of expensing must address the issue of the prevailing income tax deduction for interest expense. Under a debt-finance scenario, using the present value formula approach, one can see that the money used for investment does not derive from (potentially) taxed earnings. The interest deductions that come later reduce the level of taxable cash flow generated by the investment. However, the interest deduction argument does not address the inherent double tax problem. Additionally, tax analysts have always known that the interest deduction creates a bias toward debt finance rather than equity finance.
- 3 This section draws liberally from: David W. Brazell, Lowell Dworin, and Michael Walsh, “A History of Federal Tax Depreciation Policy,” OTA Paper 64, Office of Tax Analysis, U.S. Treasury Department, May 1989. Available at: <http://www.treasury.gov/offices/tax-policy/library/ota64.pdf>
- 4 Joel Dean, “Four Ways to Write Off Capital Investment: Management Should Have a Wider Tax Choice,” *The Journal of Business*, Vol. 29 (2), April 1956, pp. 79-89.
- 5 Brazell, *supra* note 3, pp. 1-2.
- 6 Dean, *supra* note 4; Robert R. Milroy, Donald F. Istvan, and Ray M. Powell, “The Tax Depreciation Muddle,” *The Accounting Review*, Vol. 36(4), October 1961, pp. 539-547.
- 7 Vernon L. Smith, “Tax Depreciation Policy and Investment Theory,” *International Review of Economics*, Vol. 4(1), January 1963, pp. 81 & 91.
- 8 C. Eugene Steuerle, “Is it Time to Rationalize Depreciation Policy?” *Tax Notes*, August 20, 2001, p. 11109. Available at: <http://taxpolicycenter.org/publications/template.cfm?PubID=9701>



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