

Approved: March 12, 2010
Date

MINUTES OF THE HOUSE ECONOMIC DEVELOPMENT AND TOURISM COMMITTEE

The meeting was called to order by Chairman Lana Gordon at 3:30 p.m. on March 10, 2010, in Room 152-S of the Capitol.

All members were present except:

Representative Pat George- excused
Representative Valdenia Winn- excused

Committee staff present:

Doug Taylor, Office of the Revisor of Statutes
Reed Holwegner, Kansas Legislative Research Department
Brandon Riffel, Kansas Legislative Research Department
Ann Deitcher, Committee Assistant

Conferees appearing before the Committee:

Katrin Osterhaus, Audit Supervisor, Legislative Post Audit
Barbara Hinton, Auditor, Legislative Post Audit

The Chair introduced Katrin Osterhaus who presented an overview providing background on Kansas' tax system. (Attachment 1).

Ms. Osterhaus referred to the Performance Audit Report on Kansas Tax Revenues, Part 1 regarding Reviewing Tax Credits, (on file in the Committee Chair's office). Explaining that most of the State's \$5.3 billion in State's General Fund revenues came from income and sales tax collections, she pointed out that over the past several decades, Kansas, as many other states, had become more reliant on income taxes and less reliant on sales taxes to fund State operations.

Having 47 tax credits as well as two tax refund programs (the Homestead Property Tax Refund and the Food Sales Tax Refund), the study has provided a summary of each program.

Barbara Hinton responded to some of the questions from the Committee.

Referring next to Part 2 of the Audit Report regarding Reviewing Sales Tax Exemptions, (also on file in the Committee Chair's office), Ms Osterhaus explained that in 1985, Kansas had 30 sales tax exemptions, which steadily increased to reach the current 99 existing exemptions. Evaluating the large number of exemptions, they grouped them into three main categories; the must exempt, the need to exempt and decide to exempt as a matter of public policy.

More questions and answers followed.

The Chair thanked both Ms. Osterhaus and Ms. Hinton for their contributions.

The meeting was adjourned at 4:45 p.m.

The next meeting is scheduled for Monday, March 15, 2010.

House Economic Development and Tourism – March 10, 2010; 3:30 pm

Thank You, Madam Chair, and members of the Committee!

I'm here to present the first two parts of our tax audit series dealing with tax credits and sales tax exemptions.

I'll cover a few things from the overview to provide some background on Kansas' tax system, which starts on page 4.

First of all, most of the State's \$5.3 billion in State's General Fund revenues come from income and sales tax collections. That's graphically displayed in the bar-chart at the bottom of page 5 – the black bars indicate revenues from income taxes, and the white bars indicate revenues from sales and excise taxes.

Over the past several decades, Kansas, as many other states, has become more reliant on income taxes and less reliant on sales taxes to fund State operations. On page 6, you see this graphically, with the black slice of the pie charts shrinking from 1960 to 2009.

This shift away from sales taxes can be attributed to such things as more sales occurring on the internet, for which sales taxes can't always be collected, a shift toward a more service oriented economy, and a proliferation of sales tax exemptions

Tax credits and exemptions significantly reduce the potential tax revenues:

- Tax credits - which government often offers to induce taxpayers to do certain things - reduce the State's revenues because the credits are subtracted directly from the amount of taxes the taxpayer otherwise would have to pay. Forgone revenues from credits have increased from about \$500 million in 2004 to almost \$670 million in 2007.
- Sales tax exemptions cost the State an estimated \$3 billion in 2003, and have increased to about \$4.2 billion in 2009. When purchases are exempted from sales taxes, the tax base shrinks. At the current 5.3% tax rate, having less items that are taxed means fewer revenues, unless the tax rate is increased to compensate for the loss.

Because of the large number of tax credits and exemptions involved, we weren't able to do a detailed cost-benefit analysis on each tax credit or exemption. Instead,

we reviewed various studies, tax policy guidelines and other tax literature, talked to experts from various entities, and interviewed officials from several state agencies and organizations from Kansas and other states.

