



PERFORMANCE AUDIT REPORT

Kansas Tax Revenues, Part II: Reviewing Sales Tax Exemptions

**A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
February 2010**

Legislative Post Audit Committee

Legislative Division of Post Audit

THE LEGISLATIVE POST Audit Committee and its audit agency, the Legislative Division of Post Audit, are the audit arm of Kansas government. The programs and activities of State government now cost about \$13 billion a year. As legislators and administrators try increasingly to allocate tax dollars effectively and make government work more efficiently, they need information to evaluate the work of governmental agencies. The audit work performed by Legislative Post Audit helps provide that information.

We conduct our audit work in accordance with applicable government auditing standards set forth by the U.S. Government Accountability Office. These standards pertain to the auditor's professional qualifications, the quality of the audit work, and the characteristics of professional and meaningful reports. The standards also have been endorsed by the American Institute of Certified Public Accountants and adopted by the Legislative Post Audit Committee.

The Legislative Post Audit Committee is a bipartisan committee comprising five senators and five representatives. Of the Senate members, three are appointed by the President of the Senate and two are appointed by the Senate Minority Leader. Of the Representatives, three are appointed by the Speaker of the House and two are appointed by the Minority Leader.

Audits are performed at the direction of the Legislative Post Audit Committee. Legislators

or committees should make their requests for performance audits through the Chairman or any other member of the Committee. Copies of all completed performance audits are available from the Division's office.

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DO YOU HAVE AN IDEA FOR IMPROVED GOVERNMENT EFFICIENCY OR COST SAVINGS?

The Legislative Post Audit Committee and the Legislative Division of Post Audit have launched an initiative to identify ways to help make State government more efficient. If you have an idea to share with us, send it to ideas@lpa.ks.gov, or write to us at the address above.

You won't receive an individual response, but all ideas will be reviewed, and Legislative Post Audit will pass along the best ones to the Legislative Post Audit Committee.

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LEGISLATURE OF KANSAS

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DATE: February 17, 2010

To: Members, Legislative Post Audit Committee

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This report contains the findings, conclusions, and recommendations from our completed performance audit, *Kansas Tax Revenues, Part II: Reviewing Sales Tax Exemptions*.

The report recommends that the Legislature review several sales tax exemptions that aren't consistent with good tax policy principles, may cause unfair competition between entities, or have a significant impact on the State's tax base to determine whether change should be made. In addition, it recommends that the Legislature consider establishing clear public policy goals regarding the types and classes of services it wants to exempt from sales taxes, together with a set of criteria that could be used to measure current and future sales tax exemptions against. We would be happy to discuss these recommendations or any other items in the report with any legislative committees, individual legislators, or other State officials.

We would be happy to discuss the findings presented in this report with any legislative committees, individual legislators, or other State officials.

Barbara J. Hinton
Legislative Post Auditor

READER'S GUIDE

<i>The Big Picture</i>		<i>The Details</i>	
Audit Highlights	The highlights sheet, inserted in each report, provides an overview of the audit's key findings	"At-a-Glance Box"	Used to describe key aspects of the audited agency; generally appears in the first few pages of the main report
Conclusions and Recommendations	Located at the end of the audit questions, or at the end of the report	Side Headings	Point out key issues and findings
Agency Response	Included as the last Appendix in the report	Charts, Tables, and Graphs	Visually help tell the story of what we found
Table of Contents, and lists of figures and appendices	Lets the reader quickly locate key parts of the report	Narrative Text Boxes	Highlight interesting information or provide detailed examples

This audit was conducted by Katrin Osterhaus, Brad Hoff, and Lisa Hoopes. Leo Hafner was the audit manager. If you need any additional information about the audit's findings, please contact Katrin Osterhaus at the Division's offices.

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Kansas Tax Revenues, Part II: Reviewing Sales Tax Exemptions

Kansas has enacted a number of taxes to fund government operations. A few examples are individual and corporate income tax, privilege tax (on financial institutions), sales and use tax, motor fuel taxes, mineral taxes, and the like. According to the Department of Revenue's fiscal year 2008 annual report, and information from the Insurance Department, the amount the State collected from various taxes that year, before refunds, was about \$8.5 billion.

Over the years, the Legislature has enacted a variety of tax credits and exemptions designed to stimulate certain types of economic activity or to achieve other public purposes. For example, a taxpayer who makes a cash donation of \$250 or more to the Kansas Center for Entrepreneurship receives a tax credit of 75% of the amount donated.

Some tax credits are widely available and account for large amounts of forgone tax revenue, while other credits are less frequently used. For example, based on information compiled by the Department of Revenue and the Insurance Department for the 2007 tax year, 10,450 taxpayers claimed \$36.7 million under the Business Machinery and Equipment Credit. In contrast, 21 taxpayers claimed about \$3,700 from the Agritourism Liability Insurance Credit.

With the proliferation of credits and exemptions over the years, legislators have expressed an interest in knowing whether some of those credits and exemptions still are needed or whether they have outlived their original purposes. Legislators also want to know whether transferable tax credits represent an effective use of taxpayer dollars.

This performance audit answers the following questions:

- 1. Does Kansas have any tax credits that aren't accomplishing their intended purpose or have outlived their usefulness?**
- 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?**
- 3. Does Kansas have sales or property tax exemptions that potentially should be considered for elimination?**

For reporting purposes, we separated this audit into three parts. Part I addresses the first two questions related to tax credits. Part II answers the last question related to sales tax exemptions, and Part III will answer the last question for property tax exemptions.

To answer these questions, we reviewed Kansas laws and contacted the Department of Revenue, Insurance Department, Legislative Research Department and other agencies that play a role in approving or tracking tax credits or exemptions to compile a complete list of tax credits and sales and property tax exemptions currently offered under Kansas law. We also determined when these tax benefits were enacted or increased, what their purposes are, how often they are used and, when available, the estimated loss of revenue to the State for tax credits and sales and property tax exemptions.

Because of the large number of tax credits and exemptions we reviewed, we weren't able to perform individual cost-benefit analyses for those credits and exemptions. When it was available, we reviewed cost-benefit analyses that others had performed. We also reviewed national and State reports and interviewed tax experts and State officials to identify tax policy considerations that provide support for either having or not having a tax preference, and compared Kansas' current tax credits and exemptions to them. In addition, when data were available, we reviewed cost trends for sales tax exemptions.

Generally accepted government auditing standards require us to plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We conducted this performance audit in accordance with those standards, except that we didn't conduct specific work to test the reliability of the estimates of forgone revenues from individual sales tax exemptions provided to us by the Department of Revenue.

We noted that the Department's estimates for individual sales tax exemptions for calendar years 2007, 2008, and 2009 totaled to more than the exemptions the Department reported claimed on sales tax returns. Because of the way the information is collected on the tax returns, we couldn't reconcile the differences. As a result, the reader should be aware that some of the amounts shown in this report for individual sales tax exemptions may be overstated.

With the exception noted above, given the questions posed in the audit we think it's unlikely the data are so grossly or systematically

wrong as to affect our findings and conclusions. Therefore, we think the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

A copy of the scope statement for this audit approved by the Legislative Post Audit Committee is included in *Appendix A*. Because of the number of credits and exemptions involved, we added a third question to the approved scope statement to allow us to report on credits and exemptions separately.

Our findings about sales tax exemptions begin on page 15, following a brief overview of Kansas' tax system, and tax credits and exemptions.

Overview of Kansas' Tax System and Tax Credits and Exemptions

Income and Sales Tax Collections Generate the Majority of State General Fund Revenues in Kansas

The State generates income from retail sales, income, and property taxes, as well as a number of excise taxes such as cigarette, liquor, and other taxes. Retail sales and excise taxes, as well as various income taxes generate by far the largest amount of revenue for the State General Fund, accounting for more than 93% of the total in recent years. **Figure OV-1** provides a recent history of State General Fund revenues, including an estimate for fiscal year 2010, by major type of revenue source.

As the figure shows, total State General Fund revenues increased steadily from fiscal years 2003 through 2007, but started declining in fiscal year 2008 with the onset of the most recent economic downturn. For fiscal year 2010, the Consensus Revenue Estimating Group estimated as of November 2009 that State General Fund receipts would be about \$5.3 billion, down almost 10% from the high in 2007.

Although property taxes are a significant part of the State's tax system, they primarily are levied and collected by local units of government and make up only a small portion of State General Fund revenues. The State levies 21.5 mills of property tax—20 mills to fund K-12 education and 1.5 mills to support two State building funds. Those revenues are collected in separate State funds.

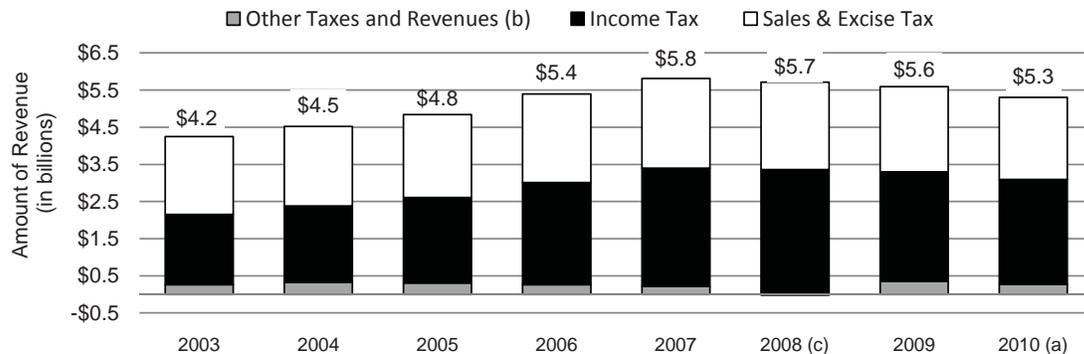
Over the past several decades, Kansas has become much more reliant on income taxes and less reliant on sales taxes to fund State operations. **Figure OV-2** on page 6 summarizes all State tax revenue sources (State General and other State funds) at various points in time beginning in 1960.

As the figure shows, the percentage of State revenues provided by income taxes tripled between 1960 and 2009, rising from 15% to 45% of the total. During the same period, the percentage of State revenues from sales and excise taxes declined from 71% of the total to 49%. This reduction occurred even though the State's sales tax rate more than doubled, from 2.5% in 1960 to 5.3% in 2009.

