Approved: 2-13-08
Date

MINUTES OF THE SENATE COMMERCE COMMITTEE

The meeting was called to order by Chairperson Karin Brownlee at 8:30 A.M. on January 23, 2008 in Room 123-S of the Capitol.

All members were present except:
Jay Emler- excused

Committee staff present:
Jennifer Thierer, Kansas Legislative Research Department
Kathie Sparks, Kansas Legislative Research Department
Jason Long, Revisor of Statutes
Jackie Lunn, Committee Assistant

Conferees appearing before the committee:
Stan Ahlerich, Kansas Inc.
Dr. Art Hall, Kansas University

Others attending:
See attached list.

Chairperson Brownlee introduced Mr. Stan Ahlerich, Kansas, Inc., to finish his review of *Leveraging our Foundations and Designing the Future: A Kansas Economic Renaissance, The 2007 Kansas Economic Development Strategic Plan*, (on file at the Kansas, Inc .Office) which he started in the meeting yesterday.

Mr. Ahlerich continued his review from yesterday's meeting of the *2007 Kansas Economic Development Strategic Plan* and began to highlight on a few more of the 43 strategies. During the review there was discussion with the Committee regarding lifelong educating and customized training as it relates to workforce development. Voetec schools were also discussed. Upon the conclusion of Mr. Ahlerich's review he stated he had received an email regarding Schult Homes, a manufacturing facility, located in Plainville, Kansas for the past 40 years. The email stated the company is closing its plant due to lack of employees. The Committee has concerns regarding the closing and there was discussion with Mr. Ahlerich. Chairperson Brownlee made the statement that Jim Garner, Secretary of Labor, had stated that the state employs 70% of all the people from the age of 16 or 18 to 100 years of age. She stated that Kansas needs more workers but they have to get them legally. The discussion continued regarding customized training.

Upon the conclusion of the discussion Mr. Ahlerich referred the Committee, for their review, to a copy of the evaluation of the Department of Commerce, stating it is one of the charges of Kansas, Inc.(On file at the Kansas, Inc. Office)

Chairperson Brownlee introduced Beth Martino from the Department of Labor, to request a bill. Ms. Martino made the request for a bill concerning the employment security law. She stated the bill would have two parts. The employment security law in Kansas currently allows the Department to wave collection from employers who owe unemployment taxes less that $1.00 and the proposal is to increase that to less than $5.00. The second piece of the bill would phase in over the next three years and would require that wage reports and unemployment taxes be filed electronically for employer with more than fifty (50) employees .

Senator Barone moved to accept the above request. Senator Schodorf seconded. Motion carried.

Chairperson Brownlee introduced Dr. Art Hall from Kansas University to give his testimony regarding the effectiveness of tax incentives of Kansas.

Dr. Hall presented written copy of a survey of 300 business owners and executives in Kansas which was from Kansas, Inc. (Attachment 1) which is attached and is incorporated into these minutes as a matter of record. Dr. Hall stated he wanted to talk to the Committee on expensing, a tax reform procedure which is simply a reduction for capital investment and is very similar to the tax credits that are currently offered, but it is a different procedure. This initiative originated form the Kansas Strategic Planning process of Kansas, Inc. He stated that legislation is presently being drafted and explained how the expensing compared to the other tax credits. He stated that the expensing proposal will benefit every business regardless of their size. They are building on the momentum that the legislature has had the last two years in the way of pro investment tax policy. They would like for the expensing proposal to apply to every single business and lower the cost of access. It will happen automatically and would be a taxpayer option. He added It is very similar in its economical effect to the tax credits that Kansas already offers. If well implemented, expensing treats every business equal no matter how big or small. Expensing will be an option ,as is the case with all the other tax credits that current law offers, but can't be taken along with any other tax credit. The policy goal of every one of the tax credits and expensing is exactly the same; in general, that is, to increase the after tax rate of return on making capital investments in Kansas. Dr. Hall explained the tax credits specifically in HPIP in comparison with expensing.

A discussion followed regarding the advantages of expensing, how it would work and the legislation being drafted. Chairperson Brownlee called on Stan Ahlerich and he stated that Kansas, Inc. is very excited about this initiative. He stated that Kansas did not have unlimited resources and that this is a comprehensive plan to attract new companies and keep the existing ones.

Chairperson Brownlee announced to the Committee that she was going to have the CEO's of aircraft manufacturing before the Committee regarding workforce development.

Due to the time restraint Chairperson Brownlee asked if KCCI could come back on another day and give their presentation. KCCI stated they would be available.

Chairperson Brownlee adjourned the meeting with the next meeting scheduled for tomorrow, January 24, 2008 at 8:30 a.m. in room 123 S.

Senate Commerce Committee
Guest List

Date: Jan 23, 2008

Christy Caldwell	Topeka Chamber of Commerce
JAY KRAMER	CARTER GROUP
Lori Lesch	PMCA of KS
Mark Bozanyak	Capitol Strategies
Beth Martino	KS Dept. of Labor
Austin Hayden	Hein Law Firm
TERRY FORSYTH	KNEA
Callie Denton Hartle	Ks Assn for Justice (KsAJ)
JEFF GLENDENING	KS CHAMBER
Wil Leiker	KS AFL-CIO
KEN DANIEL	TIBA
Joe Lawson	Post Audit
Jacquelyn Koehler	Kansas, Inc.

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 Senate Commerce Committee
January 23, 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 does not subsidize businesses. Expensing improves the expected rate of return on almost any investment relative to other types of depreciation procedures, because it allows the taxpayer to capture the time value of money embedded in the investment. Importantly, from a tax policy perspective, expensing generates a higher expected investment return by removing a tax bias built into the current depreciation rules rather than granting the business taxpayer a special privilege.

- Expensing, properly implemented, is a tax policy that treats *all* businesses equally. By allowing business taxpayers to capture the time value of money related to an investment, expensing results in uniform income tax treatment for investments of all types and sizes, given the tax rate faced by the business taxpayer.

What is the Kansas, Inc. Proposal?

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

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

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

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

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

Source: Kansas Department of Revenue

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

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

Other Important Features of the Kansas, Inc Proposal

- *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 for federal income tax purposes.

- Unlimited carry forward of unused balances.

- Taxpayers may elect the expensing deduction on an asset-by-asset basis.

- For multi-state taxpayers, the expensing deduction is directly allocable to Kansas income and not subject to apportionment.

- Recapture rules for taxpayers that buy eligible property and move it out of Kansas.

- Rules for calculating the gain or loss of an asset that has been expensed and subsequently sold.

- Expensing, because it is a deduction, automatically applies to a "consolidated group" under current Kansas law.

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

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

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

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

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

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

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

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

<u>An Example</u>

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

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

Acme Call Centers' Federal Depreciation Deduction Schedule								
Year	1	2	3	4	5	6	7	8
Amount ($)	21,435	36,735	26,235	18,735	13,395	13,380	13,395	6,690

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

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

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

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

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

- The table below illustrates a likely range of revenue (tax liability) reductions that would result from implementing the expensing system suggested by Kansas, Inc.—*assuming that every business opted to expense its investments.*
- The calculations assume that a fully mature expensing system applied to the actual Kansas income tax data recorded for the years 2005 and 2004.
- The estimates do not include the revenue offsets that would result from replacing the tax credits specified above with the expensing option—about $39 million in 2006.

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

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

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

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

Methodological Points Related to the Fiscal Note Calculations

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

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

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

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

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

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

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

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

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