Based on this work, we learned that the fairest tax system is one that can be uniformly applied to the broadest base of people, goods and services, and that exemptions should be the exception not the rule. We also learned that a number of legitimate reasons exist for allowing certain entities or transactions not to be taxed.

In the end, we categorized the various tax policy considerations we learned about into three broad categories which we used to conduct our work.

The first category includes things that policymakers are required to exempt from taxation because of Federal laws or because of the State Constitution

The second category includes things that policymakers need to exempt from taxation in order to avoid double taxation, or to ensure that taxes are paid on the end product only

The third category includes things that policymakers decide - from a public policy standpoint - to exempt from taxation.

We used that framework to evaluate tax credits in this Part I and sales tax exemptions in part II.

This gets me to Question 1, which starts on page 15: Does Kansas Have Tax Credits that Aren't Accomplishing their Intended Purpose, or Have Outlived their Usefulness?

Kansas currently has 47 tax credits as well as two tax refund programs (the Homestead Property Tax Refund and the Food Sales Tax Refund).

We provided a summary of each credit and refund program which starts on page 17 of the report. As you can see, the tax credits are organized by major category (such as assistance for low-income individuals or business/economic development). Within each group, we listed each credit or refund program, its purpose, how it's calculated, and its effective date.

The far-right of the table also shows the number of filers and the cost to the State.

If you flip to page 24-25, you see the credits and refund programs in the same order as in the previous figure, this time showing the tax filer and cost information

for 4 years instead of just one. If you look at #37, this credit is for “taxes paid to other states” and is by far the largest tax credit Kansas provides.

For the next few minutes, I’ll cover our assessment on these tax credits and refunds.

On pages 26-27, we listed 13 numbered credits that had been enacted in 2006 or later (the number for each of these credits refers back to the previous figures for quick reference). Because these credits were so new and had minimal or no activity yet, we couldn’t evaluate their effectiveness.

We identified eight credits and one refund program that appear to be accomplishing the legislature’s policy goals. They are listed starting on page 27. For example, the “Food Sales Tax Refund Program” is broad-based, benefitting over 321,000 taxpayers, and makes the tax system less regressive by allowing low-income taxpayers to get back a portion of sales taxes they paid on food purchases. On page 28, we include the “Credit for Taxes Paid to Other States.” Because this credit avoids Kansans being double-taxed, it fulfills its purpose and therefore makes sense to maintain. In all, credits in this category cost the State almost \$450 million.

Next, we identified eight tax credits that appear to be likely candidates for being repealed. Most of these tax credits had little to no use, or declining use over time. Forgone revenues from these credits totaled less than \$100,000. If you look at the figure on page 29, we provide various considerations regarding these eight credits. For example, the Agritourism Liability Insurance Credit benefited only around 25 taxpayers each year, and it can’t be determined whether the benefitting businesses wouldn’t have started up, if they hadn’t received the credit. Another example is the Temporary Assistance to Families Contribution credit. This credit hasn’t been used over the past 4 years and therefore isn’t achieving its purpose.

We identified seven tax credits that could be modified. If you follow along in the report, these credits are listed in *Figure 1-4* on pages 30 and 31. On page 30, you’ll see six credits that are structured more generously in Kansas compared to similar credits in some of the neighboring states. For example, Kansas’ “Earned Income Tax Credit” is calculated based on 17% of a taxpayers’ federal earned income credit. Colorado and Nebraska offer a 10% credit, while Oklahoma offers only 5%. If Kansas rolled its credit back to 10%, it would have saved an estimated \$26 million, based on the approximately 198,000 taxpayers using this tax credit in 2007.

Another example is the Angel Investor credit. Kansas' rate for this credit is 50%, while 12 of 18 States that offer this credit established lower rates for this credit. On the other hand, this credit likely reduces market barriers for high-risk start-up companies, and reductions in the credit rate may reduce investment levels.