Similar trends occurred nationwide. According to information provided by the National Conference of State Legislatures, between 1970 and 2008 the percentage of states' revenues from income taxes increased from about 27% to 42%, and general sales and excise taxes steadily declined from 57% to 46%.

Figure OV-1
State General Fund Tax Receipts (In Millions)
Fiscal Years 2003 - 2010 est.

Type of Revenue	2003	2004	2005	2006	2007	2008	2009	2010 est. (a)
Retail Sales and Excise Tax Revenues								
Retail Sales	\$1,567.7	\$1,612.1	\$1,647.7	\$1,736.0	\$1,766.8	\$1,711.4	\$1,689.5	\$1,660.5
Compensating Use	\$225.9	\$214.5	\$244.8	\$269.3	\$285.0	\$246.3	\$235.0	\$222.0
Cigarette	\$129.3	\$119.8	\$119.0	\$117.9	\$115.3	\$112.7	\$107.2	\$102.0
Tobacco Products	\$4.5	\$4.8	\$5.0	\$5.1	\$5.3	\$5.5	\$5.7	\$6.0
Cereal Malt Beverage	\$2.3	\$2.2	\$2.1	\$2.1	\$2.1	\$2.2	\$2.1	\$2.2
Liquor -- Gallonage	\$14.8	\$15.8	\$15.7	\$16.7	\$17.1	\$17.6	\$18.2	\$18.5
Liquor -- Enforcement	\$38.8	\$40.3	\$41.9	\$44.2	\$47.1	\$50.0	\$53.8	\$57.0
Liquor -- Drinking Places	\$6.9	\$7.2	\$7.4	\$8.0	\$8.6	\$8.9	\$9.1	\$9.5
Corporate Franchise	\$31.1	\$36.8	\$47.1	\$46.9	\$47.9	\$46.7	\$41.7	\$26.0
Severance -- gas	\$56.3	\$66.1	\$75.4	\$96.5	\$79.6	\$91.5	\$73.8	\$47.7
Severance -- oil	\$16.5	\$18.6	\$28.0	\$36.9	\$36.4	\$56.7	\$50.4	\$54.0
Subtotal	\$2,094.1	\$2,138.2	\$2,234.1	\$2,379.6	\$2,411.1	\$2,349.5	\$2,286.7	\$2,205.4
Income Tax Revenues								
Individual	\$1,750.1	\$1,888.4	\$2,050.6	\$2,371.3	\$2,709.3	\$2,896.7	\$2,682.0	\$2,560.0
Corporation	\$105.2	\$141.2	\$226.1	\$350.2	\$442.4	\$432.1	\$240.3	\$245.0
Financial Institution	\$31.1	\$25.4	\$22.1	\$31.1	\$31.1	\$33.2	\$26.2	\$24.0
Subtotal	\$1,886.4	\$2,055.0	\$2,298.7	\$2,752.5	\$3,182.9	\$3,361.9	\$2,948.5	\$2,829.0
Property Tax Revenues								
Motor Carriers	\$15.7	\$19.5	\$20.5	\$22.1	\$25.8	\$29.0	\$29.3	\$24.0
General Property	--	\$13.7	\$0.5	\$0.1	--	--	--	--
Motor Vehicle	--	\$1.5	\$1.8	\$1.9	--	--	--	--
Sub-total	\$15.7	\$34.7	\$22.8	\$24.0	\$25.8	\$29.0	\$29.3	\$24.0
Other Tax Revenues								
Insurance Premiums	\$94.5	\$106.9	\$106.8	\$112.2	\$113.8	\$117.6	\$119.6	\$117.5
Estate	\$47.0	\$48.1	\$51.9	\$51.8	\$55.6	\$44.2	\$22.5	\$14.5
Miscellaneous	\$4.4	\$4.4	\$4.3	\$5.1	\$5.5	\$5.2	\$1.8	\$2.0
Subtotal	\$145.9	\$159.4	\$163.0	\$169.1	\$174.9	\$167.1	\$143.9	\$134.0
Total Tax Revenues	\$4,142.0	\$4,387.2	\$4,718.5	\$5,325.3	\$5,794.7	\$5,907.4	\$5,408.3	\$5,192.4
Other Revenue								
Interest Income	\$19.1	\$13.9	\$23.3	\$54.3	\$92.3	\$111.3	\$64.2	\$20.0
Transfers	(\$13.0)	\$16.7	\$23.6	(\$42.2)	(\$142.4)	(\$377.7)	\$35.6	\$33.7
Agency Earnings	\$97.6	\$101.0	\$75.9	\$57.0	\$64.5	\$53.9	\$80.9	\$54.6
Subtotal	\$103.7	\$131.6	\$122.7	\$69.1	\$14.3	(\$212.5)	\$180.7	\$108.3
Total Receipts	\$4,245.8	\$4,518.9	\$4,841.3	\$5,394.4	\$5,809.0	\$5,694.9	\$5,589.0	\$5,300.7



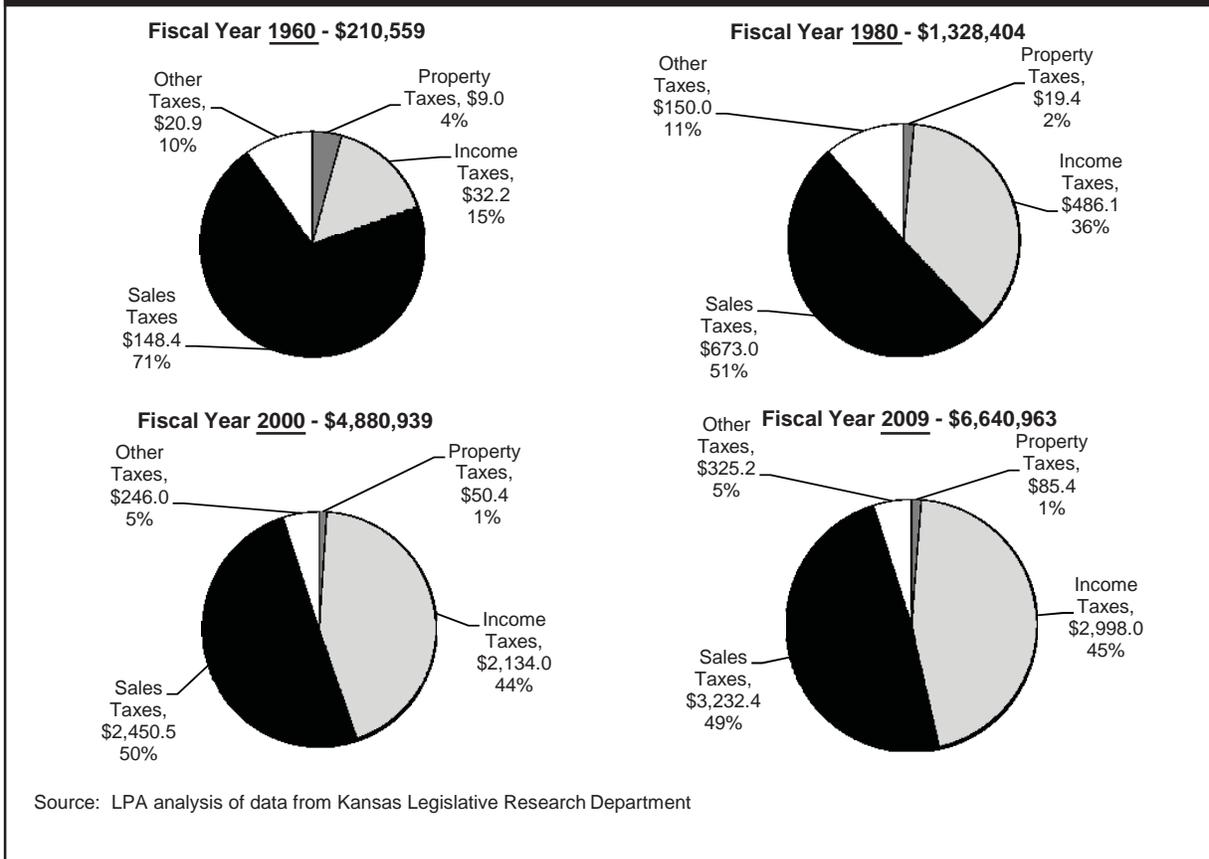
(a) Estimated as of November 5, 2009, by the Consensus Revenue Estimating Group.

(b) Property taxes, Other Taxes, and Other Revenues were combined into this category for the chart.

(c) In fiscal year 2008, transfers contributed to a net loss of \$16 million in the "Other Taxes and Revenues" category.

Source: LPA analysis of data provided by the Legislative Research Department.

Figure OV-2
Summary of ALL State Revenues - SGF and Other
Funds From FY 1960 to 2009 (in millions)



Several factors have contributed to the shift away from sales taxes as the State’s primary revenue source. According to legislative testimony by Department of Revenue and Legislative Research staff at various tax committee hearings in the past, the shift in revenue sources likely is caused by the following factors:

- **More sales are being made on the Internet** – Before the Internet, people primarily bought goods from retail establishments or through catalogs, both of which collected and remitted sales taxes to the State. Now, many items can be purchased over the Internet, and many of those transactions don’t result in sales taxes being collected. An article in the January 2008 issue of *Governing* magazine described Internet sales as a national problem, with the biggest obstacle to taxing Internet transactions being the wide variety of sales tax structures used by the individual states (and their localities).
- **A shift toward a more service-oriented economy** – In the past, more of the transactions that occurred in the Kansas economy involved the purchase of agricultural or manufactured goods, which were subject to sales taxes. With the shift toward a more service-oriented economy (e.g. professional services such as accounting or legal services, or health and personal care services), sales tax revenues haven’t kept up with the growth of the overall economy because those services generally aren’t taxed. Based on the latest information reported by the Federation of Tax Administrators, Kansas is one of 43 states not taxing professional services.

- **A proliferation of sales tax exemptions** – Between 1985 and 2009, the number of Kansas sales tax exemptions grew from 30 to almost 100, or more than triple. Tax exemptions shrink the tax base from which sales taxes are collected.

Tax Credits and Exemptions Enacted Over the Years Have Reduced the State's Potential Tax Revenues Significantly

Tax revenues are generated by applying a rate to a taxable base. For sales taxes, the rate is the State's tax rate (currently set at 5.3%) and the tax base is all taxable sales. For property taxes, various types of real and personal property assessment rates are set out in the State's Constitution to establish the assessed values (the tax base). For property tax, the assessed real and personal property values make up the tax base, while the mill levy is the rate.

Granting sales or property tax exemptions takes certain transactions **out** of the tax base, which reduces its size. When that happens, the same tax rate applied to the smaller tax base results in reduced tax revenues.

For the State to generate the same amount of tax revenue as before, the remaining taxable sales and property must be taxed at a higher rate than they otherwise would have been. People or businesses that pay those higher taxes end up subsidizing those who benefitted directly from the exemptions.

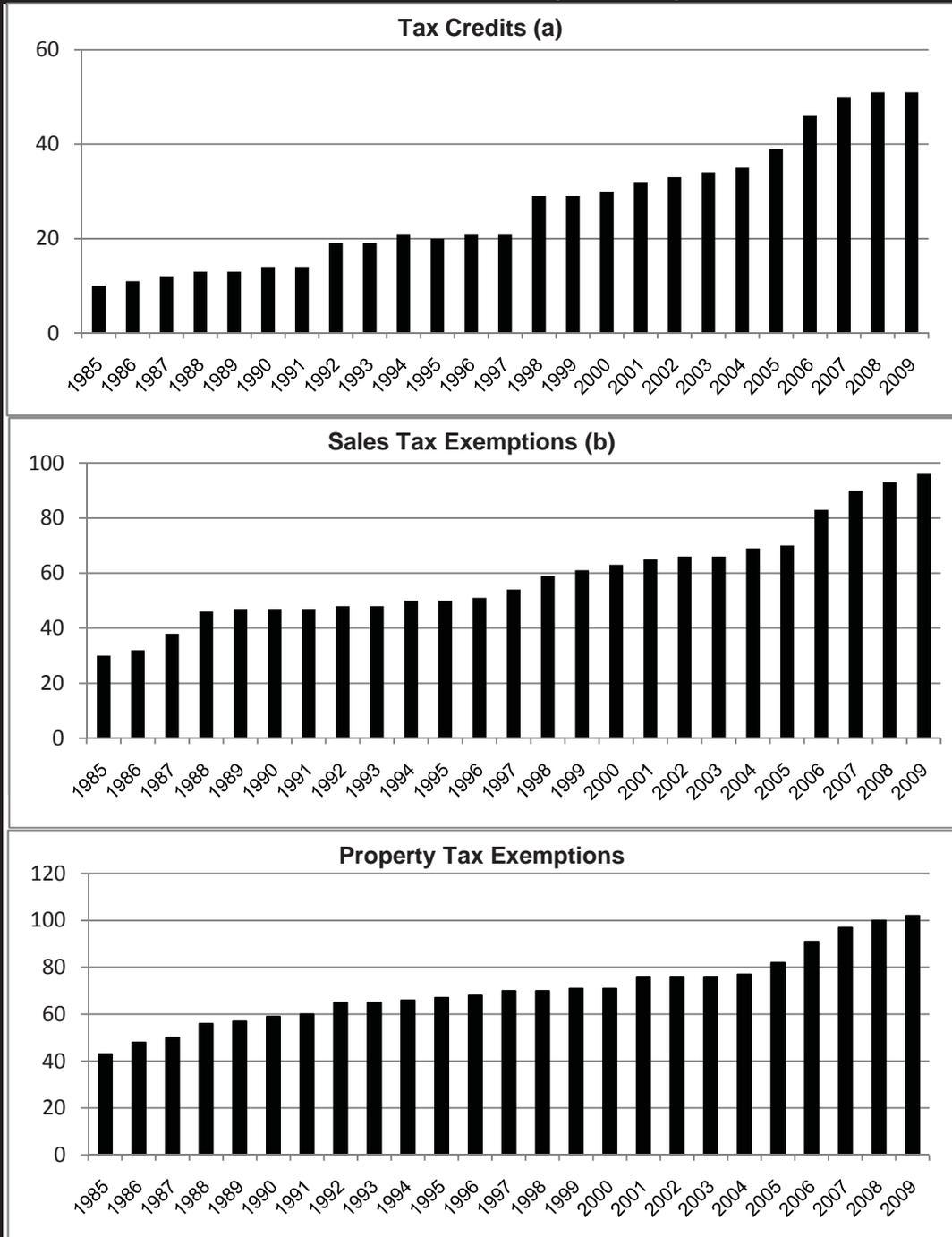
For income taxes, the base is all taxable individual or corporate income. Tax credits, which the government offers to try to induce certain actions by the taxpayer, reduce income tax revenues because they are subtracted directly from the amount of taxes due.

The number of enacted tax credits and sales and property tax exemptions has grown since 1985. As *Figure OV-3* on the next page shows, between 1985 and 2009, the number of tax credits and refund programs increased from 10 to 51 (this includes two tax credits that haven't expired, but funding for them has run out so they aren't available for new taxpayers). During that same time, the number of sales tax exemptions increased from 30 to almost 100, and the number of property tax exemptions more than doubled from 43 to more than 100.

Besides creating new credits and exemptions which is shown in *Figure OV-3*, the Legislature also broadened existing ones. For example:

- The 2006 Legislature increased the Adoption Tax Credit (which reimbursed the taxpayer 25% of adoption expenses) to 50% for expenditures relating to adopting a Kansas resident child, and to 75% for adopting a Kansas resident child with special needs.

**Figure OV-3
Number of Tax Credits, Sales Tax Exemptions, and Property Tax Exemptions
Enacted in Kansas Law (1985-2009)**



(a) This analysis includes six credits that were created and expired during this time period. In 2009, 51 tax credits/refund programs include two credits that haven't expired, but funding has run out so they aren't available for new taxpayers.

(b) This analysis doesn't include three sales tax exemptions that were created but expired during this time period.

Source: LPA analysis of Kansas law and data provided by the Kansas Department of Revenue and the Insurance Department.

- The 1977 sales tax exemption on prosthetic and orthopedic devices was revised four times to include handicap-accessible devices for cars in 1995; mobility enhancing devices (which replaced orthopedic devices) in 2003; hearing aids (including parts and batteries) in 2004; and oxygen delivery equipment, kidney dialysis equipment, and enteral feeding systems in 2007.
- In 1992, a property tax exemption on all farm machinery and equipment (created in 1982) was revised to include all aquaculture and Christmas tree machinery and equipment.

Lost revenues from tax credits and sales exemptions have increased significantly over the past several years. Some credits or exemptions have relatively modest effects on reducing revenues, while others can have a much larger effect. For example, a sales tax exemption on property and services purchased by non-profit homeless shelters (and any sales made by or on behalf of these organizations), resulted in estimated forgone State sales tax revenues of about \$110,000 in fiscal year 2009. In comparison, forgone revenues from sales tax exemptions on prescription drugs were estimated to be about \$70 million for fiscal year 2009.

Taken together, lost tax revenues from all the tax preferences studied in this report significantly increased, as summarized below:

- **Tax Credits:** Information on the amount of tax credits (and two refund programs) is tracked by the Department of Revenue and the Insurance Department as part of their processing of various income, privilege, and premium tax returns. Based on that information, the State's lost revenues from tax credits and refund programs increased from about \$496 million in tax year 2004 to almost \$669 million in 2007.
- **Sales Tax Exemptions:** Forgone revenues from sales tax exemptions exist only in the form of estimates, which the Department staff update annually. For fiscal year 2003, sales tax exemptions totaled an estimated \$3 billion in forgone sales tax revenues, which had risen to \$4.2 billion by 2009 (a 41% increase). Sales tax revenues over that period increased by only 7.8%.
- **Property Tax Exemptions:** The Department doesn't track the actual or estimated cost of real and personal property tax exemptions enacted in statute. That's because property taxes are primarily a local revenue source. However, summary information from the Department's Division of Property Valuation shows the appraised value of real estate exempt from taxation was \$24.4 billion in 2008, up from \$19.4 billion in 2003. This information doesn't include the appraised value of personal property exempt from taxation.

In addition to reducing revenues through tax credits and exemptions, the Legislature has taken additional actions that reduce State General Fund revenues. For example:

- **The corporate franchise tax is being phased out:** This initiative started in tax year 2007. With its complete repeal in 2011, the lost revenue that year will be an estimated \$37 million.
- **The corporate income tax surcharge was reduced:** The rate will drop from 3.35% in tax year 2007 to 3% by tax year 2011. This change is estimated to reduce tax receipts by almost \$16 million in both tax years 2010 and 2011.
- **A portion of withholding taxes was diverted from the State General Fund to be committed to Biosciences:** The 2004 Kansas Legislature established the Bioscience Development Investment Fund. For a period of 15 years, a portion of the withholding taxes payable by certain bioscience companies will go to that Fund rather than to the State General Fund. Those withholding taxes will be used to fund bioscience programs and repay bonds. The statute caps the cumulative payments into this Fund at \$581.8 million.

Various Legislative or Review Committees Have Studied Issues Related to State's Tax System in the Past

The 2002 Legislature frequently discussed the elimination of sales tax exemptions as a way of finding additional revenues needed as a result of the recession that began in 2001. Ultimately it raised the sales tax rate from 4.9% to 5.3% and created the Special Committee on Assessment and Taxation, which met several times to discuss repealing various sales tax exemptions.

The Committee didn't propose specific legislation, but encouraged the 2003 Legislature to conduct a global study of Kansas' overall State and local tax policy and structure. The Committee also asked the Department of Revenue to work on continuing to update fiscal notes associated with removing sales tax exemptions and with extending the sales tax to previously untaxed services.

Since that time, a number of committees have reviewed various policy concerns related to the erosion of tax base and other tax issues. Here's a summary of these activities:

- **The 2004 Special Committee on Assessment and Taxation** discussed the confidentiality and disclosure of tax information. The Committee recommended the introduction of a bill, endorsing a proposal on relaxing certain confidentiality provisions. The same Committee heard a Department of Revenue summary on corporate income tax receipts. In that information, the Department noted the U.S. Supreme Court's opinion that tax exemptions and tax deductibility are a form of subsidy that is administered through the tax system. A tax exemption has much the same effect as a cash grant to the organization of the amount of tax it would have to pay on its income.