The Center for Entrepreneurship credit on page 31 allows a taxpayer to make a contribution for which the State provides a 75% tax credit. The same contribution also can be deducted on the taxpayers' federal income tax return. Kansas currently doesn't require the deduction to be added back in for the Kansas tax return, as is required for several other tax credits. This means that the taxpayer can receive a double benefit from the same contribution he or she has made.

What's left are twelve tax credits. For these credits, we identified tax considerations for both maintaining them, and for not having them. We couldn't substitute our judgment for the Legislature's when it comes to policy decisions. Instead, we summarized the various considerations in a format to allow the Legislature to re-evaluate whether these credits provide a good balance between funding needs and the public policy goals. I'll walk through a few examples next:

If you flip to page 32, you'll see the first five credits listed under the "primary consideration of no or minimal use". One example is number 49, the Small Insurance Company credit: only 11 insurance companies took this credit, five of which were based in Kansas. It's structured so that smaller companies get a proportionally larger credit, and it encourages smaller companies to start (and remain) in business within the State. However, it's unlikely that the State's cost of about \$50,000 to \$60,000 and the small number of companies it reaches, directly results in a positive economic effect that wouldn't otherwise occur.

The primary consideration for the business and job development credit is the fact that this credit likely doesn't cause, but simply subsidizes business actions. Dr. Art Hall from the University of Kansas found the this credit provides too small of an incentive for businesses to make investment decisions based on the credit. At a cost of over \$11 million, this credit also significantly erodes tax revenues.

On the other hand, Department of Commerce officials cite this credit as an important part of their economic development toolbox, and all surrounding states have similar credits.

On top of page 33, you'll see the Historic Preservation Credit, which has proven to be significantly more expensive than expected. In addition, its transfer option makes this credit not cost effective for the State. However, this credit accomplishes its purpose by allowing about 600 projects to be completed so far, which aids economic development and revitalizes neighborhoods.

For the Business Machinery and Equipment as well as the Telecommunications and Railroad Credit, the primary consideration is their potential to cause competitive inequities between businesses. These inequities are the result of the 100% property tax exemption that was enacted in 2006. In essence, businesses with older equipment can get the credit which reimburses them for 25% of their property tax. Businesses that have purchased new equipment since the property tax exemption was enacted don't have to pay ANY property taxes.

While conducting our work for the audit, we also noted a couple of issues related to the accuracy of the Department of Revenues' tax credit data, including a number of data reliability issues within the individual tax credit databases, and inaccurate aggregate cost data for several tax credits, such as under stated costs for the Business and Job Development and High Performance Incentive Program Credit, and inaccurate outcome data for these two credits.

We also found that Kansas generally lacks a strong system for reviewing and evaluating tax credits. While Kansas has a statute requiring an annual cost-effectiveness study on economic development credits, it doesn't specify which credits are to be included. Additionally, the law doesn't specify details as to the type of evaluation envisioned. Other states provide more guidance on what such evaluations should involve.

Our last finding in this question is that Kansas doesn't routinely merge information about tax credits that are processed by the Department of Revenue and the 20 credits the Insurance Department processes, which cost the State about \$75 million. Without information from both sources, the Legislature doesn't have a complete picture.

Next, I'll cover our main findings from Question 2: What transferable tax credits exist in Kansas, and Are they a Cost-Effective Means of Generating Money To Fund Certain Types of Projects or Causes? This question starts on page 42, if you follow along in the report.

Of the 47 currently available credits, Kansas has 4 that are transferable. This means a taxpayer can sell his or her tax credit to someone else to use. The feature is attractive when taxpayers don't have large enough tax liabilities (or no tax liabilities) to use before the credit expires. Typically, the credit is sold for less than face value which still benefits the seller with cash in hand, and benefits the buyer who bought the credit for less than it's worth.

If you flip to page 44, the figure shows the four transferable credits Kansas offers: Angel Investor, Community Service Contribution, Deferred Maintenance and Historic Preservation. While each of these credits has slightly different features, the Historic Preservation credit has the least-restrictive rules. That's because the credit can be split into several pieces, and transferred to others an unlimited number of times.