- **The 2005 Special Committee on Assessment and Taxation** was tasked with an analysis of State and local tax policy, which included discussions of the tax mix, concerns about mill levy increases in rural areas, tax base erosion, growing State and local debt, and a declining elasticity of State General Fund tax receipts due to growing earmarks and shift towards a service industry. The Committee also received 11 tax policy objectives that had been recommended by the 1995 Governor's Tax Equity Task Force, which included such things as keeping the administration of the tax system fair and efficient. Among other things, the Committee recommended for the Department of Revenue to conduct additional studies on the tax base erosion.
- **The 2006 Special Committee on Assessment and Taxation** was tasked with reviewing the latest research on erosion of sales and property tax bases. As part of the hearings, the Committee received several studies that had been commissioned by the Department of Revenue. Among other things, the Committee strongly recommended that six specific questions relating to justification of any new exemptions be answered by all parties seeking sales tax exemption legislation (e.g. Does the exemption establish an unfair competitive advantage for one entity over another?).
- **The 2007 Special Committee on Assessment and Taxation** again reviewed sales tax exemptions. The Committee reviewed the findings of an extensive review by the Joint Committee on State Tax Structure, often referred to as the Hodge Commission. The Committee also learned about more recent developments with regard to granting a number of exemptions to specifically named organizations, granting exemptions not only on purchases but also on sales, and allowing exemptions on behalf of an organization. The Committee strongly recommended the Legislature consider establishing objective standards for granting sales tax exemptions, and a working-group to develop an audit scope statement for the Legislative Division of Post Audit.

Recently, the Kansas Advisory Council on Intergovernmental Relations (KACIR) released a tax policy evaluation guide for legislators to use when considering tax policy changes. During 2002, the Legislature created the KACIR to continuously study the State and local tax structure and the revenue requirements and fiscal policies of the State and its local units of government. The Council's 15 members consist of officials from the executive and legislative branches of government and from school districts.

Together with the Department of Revenue, the Council commissioned various comprehensive tax studies. In September 2009, the Council released a "Tax-Base Policy Evaluation Guide" for legislators to use when considering tax policy changes.

***A Number of Legitimate
Reasons Exist For
Allowing Certain Entities
Or Transactions
Not To Be Taxed***

Generally speaking, the fairest tax system is one that can be uniformly applied to the broadest base of people, goods, and services. According to the literature we reviewed, exemptions from taxation should be the exception, not the rule. When granting tax credits or exemptions, policymakers should consider whether the benefit to the public is worth the tax revenue that is lost, or worth making other taxpayers pay more to make up the difference.

As noted earlier, Kansas currently has hundreds of tax credits and sales and property tax exemptions. There was no way we could conduct cost-benefit analyses on all these tax preferences for this audit within a reasonable timeframe, and for many of them the necessary information wouldn't have been available anyway. Instead, we reviewed various studies on Kansas' tax system, and one study evaluating the effectiveness of two specific tax credits.

We also reviewed the State Constitution and federal laws, tax policy guidelines outlined by KACIR and the National Conference of State Legislatures (NCSL), and other tax literature; talked to experts from the National Tax Foundation, and from taxpayer advocacy groups such as Americans for Prosperity; and interviewed officials from several State agencies and organizations and from neighboring states.

These efforts allowed us to identify various tax policy considerations that policymakers need to take into account in deciding whether or not to grant or maintain tax credits and exemptions. They generally fell into three categories:

- those things policymakers are **required** to exempt from taxation (such as property tax exemptions required by the State Constitution)
- those things policymakers **need** to exempt from taxation (such as exemptions that prevent the government from taxing itself)
- those things policymakers **decide from a public policy standpoint** to exempt from taxation (such as credits to encourage the development of certain forms of energy, or exemptions that are intended to facilitate the creation or retention of jobs). For these types of tax preferences, a variety of factors have to be considered, such as whether the exemption or credit significantly reduces the tax base, whether it helps minimize the regressivity in the State's tax system, whether it's significant enough to achieve the intended purpose, and the like.

Figure OV-4 on page 14 shows the tax policy considerations we identified under these three categories. In drawing conclusions about the tax credits and exemptions we reviewed, we applied these and other tax policy considerations, and analyzed available data such as usage and cost information.

Part I of this audit focused on tax credits. Part II focuses on sales tax exemptions, and Part III will focus on property tax exemptions. Due to time constraints, we didn't review exemptions related to motor fuel or severance taxes. Other tax preferences or incentives, such as deductions, abatements, or diversions that are offered by the State were not part of this audit.

Figure OV-4
Tax Policy Considerations Used To Evaluate Tax Preferences

A. Tax Preferences That Are Required by the State Constitution (*Article 11(b)(2)*):

All property used exclusively for State, county, municipal, literary, educational, scientific, religious, benevolent and charitable purposes, farm machinery and equipment, merchant's and manufacturer's inventories and livestock and all household goods and personal effects not used for the production of income.

B. Tax Preferences That Are Required by Federal Law:

1. Sales tax exemption on food stamps based on Federal Food Stamp Act of 1977 (*7 U.S.C. Paragraph 2013(a)*)
2. Sales tax exemption on products related to the Child Nutrition Act of 1966 (*42 U.S.C. Paragraph 1786 (c)(4)*)
3. Tax exemptions related to property involved with Interstate Commerce

C. Tax Preferences That Tax Policies Suggest Need To Be Exempt from Taxation:

1. Goods and services purchased by government entities (*taxing government entities would increase the cost of providing government services*)
2. Goods and services subject to another equivalent or "in lieu of" tax (*avoids double taxation of products such as motor fuel, which has an excise tax instead of a sales tax*)
3. Items sold that aren't a final sale to the consumer (*maintains the sales tax as the final tax on consumption*)
4. Isolated or occasional sales (*relieves the seller of the administrative burden of collecting/filing taxes for things like garage sales, flea markets or bazaars.*)

D. Tax Preferences That Are Made as a Matter of Public Policy:

I. Examples of Tax Policy Considerations That Can Favor Having a Tax Preference:

1. Promoting broad-based equity (*e.g., exempting the sale of mobile homes from sales tax because other residential home sales aren't subject to sales tax*)
2. Promoting a broad-based tax structure that benefits the public at large (*e.g., a tax structure that's balanced and diversified and provides adequate revenues to finance public services over time*)
3. Minimizing regressivity in the State's tax system to reduce the tax burden on the poor (*e.g., providing refunds to low-income taxpayers for food sales because they pay proportionally more of their income on food than other taxpayers*)
4. Reducing market barriers to accomplishing a goal that would benefit the broader public (*e.g., providing a tax credit for companies to offer health insurance benefits that they otherwise wouldn't offer because of high costs*)
5. Encouraging economic growth and development (*e.g., creating incentives for companies to create or retain jobs that otherwise wouldn't occur*)
6. Staying competitive with other states (or countries for global enterprises) that have a tax preference, to guard against significant loss of sales or business (*e.g., offering economic development credits or property tax exemptions for businesses looking to expand or relocate*)
7. Subsidizing certain activities that reduce the services or costs that government otherwise would have to provide (*e.g., offering a tax credit to help fund deferred maintenance costs for universities*)

II. Examples of Tax Policy Considerations That Can Favor Not Having a Tax Preference:

1. The purpose or goal of the tax preference can't be clearly articulated or measured
2. The tax preference isn't likely to achieve the public policy goal, or evidence shows it isn't achieving that goal (*e.g., tax preference isn't being used, or likely is too small to cause the entity or individual to take the action*)
3. The cost of the tax preference to the State can't be measured, or evidence shows the cost is greater than expected, or more than policymakers are willing to fund
4. The cost of the tax preference is greater than the benefits the State receives in return
5. The tax preference is too narrow, favoring selected industries, entities, or activities over others without a clear reason for doing so
6. The tax preference creates unfair competition between similar entities
7. The tax preference significantly erodes the State's tax base
8. The tax preference has a significant negative effect on local tax revenues
9. The tax preference is an inefficient or ineffective way of accomplishing the public policy goal (*e.g., 100% tax credit for select entities, instead of funding the activity through a direct appropriation*)
10. The industry is regulated by the State and can recover the necessary costs of doing business from customers and is provided a certain profit through regulated rate of return set by the State
11. The tax preference creates difficulties in administering it because of how it's designed or because it leads to confusion of who can benefit from it.

Source: LPA review of tax policy literature, Kansas Constitution, and federal laws.

Question 1: Does Kansas Have Sales Tax Exemptions that Potentially Should Be Considered for Elimination?

Answer in Brief:

Kansas currently has 99 sales tax exemptions that cost the State an estimated \$4.2 billion in fiscal year 2009. Sales tax exemptions in several areas provide unequal treatment for similar types of taxpayers, including \$2.2 million in exemptions granted to 44 specifically named organizations. Kansas also exempts some non-profit organizations from paying sales taxes, but not their for-profit counterparts. Such exemptions are not in-line with good tax policy principles. The Legislature hasn't formally adopted a public policy goal regarding the types of organizations, services, or activities it wants to exempt from sales tax.

In all, 13 sales tax exemptions accounted for \$4.1 billion (96%) of the total estimate of revenues forgone in 2009. Six of those exemptions, accounting for \$3.4 billion, relate primarily to taxing goods at the final point of sale, and not taxing government entities. Seven exemptions totaling almost \$700 million were for machinery and equipment, education/youth activities, labor services, utilities, and prescription drugs. Although they significantly erode the State and local tax bases, there are other significant considerations for having them. Finally, in recent years, the Legislature has broadened many sales tax exemptions to allow purchases on behalf of or sales by certain entities. We noted several issues with these exemptions. Our findings are discussed in more detail in the sections that follow.

The Legislature Passed the Retailers' Sales Tax Act in 1937

That law imposes a tax on a wide variety of tangible goods sold at retail, including the following types of transactions:

- the retail sale of tangible personal property
- the sale of meals or drinks at establishments that regularly sell these items to the public
- admissions to entertainment, amusement, or recreation places in Kansas

When originally enacted, the State sales tax rate was 2% of taxable sales. Since then, the sales tax rate has changed several times. The most recent increase occurred in 2002, when the rate was raised to 5.3%.

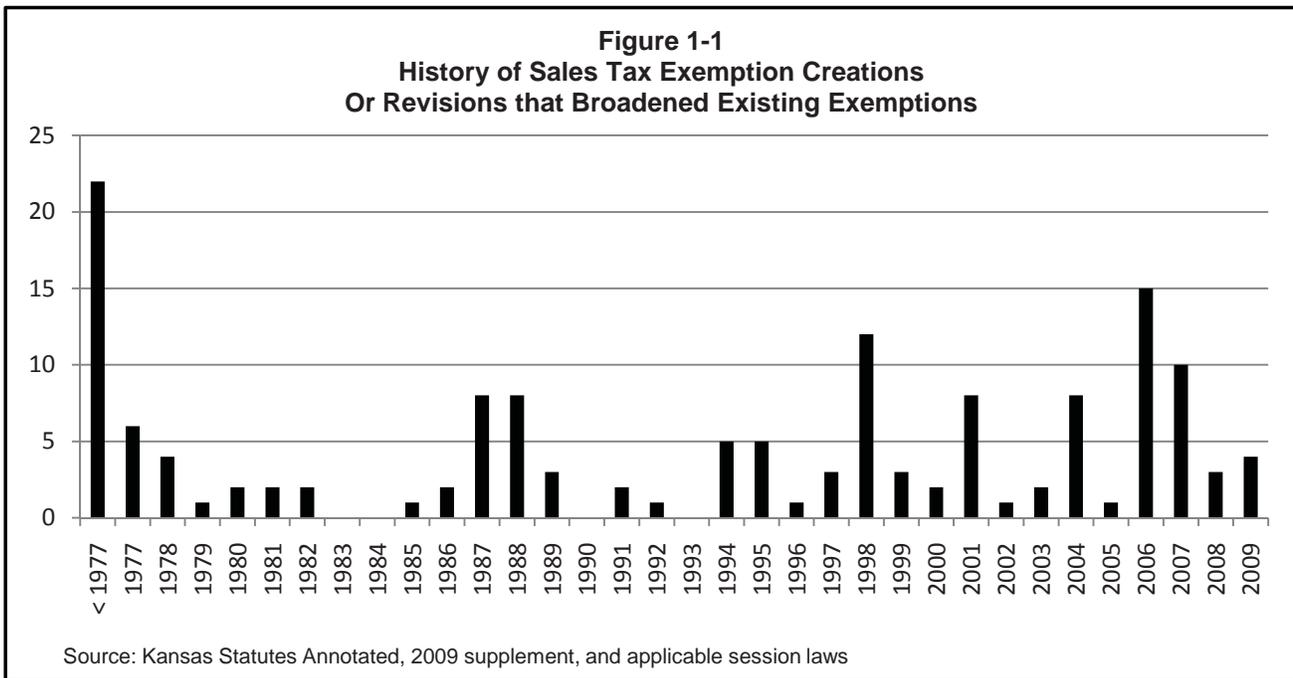
Since 1970, cities and counties also have been allowed to levy a local sales tax up to a current maximum of 4%. According to information from the Department of Revenue, 716 jurisdictions in Kansas levy local sales taxes averaging about 1.5%. Among those jurisdictions,

the highest local rate was 3.75% and the lowest was 0.5%. The most frequent rate—levied in more than 300 jurisdictions—was 1%.

Before they can take advantage of a sales tax exemption, individuals, organizations, and businesses must apply for an exemption certificate from the Department of Revenue. If the entity or the service or activity the entity performs is tax exempt, the Department grants a renewable one-year exemption certificate. The sales tax exemption certificate enables the entity to make purchases at retail stores and other locations without having to pay sales taxes.

Kansas Currently Has 99 Sales Tax Exemptions That Cost The State an Estimated \$4.2 Billion in 2009

Over the years, the Legislature has taken steps to provide exemptions for many items that otherwise would have been subject to sales taxes. As illustrated in *Figure 1-1*, the number of new or expanded sales tax exemptions has increased sporadically over the years.



As the figure shows, there have been several spikes in these numbers over the last 10 or more years. For example:

- **12 exemptions were added or expanded in 1998.** Those included such entities as non-profit zoos, parent-teacher organizations, organizations distributing food, and dues charged for military/veteran or community service organizations.
- **8 exemptions were added or expanded in 2001.** Those included exemptions for sales of bingo card faces and instant bingo tickets,

Kansas chapters of the Parkinson’s Association and the Kidney Foundation, and several exemptions related to water districts or water furnished by political subdivisions.

- **25 exemptions were added or expanded in 2006 and 2007.** Many of these were for specifically named organizations such as Special Olympics Kansas Inc., Marillac Center Inc., West Sedgwick County Sunrise Rotary Club, Catholic Charities, and Youthville.

In addition to items specifically exempted from taxation, numerous services fall outside the current tax system because they aren’t tangible property. A 2008 survey by the Federation of Tax Administrators showed that the retail sales tax in Kansas applied to only 74 of 168 potentially taxable services. Examples of services not taxed in Kansas are investment counseling services, limousine services, and other professional services such as fees charged by accountants, attorneys, or architects.

Kansas’ 99 sales tax exemptions apply to organizations and businesses. These tax exemptions are summarized in *Figure 1-2* starting on the next page. As the figure shows, these exemptions generally fall into three broad categories:

- **Exemptions that are required by law.** Six exemptions are required by federal laws relating to interstate commerce or to purchases made under certain federal programs. These exemptions accounted for an estimated \$31.3 million (less than 1%) in forgone tax revenues in 2009.
- **Exemptions that are needed to avoid such things as double taxation or taxing governmental entities.** Tax policy literature we reviewed generally concluded that such exemptions are necessary, even if they aren’t required. Altogether, 21 of the 99 sales tax exemptions listed (21%) fit this category. These exemptions accounted for an estimated \$3.4 billion (almost 81%) of the sales tax revenue the State gave up in 2009.
- **Exemptions the Legislature has enacted as a matter of public policy.** Those exemptions cover a variety of entities or types of sales or activities. Together, they account for about **\$800 million** in forgone revenues. The largest categories for fiscal year 2009 were as follows:

<u>Exemption category</u>	<u>Number of Exemptions</u>	<u>Cost in Millions</u>	<u>% of Total Rev. Forgone FY 2009</u>
Consumer	10	\$351.3	8.3%
Business	11	\$215.3	5.1%
Health Care	8	\$83.1	2.0%
Educational	2	\$59.4	1.4%
Agricultural	2	\$50.2	1.2%

**Figure 1-2
Description and Cost Information for Kansas' Sales Tax Exemptions**

#	Exempt Entity	Description of Exemption or Exclusion	Sub-Category	Statutory Citation	Enacted/ Most Recent Expansion	Estimated Cost of Exemption (in millions)		
						FY 2009	FY 2010	FY 2011
LEGALLY REQUIRED EXEMPTIONS								
1	Railroads and public utilities	Property purchased by a railroad or public utility for use in the movement of interstate commerce.	Comm/Industry and Util./ Energy	79-3606 (f)	1966	\$15.5	\$16.1	\$16.6
2	Railroad companies	Sales of materials and services used in repairing, servicing, maintaining, or modifying railroad rolling stock used in interstate commerce.	Commerce & Industry	79-3606 (v)	1980	\$0.9	\$1.0	\$1.0
3	Food stamp recipients	Property purchased with food stamps issued by the U.S. Department of Agriculture.	Social Services	79-3606 (dd)	1986	\$7.6	\$7.8	\$8.1
4	WIC recipients	Property purchased with vouchers issued under the federal special supplemental food program for women, infants and children.	Social Services	79-3606 (gg)	1987	n/a	n/a	n/a
5	Liquid petroleum and gas pipeline cos.	Liquid and natural gas pipeline equipment and associated services housed in Kansas for repair, etc., then shipped outside Kansas.	Utilities/ Energy	79-3606 (aa)	1982	Minimal	Minimal	Minimal
6	Purchasers of aircraft	Sales of new/modified aircraft for use in interstate or foreign commerce, and all aircraft sales for use outside the United States.	Vehicles/ Aircraft	79-3606 (g)	1949 / 2004	\$7.3	\$7.6	\$7.8
Subtotal, estimated cost of exemptions:						\$31.3	\$32.4	\$33.6
CONCEPTUAL TAX POLICY EXEMPTIONS (E.G. AVOIDING DOUBLE TAX, TAXING AT POINT OF FINAL SALE)								
7	Agricultural businesses	Sales of animals, fowl, and aquatic plants and animals used in agriculture or aquaculture to produce human food; animal, dairy, or poultry products; fiber or fur, or offspring.	Agriculture	79-3606 (o)	1970 / 1994	\$166.0	\$171.8	\$177.8
8	Businesses that manufacture or produce products	Property that becomes an ingredient or component part of property or services produced or manufactured for ultimate sale at retail.	Commerce & Industry	79-3606 (m)	1970	\$2,248.1	\$2,326.8	\$2,408.2
9	Businesses that manufacture or produce products	Property consumed in the production, manufacturing, processing, mining, drilling, refining, or compounding of property, and the treating of by-products or wastes derived from such production processes; or irrigation of crops for ultimate sale at retail.	Commerce & Industry	79-3606 (n)	1970 / 1995	\$295.0	\$305.3	\$316.0
10	Individuals	Motor fuels and other items already taxed by sales or excise tax.	Misc.	79-3606 (a)	1937	\$232.5	\$240.7	\$249.1
11	Individuals	Isolated or occasional sales of property or services, except motor vehicles.	Misc.	79-3606 (l)	1965	n/a	n/a	n/a
12	Non-Kansas purchasers of vehicles or aircraft	Vehicles, trailers, or aircraft sold and delivered to an out-of-State resident (item sold doesn't stay in Kansas after sale for more than 10 days).	Vehicles/ Aircraft	79-3606 (k)	1963 / 1982	\$15.4	\$16.0	\$16.5
Subtotal, estimated cost of exemptions:						\$2,957.0	\$3,060.5	\$3,167.7
GOVERNMENTAL EXEMPTIONS								
13	Public broadcasting stations	Property and services purchased by a public broadcasting station licensed by FCC as a noncommercial educational television or radio station.	Commun./Enter-tain/Cultural	79-3606 (ss)	1994	Minimal	Minimal	Minimal
14	Kansas Insurance Guaranty Association	Kansas Insurance Guaranty Association exempt from sales tax.	Government	40-2913	1970	not available	not available	not available
15	KS Health Insurance Guaranty Association	Kansas Health Insurance Guaranty Association exempt from sales tax.	Government	40-3015	1972	not available	not available	not available
16	Kansas Bioscience Authority	Purchases by the Kansas Bioscience Authority for its public purposes, but not to extend to persons or entities conducting business on the authority's property for which payment of State and local taxes are required.	Government	74-99b12	2004	not available	not available	not available