We found that the transfer feature for the Angel Investor, Community Service, and Deferred Maintenance credits is cost-effective for the State. That's because the tax credit essentially reimburses the taxpayer for a portion of the investment or donation he or she made towards the cause. Whether or not the tax credit is subsequently transferred doesn't reduce the amount the taxpayer initially provided to the start-up company or towards the project.

When historic preservation credits are transferred, only about 85 cents of the money the State gives up actually reaches the project. If you flip to page 48, the graphic shows the process for this credit. It starts with a historical rehabilitation project plan that must be approved by the State Historical Society. Once the agency approves the plan, the developer can use the anticipated tax credit as collateral to secure financing from the bank. In our graphic, the hypothetical project costs \$1 million with a potential tax credit of \$250,000. The bank typically purchases the anticipated credit at a discounted amount, let's say \$215,000. The project developer uses the \$215,000 in addition to other financing to complete the project. If all goes as planned, the State issues the \$250,000 credit when the project is complete. However, only \$215,000 of the State's tax credit reaches the project.

On page 49, we show that between 2001 and 2009, the State has issued \$58.1 million in tax credits for 570 completed projects thus far. Of this amount, \$51 million has been transferred, generating \$43.4 million, which translates to about 85 cents on the dollar.

Aside from this primary analysis, we also reviewed additional data because of the concerns related to the rising cost of this credit. If you flip to page 50, the left part of *Figure 2-7* shows that the amount of approved project costs approached \$312 million so far. At 25%, the amount of tax credits those projects will generate is about \$78 million. In the next column, we show that so far, \$58 million of tax credits have been issued. In the far right column, you see that only about \$44.2 million of these tax credits have actually been claimed through tax returns so far.

As a result, the State will be on the hook to issue tax credits on historic preservation projects that *have already been approved*, and taxpayers will be able to claim tax credits that *haven't* been claimed thus far.

The second point to take away from that figure is that the Historic Preservation credit has quickly surpassed the annual cost of \$1 million that was estimated for fiscal note purposes. As the last column shows, this credit reached \$8.5 million in 2007, and preliminary cost data show its cost at \$10.5 million for 2008.

As in question 1, we found some data reliability issues for the Historic Preservation and Angel tax credits, which are described in more detail on page 51. In essence, staff responsible for entering these tax credits hadn't recorded all of the credits in the agency's databases, even though they had been claimed on tax returns.

With that I conclude my presentation and stand for any questions.

My next presentation covers part II, dealing with sales tax exemptions. The question starts on page 15: **Does Kansas Have Sales Tax Exemptions that Potentially Should Be Considered for Elimination?**

In 1985, Kansas had 30 sales tax exemptions, which steadily increased to reach the currently 99 existing exemptions. The State's forgone revenues from the exemptions are estimated to cost \$4.2 billion in fiscal year 2009. Besides enacting new exemptions, the Legislature frequently broadens existing ones, which is graphically shown on page 16 of the report.

To evaluate the large number of exemptions, we first grouped them into the three main categories I touched on earlier (must exempt, need to exempt, and decide to exempt as matter of public policy).

Starting on page 18, we show a comprehensive table of all 99 sales tax exemptions. This table is organized into various categories I want to cover briefly: The first six exemptions are those that are *legally required*, and therefore fall into the "must exempt" group. For example you see #3 there which is designed to exempt groceries purchased through the federal food stamp program. Exemptions in this group cost an estimated \$32 million.

The second group includes *conceptual* exemptions which are those that avoid double taxation and ensure that sales taxes are collected at the point of final sales. These exemptions are needed according to tax policy considerations. It's also important to recognize that the six exemptions in this group, especially #8, account for the majority of the estimated TOTAL lost revenues, at about \$3 billion.

The next group of exemptions are those granted to governmental entities, which is in line with tax policy considerations. In this group, I want to point out #26 and 27 –which are mostly for government, but they also include some other entities such as nonprofit hospitals or non-profit educational institutions. The 15 exemptions in this group are estimated to cost about \$460 million.