**Figure 1-2
Description and Cost Information for Kansas' Sales Tax Exemptions**

#	Exempt Entity	Description of Exemption or Exclusion	Sub-Category	Statutory Citation	Enacted/ Most Recent Expansion	Estimated Cost of Exemption (in millions)		
						FY 2009	FY 2010	FY 2011
GOVERNMENTAL EXEMPTIONS (CONTINUED)								
17	Kansas Electric Transmission Authority	Purchases made by the Kansas Electric Transmission Authority.	Government	74-99d11	2005	not available	not available	not available
18	Federal government	Gross receipts received from renting rooms by hotels to the federal government and any agency, officer or employee thereof in association with the performance of official government duties.	Government	79-3603 (g)	2002	\$0.1	\$0.1	\$0.1
19	Cities	Service of leasing and renting machinery and equipment owned by city purchased with industrial revenue bonds prior to July 1, 1973.	Government	79-3603 (h)	before 1977	--	--	--
20	Federal government or its contractors	Property or services purchased by the federal government, its agencies, instrumentalities, or contractors for construction or repair of buildings or other projects	Government	79-3606 (e)	1937	\$5.5	\$5.7	\$5.9
21	Local water districts	Property or services purchased directly or indirectly by a groundwater management district, rural water district, or water supply district.	Government	79-3606 (s)	1977 / 2001	\$0.04	\$0.04	\$0.05
22	Port authority	Property and services purchased directly by a port authority or its contractor.	Government	79-3606 (z)	1981	Minimal	Minimal	Minimal
23	Rural firefighting organizations	Property and services purchased by or on behalf of a rural fire fighting organization.	Government	79-3606 (uu)	1997	Minimal	Minimal	Minimal
24	Public libraries	Sales made by or on behalf of a public library.	Libraries	79-3606 (ooo)	2006	\$0.01	\$0.01	\$0.01
25	County law libraries	Property and services purchased - directly or indirectly - by a county law library maintained pursuant to law, and sales made by or on behalf of a county law library.	Libraries	79-3606 (rrr)	2006	\$0.1	\$0.1	\$0.1
26	State and local gov't entities (excluding educ. institutions or local units furnishing utilities), plus select public / private health-related entities	Property or services purchased directly by (1) the State of Kansas, a political subdivision (other than a school or educational institution or a political subdivision engaged in the business of furnishing gas, electricity or heat to others, and (2) by a public or private nonprofit hospital, nonprofit blood bank, nonprofit tissue or organ bank, or public hospital authority.	Misc.	79-3606 (b)	1937 / 2001	\$330.9	\$342.5	\$354.5
27	Government entities, plus private schools & private or non-profit hospitals & educational institutions	Property or services purchased by contractors for building or repairing public or private non-profit hospitals, elementary/secondary schools, and non-profit educ. institutions; public hospital authorities; state correctional institution; or any political subdivision.	Misc.	79-3606 (d)	1970 / 2007	\$119.0	\$123.1	\$127.4
Subtotal, estimated cost of exemptions:						\$455.7	\$471.6	\$488.1
PUBLIC POLICY: AGRICULTURAL EXEMPTIONS								
28	Agricultural businesses	Sales of farm or aquaculture machinery and equipment, parts and services for repair and replacement. Amended in 2006 to add work-site vehicles, and in 2007 to include precision farm equipment.	Agriculture	79-3606 (t)	1978 / 2007	\$49.2	\$51.4	\$53.2
29	Agricultural businesses	Sales of seeds, tree seedlings, fertilizers, insecticides, etc., and services purchased and used to produce plants used to prevent soil erosion on land devoted to agricultural use.	Agriculture	79-3606 (mm)	1988	\$1.0	\$1.0	\$1.0
Subtotal, estimated cost of exemptions:						\$50.2	\$52.4	\$54.2

**Figure 1-2
Description and Cost Information for Kansas' Sales Tax Exemptions**

#	Exempt Entity	Description of Exemption or Exclusion	Sub-Category	Statutory Citation	Enacted/ Most Recent Expansion	Estimated Cost of Exemption (in millions)		
						FY 2009	FY 2010	FY 2011
PUBLIC POLICY: BUSINESS EXEMPTIONS								
30	Businesses that sever oil or gas	All sales of drill bits and explosives used in the exploration or production of oil or gas.	Commerce & Industry	79-3606 (pp)	1988	\$0.4	\$0.4	\$0.4
31	Movie theatres	Lease or rental of films, records, tapes, etc. by motion picture exhibitors.	Commun./Enter-tain/Cultural	79-3606 (i)	1961	\$1.7	\$1.8	\$1.8
32	Buyers of customized software	Customized computer software and services for modifying software for single end use and billed as a separate invoiced item.	Labor Services	79-3603 (s)	2004	\$5.2	\$5.3	\$5.5
33	Qualified businesses	Property or services purchased to construct, reconstruct, enlarge, remodel a qualified business, including the sale & install. of machinery and equip.	Machinery & Equipment	79-3606 (cc)	1986	\$65.6	\$67.9	\$70.2
34	Qualified plants and facilities	Sales of machinery and equipment used primarily to manufacture, assemble, process, finish, store, warehouse or distribute property for resale.	Machinery & Equipment	79-3606 (kk)	1988 / 1998	\$115.8	\$119.9	\$124.1
35	Broadcasting stations	Machinery and equipment purchased by over-the-air free access public or private radio or television stations to produce the necessary signal/ electricity.	Machinery & Equipment	79-3606 (zz)	1998	\$1.0	\$1.0	\$1.0
36	Warehouse/distribution facilities	Sales of material handling equipment, racking systems & other related machinery & equipment used in a warehouse or distribution facility; installation, repair, maintenance services, and replacement parts.	Machinery & Equipment	79-3606 (ff)	2000	\$6.3	\$6.5	\$6.7
37	Restaurant employees	Meals served without charge, or food used to prepare those meals, to employees who furnish or sell such meals or drinks to the general public.	Misc.	79-3606 (j)	1965	\$3.8	\$3.9	\$4.1
38	Businesses hurt by the Greensburg tornado	Property or services purchased to construct, reconstruct, enlarge, or remodel a business facility located in Kiowa County before May 4, 2007, and damaged by severe weather on that date.	Natural Disasters	79-3606e	2007	-	-	-
39	Businesses and farmers hurt by natural disasters	Property or services purchased to construct, reconstruct, enlarge or remodel a business facility (includes machinery and equipment and fences for agriculture) damaged or destroyed by a declared natural disaster.	Natural Disasters	79-3606f	2008	not available	not available	not available
40	Businesses that sever oil or gas	Sales of natural gas, electricity, heat, & water delivered through mains, lines or pipes when used in severing oil, or to any property exempt from property tax under K.S.A. 79-201b.	Utilities/Energy	79-3606 (w)	1994 / 1995	\$15.6	\$12.0	\$12.4
Subtotal, estimated cost of exemptions:						\$215.3	\$218.7	\$226.3
PUBLIC POLICY: CHARITABLE, RELIGIOUS, AND BENEVOLENT EXEMPTIONS								
41	Non-profit museums or historical societies	Sales of property and services purchased by a 501(c)(3) non-profit museum or historical society to stimulate public interest in the exploration of space.	Commun./Enter-tain/Cultural	79-3606 (qq)	1988	\$0.4	\$0.4	\$0.4
42	Non-profit corporation for KS Korean War memorial	Property and services purchased by or on behalf of a 501(c)(3) not-for-profit corporation for the purpose of constructing a Kansas Korean War memorial.	Commun./Enter-tain/Cultural	79-3606 (ft)	1996	-	-	-
43	Qualified non-profit museums	Property and services purchased by a contractor to restore, construct or reconstruct, equip, maintain, repair, enlarge, furnish, or remodel a Governor's hometown museum.	Commun./Enter-tain/Cultural	79-3606 (tt)	2006	\$0.1	\$0.1	\$0.1
44	Non-profit zoos	Property and services purchased directly or indirectly by a 501(c)(3) non-profit zoo or on behalf of a zoo.	Education	79-3606 (xx)	1998	\$0.6	\$0.6	\$0.6
45	Parent-Teacher associations	Property and services purchased by a parent-teacher assn. or organizations and all sales of tangible personal property by or on behalf of such association.	Education	79-3606 (yy)	1998	\$0.6	\$0.6	\$0.6
46	Sponsors of triennial cultural/historic events	Sales of admissions to any cultural and historical event which occurs triennially.	Fundraisers/ Fees/ Dues	79-3603 (e)	1988	Minimal	Minimal	Minimal

**Figure 1-2
Description and Cost Information for Kansas' Sales Tax Exemptions**

#	Exempt Entity	Description of Exemption or Exclusion	Sub-Category	Statutory Citation	Enacted/ Most Recent Expansion	Estimated Cost of Exemption (in millions)		
						FY 2009	FY 2010	FY 2011
PUBLIC POLICY: CHARITABLE, RELIGIOUS, AND BENEVOLENT EXEMPTIONS (CONTINUED)								
47	Non-profit organizations	Property that will admit the purchaser to an annual event sponsored by a 501(c)(3) non-profit organization.	Fundraisers/ Fees/ Dues	79-3606 (ri)	1989	\$0.0	\$0.0	\$0.0
48	Religious organizations	Property and services purchased by religious organizations and used exclusively for religious purposes.	Religious Activities	79-3606 (aaa)	1999	\$17.4	\$18.0	\$18.6
49	Contractors preparing meals on wheels	Food purchased by contractors to prepare meals for delivery to homebound elderly or disabled people.	Social Services	79-3606 (v)	1978 / 2004	\$0.8	\$0.9	\$0.9
50	Community action groups or agencies	Tangible personal property purchased by a community action group or agency to repair or weatherize housing occupied by low-income individuals.	Social Services	79-3606 (oo)	1988	Minimal	Minimal	Minimal
51	Individuals buying food	Sales of food for human consumption by organizations exempt by 501(c)(3) under food distribution programs that offer such food below cost in exchange for the buyer's performance of community service.	Social Services	79-3606 (bbb)	1998	Minimal	Minimal	Minimal
52	Domestic violence shelters	Property and services purchased by or on behalf of domestic violence shelters that are member agencies of the Kansas coalition against sexual and domestic violence.	Social Services	79-3606 (hhh)	2004	\$0.1	\$0.1	\$0.1
53	Non-profit food-distribution organizations	Property and services purchased by 501(c)(3) organizations (or contractors) distributing food without charge to other nonprofit food distribution programs.	Social Services	79-3606 (iii)	2006	\$0.2	\$0.2	\$0.3
54	Non-profit homeless shelters	Property and services purchased by or on behalf of 501(c)(3) homeless shelters, and sales made by or on behalf of these organizations.	Social Services	79-3606 (ppp)	2006	\$0.1	\$0.1	\$0.1
55	Non-profit youth organizations (e.g. Boy Scouts & Girl Scouts)	Property bought directly by or on behalf of a nonprofit organization for nonsectarian comprehensive multidiscipline youth development programs. and activities provided/sponsored by such organization.	Youth Activities	79-3606 (ii)	1987 / 1998	\$2.6	\$2.7	\$2.8
Subtotal, estimated cost of exemptions:						\$22.9	\$23.7	\$24.5
PUBLIC POLICY: CHARITABLE AND OTHER ORGANIZATIONS, BY NAME								
56	Booth Theatre Foundation	Property and services purchased directly or indirectly by the Booth Theatre Foundation, Inc.	Commun./Enter-tain/Cultural	79-3606 (xxx)	2007	\$0.031	\$0.032	\$0.033
57	Kansas Academy of Science Foundation	Property and services purchased by or on behalf of the Kansas Academy of Science.	Education	79-3606 (ggg)	2000	Minimal	Minimal	Minimal
58	Frontenac Education Foundation	Property purchased by or behalf of Frontenac Education Foundation and sales made by or on behalf of such organization.	Education	79-3606 (www)	2007	\$0.002	\$0.002	\$0.002
59	TLC Charities Foundation, Inc	Property and services purchased by the TLC Charities Foundation, Inc., and sales made by or on behalf of such organization.	Fundraisers/ Fees/ Dues	79-3606 (yyy)	2007	\$0.001	\$0.001	\$0.001
60	Rotary Club of Shawnee Foundation	Property purchased by the Rotary Club of Shawnee Foundation.	Fundraisers/ Fees/ Dues	79-3606 (zzz)	2007	Minimal	Minimal	Minimal
61	Guadalupe Health Foundation	Guadalupe Health Foundation, sales of entry or participation fees, charges or tickets for annual fundraising event.	Fundraisers/ Fees/ Dues	79-3606 (bbbb)	2008	\$0.111	\$0.115	\$0.119
62	Wayside Waifs	Property and services purchased by or on behalf of Wayside Waifs for its annual fundraising event, and sales made by or on behalf of such organization	Fundraisers/ Fees/ Dues	79-3606 (cccc)	2008	\$0.008	\$0.008	\$0.009

**Figure 1-2
Description and Cost Information for Kansas' Sales Tax Exemptions**

#	Exempt Entity	Description of Exemption or Exclusion	Sub-Category	Statutory Citation	Enacted/ Most Recent Expansion	Estimated Cost of Exemption (in millions)		
						FY 2009	FY 2010	FY 2011
PUBLIC POLICY: CHARITABLE AND OTHER ORGANIZATIONS, BY NAME (CONTINUED)								
63	Individual non-profit entities	Property purchased by, and all sales of such property by or on behalf of the following organizations who are organized under the federal income taxation code as a 501 (c)(3): American Heart Association, Kansas Affiliate; Kansas Alliance for the Mentally Ill, Inc.; Kansas Mental Illness Awareness Council; American Diabetes Association Kansas Affiliate; American Lung Association, Kansas Affiliate; Kansas chapters of Alzheimer's Disease Association; Kansas chapters of Parkinson's Association; National Kidney Foundation of Kansas; Heartstrings Community Foundation; Cystic Fibrosis Foundation, Heart of America Chapter; Spina Bifida Association of Kansas; Community Housing Wyandotte County, Inc.; Cross-lines Cooperative Council, Dreams Work, Inc.; KSDS, Inc.; Lyme Association of Greater Kansas City, Inc.; Dream Factory; Ottawa Suzuki Strings; International Association of Lions Clubs; Johnson County Young Matrons; American Cancer Society; Community Services of Shawnee, Inc.; Angel Babies Association; and the Kansas Fairground Foundation.	Misc.	79-3606 (vv)	1997 / 2009	\$0.791	\$0.819	\$0.847
64	All Beef Battalion, Inc.	Property or services purchased by or on behalf of All Beef Battalion, Inc. for educating, promoting, and participating as a contract group through the beef cattle industry to carry out such projects that provide support and morale to members of the U.S. armed forces and military services.	Misc.	79-3606 (eeee)	2009	n/a	\$0.004	\$0.004
65	Habitat for Humanity	Property purchased by the Habitat for Humanity for use within a housing project.	Social Services	79-3606 (ww)	1997	\$0.115	\$0.119	\$0.123
66	Special Olympics Kansas Inc.	Property and services purchased by Special Olympics Kansas, Inc., for the purpose of providing year-round sports training and competition, and sales made by or on behalf of Special Olympics.	Social Services	79-3606 (lll)	2006	\$0.027	\$0.028	\$0.029
67	Marillac Center, Inc.	Property and services purchased by or on behalf of Marillac Center, Inc. and sales made by or on behalf of the organization.	Social Services	79-3606 (mmm)	2006	\$0.054	\$0.055	\$0.057
68	TLC for Children and Families, Inc	Property and services purchased by TLC for Children and Families, Inc., and sales made by or on behalf of TLC.	Social Services	79-3606 (qqq)	2006	\$0.171	\$0.177	\$0.184
69	Catholic Charities and Youthville	Property and services purchased by Catholic Charities or Youthville, and sales made by or on behalf of these organizations.	Social Services	79-3606 (sss)	2006	\$0.643	\$0.665	\$0.689
70	Kansas Children's Service League	Property and services purchased by Kansas Children's Service League, and sales made by or on behalf of the organization.	Social Services	79-3606 (uuu)	2006	\$0.150	\$0.155	\$0.161
71	West Sedgwick County - Sunrise Rotary Club	Property and services purchased by West Sedgwick County - Sunrise Rotary Club for constructing a boundless playground.	Youth Activities	79-3606 (nnn)	2006	\$0.021	\$0.022	\$0.023
72	Jazz in the Woods	Property and services purchased by Jazz in the Woods, and sales made by or on behalf of the organization.	Youth Activities	79-3606 (vvv)	2007	\$0.010	\$0.011	\$0.011
73	Victory in the Valley, Inc.	Property and services purchased by or on behalf of Victory in the Valley, Inc., [supports people with cancer], & sales made by/on behalf of such organization.	Social services	79-3606 (aaaa)	2007	\$0.018	\$0.018	\$0.019
74	Goodwill Industries and Easter Seals	Property or services purchased by or on behalf of Goodwill Industries or Easter Seals of Kansas, Inc to provide education, training, & employment opportunities for people with disabilities and other barriers to employment.	Social Services	79-3606 (dddd)	2009	n/a	\$0.038	\$0.039
75	Sheltered Living, Inc.	Property and services purchased by Sheltered Living, Inc., for providing residential and other services for people with developmental disabilities or mental retardation, or both; and sales made on behalf of such organization.	Social Services	79-3606 (ffff)	2009	n/a	\$0.030	\$0.031
Subtotal, estimated cost of exemptions:						\$2.2	\$2.3	\$2.4

**Figure 1-2
Description and Cost Information for Kansas' Sales Tax Exemptions**

#	Exempt Entity	Description of Exemption or Exclusion	Sub-Category	Statutory Citation	Enacted/ Most Recent Expansion	Estimated Cost of Exemption (in millions)		
						FY 2009	FY 2010	FY 2011
PUBLIC POLICY: CONSUMER EXEMPTIONS								
76	Bingo players	From and after July 1, 2002, all sales of bingo cards, bingo faces, and instant bingo tickets by licensees under K.S.A. 79-4701 et seq., and amendments thereto, shall be exempt from sales taxes.	Gaming	79-3603 (v)	2001	\$2.7	\$2.8	\$2.9
77	Individuals who buy lottery tickets	Sales of lottery tickets and shares made as part of a lottery operated by the State of Kansas.	Gaming	79-3606 (ee)	1987	\$14.1	\$14.6	\$15.1
78	People/orgs that hire contractors for construct./ reconstruction	Labor services for installing or applying property in original construction of a building or facilities, or the construction, reconstruction, restoration, replacement, or repair of a residence, bridge, or highway.	Labor Services	79-3603 (p)	1977	\$181.8	\$188.2	\$194.8
79	Renters of mobile homes	Leases or rentals of property used as a dwelling (only mobile homes) for more than 28 consecutive days.	Residences	79-3606 (u)	1978	\$0.7	\$0.8	\$0.8
80	Buyers of used mobile homes	Sales of used mobile homes or manufactured homes (does not include the original retail sale).	Residences	79-3606 (bb)	1985 / 1991	\$4.4	\$4.6	\$4.7
81	Buyers of new mobile homes	Sales of new mobile homes or manufactured homes to the extent of 40% of the gross receipts received from such sale.	Residences	79-3606 (ff)	1987 / 1991	\$3.3	\$3.4	\$3.5
82	Customers of telecommunications companies	Interstate or international 800 or 900 WATS lines or private communications services; value-added non-voice data services; telecommunication services to telecommunication service providers that will be used for telecommunication services, including carrier access services; or any service or transaction among entities classified as members of an affiliated group.	Utilities/ Energy	79-3603 (b)	1992	\$1.4	\$1.5	\$1.5
83	Customers of certain utilities	Sales of gas, electricity, and heat delivered through mains, lines, or pipes to residences for noncommercial use and for agricultural use (including propane); and sales of propane gas, LP gas, coal, wood, and other fuel for heating or lighting noncommercial purposes.	Utilities/ Energy	79-3603 (c)	1979 / 2001	\$135.5	\$140.3	\$145.2
84	Individuals, family members, corporations	The transfer of motor vehicles or trailers by (1) a person to a corporation or limited liability company solely in exchange for stock or securities; (2) one corporation or limited liability to another as part of a complete asset transfer; (3) one family member to another immediate family member.	Vehicles/ Aircraft	79-3603 (o)	1976 and earlier / 2001	\$0.2	\$0.2	\$0.2
85	Car buyers	Modified definition of sales or selling price to not include cash rebates granted by a manufacturer to a purchaser or lessee of a new motor vehicle if paid directly to the retailer as a result of the original sale. The exemption was granted from July 1, 2006 and ending June 30, 2009.	Vehicles/ Aircraft	79-3602 (ll)	2006	\$7.0	-	-
Subtotal, estimated cost of exemptions:						\$351.3	\$356.3	\$368.8
PUBLIC POLICY: EDUCATIONAL EXEMPTIONS								
86	People with school children	Rental of nonsectarian textbooks by public or private elementary/secondary schools.	Education	79-3606 (h)	1963	\$1.0	\$1.0	\$1.0
87	Educational institutions	Property or services purchased and leased by public and private elementary or secondary schools or private nonprofit educational institutions that are used primarily for non-sectarian school-sponsored activities, or used to build, repair or enlarge buildings, but not those used for human habitation.	Youth Activities	79-3606 (c)	1941	\$58.5	\$60.5	\$62.6
Subtotal, estimated cost of exemptions:						\$59.4	\$61.5	\$63.7