The rest of the figure lists the remaining sales tax exemptions that have been created **as a matter of public policy**: Starting at the bottom of page 19, we show two agricultural exemptions that are estimated to cost about \$50 million. Page 20 shows 11 business-related exemptions at about \$215 million in total. The next two groups are those targeted to charitable, religious or benevolent exemptions, which I'll cover in more detail in just a bit.

On page 23, you see several exemptions for consumers. For example, this group includes an exemption on lottery tickets (#77) and utilities (#83). These 10 exemptions cost the State an estimated \$351 million. At the bottom of the page you'll see a couple of exemptions that are related to education, which cost about \$60 million.

On page 24, we list 4 exemptions related to services, while the last group of exemptions relates to health care, for such items such as prescription drugs and insulin, and for property and services bought by health care centers. The eight exemptions in this last group are estimated to cost about \$83 million.

In evaluating the sales tax exemptions that are enacted as a matter of public policy, we noted that a number of them provide unequal treatment for similar types of taxpayers or services. First of all, Kansas currently exempts 44 individually named non-profit organizations. We also identified 4 exemptions that, while they don't name a specific entity, are written very narrowly. These exemptions are shown in *Figure 1-3* on page 27. Because they don't apply to a broad group or class of taxpayers, and could create unfair advantages to similar non-profit entities that aren't exempted, they go against good tax policy principles.

Similarly, the exemption for coin-operated laundries appears to create an unfair advantage to those businesses, compared to other businesses involved with laundries, or other coin-operated businesses such as car-washes.

Third, we identified a number of exemptions that are granted to certain "non-profit" entities, but not their "for-profit" counterparts. The five exemptions in this area are listed in the middle on page 26. For example, the first one is medical supplies and equipment purchased for certain non-profit nursing homes, while for-profit nursing homes have to pay sales tax on the same items.

Lastly, we found that Kansas currently exempts a number of IRS recognized non-profit organizations, but the Department of Revenue estimates that there are still about 10,000 Kansas non-profit entities that don't have sales tax exemptions. This inconsistency puts non-profits on an unequal footing, mainly as a result of Kansas exemptions having been created in a piece-meal fashion over time, and because the Legislature doesn't have a clear public policy goal that helps guide what services or entities should be exempted from paying sales taxes.

Another way of looking at these exemptions is by how much they cost. In fiscal year 2009, the 13 largest sales tax exemptions accounted for \$4.1 billion, or 96%

of forgone revenues. *Figure 1-4* on page 29 summarizes these exemptions. The top portion of the figure includes six exemptions that are considered necessary given various tax policy considerations, and cost an estimated \$3.4 billion.

The seven exemptions listed in the bottom portion include those that were enacted as a matter of public policy. As you can see, this portion includes three exemptions related to machinery and equipment, one exemption geared toward educational and youth activities, one exemption on specific labor services related to construction, an exemption on utilities used in residences or by farms, and a health care exemption related to prescription drugs. Altogether, these seven exemptions cost nearly \$700 million.

As with tax credits, we attempted to provide additional information that may aid the Legislature in considering whether these exemptions should continue to be maintained, given that they were created decades ago, and weren't as costly then.

Those discussions can be found on page 30. For example, the prescription drug exemption at the bottom of the page significantly erodes the state and local tax base, but makes the tax system more regressive. Additionally, all four neighboring states allow a similar sales tax exemption.

Our last finding in this question deals with a recent shift in what's being exempted. Historically, sales tax exemptions that were granted for specific organizations applied to the purchases those organizations made. In more recent years, exemptions have been written to not only include the organization itself, but also others acting "on behalf" of the entity. This can lead to abuse if purchases aren't actually made for the exempted organization. In addition, a number of recent exemptions also allowed sales made by the organization to be exempted from taxes. This not only reduces the tax base further, it also shifts the benefit from the organization to the consumer. *Figure 1-5* on page 32 details the various exemptions that have been broadened this way.

With that, I conclude my presentation and stand for any questions you may have.