Figure 1-2
Description and Cost Information for Kansas' Sales Tax Exemptions

#	Exempt Entity	Description of Exemption or Exclusion	Sub-Category	Statutory Citation	Enacted/ Most Recent Expansion	Estimated Cost of Exemption (in millions)		
						FY 2009	FY 2010	FY 2011
PUBLIC POLICY: EXEMPTION OF SERVICES								
88	Advertising agencies and broadcast stations	All sales of services rendered by an advertising agency or broadcast station.	Commun./Entertain/Cultural	79-3606 (nn)	1988	\$4.2	\$4.4	\$4.5
89	Sports and recreation organizations	Fees and charges by any political subdivision, certain organizations exempt from property tax, or youth recreation organization exclusively providing services to children 18 or younger as a 501(c)(3) organization for sports, games, and other recreational activities; and entry fees and charges for participation in a special event or tournament sanctioned by a national sporting association to which spectators are charged an admission.	Fundraisers/ Fees/ Dues	79-3603 (m)	1978 / 1998	\$0.9	\$0.9	\$1.0
90	People who pay dues/ memberships in veterans & comm. svc orgs & zoos	Dues charged by any veterans or community service organization, and sales of memberships in a 501(c)(3) nonprofit organization whose purpose is to support the operation of a non-profit zoo.	Fundraisers/ Fees/ Dues	79-3603 (n)	1998	\$0.3	\$0.3	\$0.4
91	Users of coin-operated laundries	The gross receipts from coin-operated laundry services, whether automatic or manually operated.	Misc.	79-3603 (f)	1976 and earlier	\$0.4	\$0.4	\$0.4
Subtotal, estimated cost of exemptions:						\$5.8	\$6.0	\$6.3
PUBLIC POLICY: HEALTH CARE EXEMPTIONS								
92	Non-profit corporations involved in public health	Educational materials purchased for distribution to the public at no charge by a non-profit public health organization.	Education	79-3606 (ll)	1988	\$0.1	\$0.1	\$0.1
93	Buyers of prescription drugs	Sales of drugs dispensed pursuant to a prescription by a licensed or mid-level practitioner.	Health care	79-3606 (p)	1977 / 1999	\$70.4	\$72.8	\$75.4
94	Buyers of insulin	Sales of insulin dispensed by pharmacist for treatment of diabetes.	Health care	79-3606 (q)	1977	\$0.5	\$0.6	\$0.6
95	Buyers of certain prescribed devices	Sales of prescribed oxygen delivery or kidney dialysis equipment, enteral feeding systems, and prosthetic and mobility enhancing equipment, and sales of prescribed hearing aids, parts, and batteries.	Health care	79-3606 (r)	1977 / 2004	\$8.3	\$8.6	\$8.9
96	Non-profit nursing homes	Medical supplies and equipment purchased directly by a non-profit skilled nursing home or - intermediate nursing care home to provide medical services to residents.	Health care	79-3606 (hh)	1987 / 2003	\$1.0	\$1.1	\$1.1
97	Buyers of prescribed dietary supplements	Sales of dietary supplements dispensed by prescription order by a licensed practitioner or mid-level practitioner.	Health care	79-3606 (jjj)	2006	Minimal	Minimal	Minimal
98	Community-based mental retardation/health centers	Property and services, including the leasing of property, purchased for community-based mental retardation or mental health centers.	Social Services	79-3606 (lj)	1987 / 2004	\$2.4	\$2.5	\$2.6
99	Health care centers and clinics	Property and services purchased by health care centers and clinics serving the medically underserved.	Social Services	79-3606 (ccc)	1999	\$0.4	\$0.4	\$0.4
Subtotal, estimated cost of exemptions:						\$83.1	\$86.0	\$89.0
TOTAL estimated cost of exemptions:						\$4,234.2	\$4,371.4	\$4,524.5

Source: Kansas Statutes Annotated, 2009 Supplement, and applicable session laws, and unaudited information from the Department of Revenue on estimated costs.

The Department of Revenue estimates that these 99 individual sales tax exemptions cost the State \$4.2 billion in fiscal year 2009. That information is shown as part of *Figure 1-2*. Many of those estimates initially were made for fiscal notes at the time the exemptions were created or broadened. The Department periodically reviews the method by which the estimate is made (the last review was published in January 2003). Outside any changes from these periodic reviews or legislative revisions affecting the individual exemptions, the individual exemption cost estimates are simply inflated annually.

The reader should be aware that the estimated lost sales tax revenues due to sales tax exemptions may be over- or understated. The estimates could be overstated based on the Department's retailers' sales returns: Retailers must file periodic sales tax returns with the Department which capture the amount of sales tax they owe. To calculate their taxes due, retailers must first list the sales they had that weren't taxable. For fiscal year 2009, they reported about \$68.1 billion in nontaxable sales. At the State's current sales tax rate, lost revenues would represent about \$3.6 billion, which includes sales that weren't taxable for reasons other than being tax exempt. Even if those items are included, actual lost tax revenues based on retailers' returns are below the Department's aggregate estimate of lost tax revenues from exemptions (\$3.6 billion versus \$4.2 billion in 2009).

However, a number of exemptions for things such as sales of girl scouts cookies, garage sales, or occasional sales of vehicles between family members never get reported on a retail sales tax return. There's no way to know the exact total amounts for these types of transactions, so we can't know if they account for enough sales to account for the difference between the Department's \$4.2 billion estimate and the \$3.6 billion in lost revenues supported by the tax returns.

As a result, it's not possible to know for certain how much each of the enacted exemptions actually cost the State.

***Sales Tax Exemptions
In Several Areas Provide
Unequal Treatment
For Similar Types
Of Taxpayers***

As shown in the Overview (*Figure OV-4*), the tax policy literature we reviewed included the following principles:

- tax exemptions generally should be applied equitably to broad groups or classes of services, entities, or individuals
- tax exemptions should not create an unfair competitive advantage for one similar industry or entity over another

We noted the following tax exemptions that provide unequal treatment for similar types of taxpayers or services:

- **Exemptions for individually named organizations or very narrowly defined activities.** Currently, Kansas exempts 44 individually named non-profit organizations from paying sales taxes, many of which were only recently exempted. These include individually named animal shelters, cultural organizations, rotary clubs, adoption and foster care providers, and medical and educational organizations. **Figure 1-3** on page 27 lists these organizations, plus four narrowly defined activities for which a sales tax exemption was granted.
- **Exemptions for coin-operated laundries.** Exempting coin-operated laundries from paying sales taxes [K.S.A. 79-3603(f)] treats coin-operated facilities differently from other laundry businesses, such as dry cleaners. In addition, coin-operated laundries receive a tax break while other coin-operated businesses, such as car washes, don't benefit.
- **Exemptions for non-profit entities, but not for their for-profit counterparts.** Again, exempting these non-profit organizations from sales taxes treats them differently from for-profit entities that offer the same types of services. That can lead to an unfair competitive advantages for the non-profit organizations. Examples of statutes we identified in this area are summarized below:
 - *K.S.A. 79-3606(hh). Exempts purchases of medical supplies and equipment by a **non-profit** skilled or intermediate care nursing home for the purpose of providing medical services to residents.*
 - *K.S.A. 79-3606(b). Among other things, exempts purchases by public or private **non-profit** hospitals and **non-profit** blood banks.*
 - *K.S.A. 79-3606(d). Among other things, exempts purchases by contractors for building or repairing public or private **non-profit** hospital facilities and educational institutions.*
 - *K.S.A. 79-3606(c). Among other things, exempts purchases by **non-profit** educational institutions for educational activities or to build or repair educational buildings.*
 - *K.S.A. 79-3606 (ii). Exempts purchases by non-profit organizations for nonsectarian comprehensive multidiscipline youth development programs and activities.*
- **Exemptions for some non-profit organizations, but not all of them.** According to information provided by the Department of Revenue, Kansas had about 18,200 entities registered as non-profits under section 501 (c) of the IRS code in 2008. Kansas exempts all 2,454 religious organizations registered with the IRS. However, current exemptions only partially cover charitable and educational organizations. Department officials estimate that about 10,000 organizations with a 501(c)(3) designation currently aren't exempted.

Department data show that Nebraska and Oklahoma treat exemptions for non-profit organizations similar to Kansas—exemptions are limited to certain non-profit groups and activities. Missouri and Colorado exempt most 501(c)(3) organizations, including religious, civic, charitable, social, fraternal and service organizations, and educational institutions.

**Figure 1-3
Sales Tax Exemptions That Target Specifically Named Entities
Or Very Narrowly Defined Entities or Activities**

Statute	Description of Exemption or Exclusion	Year Enacted/ Broadened	FY 2009 (in millions)
EXEMPTIONS FOR NAMED NON-PROFIT ORGANIZATIONS			
79-3606 (vv)	The following 501 (c)(3) Non-profit organizations: American Heart Association Kansas Affiliate; Kansas Alliance for the Mentally Ill, Inc.; Kansas Mental Illness Awareness Council; American Diabetes Association Kansas Affiliate; American Lung Association, Kansas Affiliate; Kansas chapters of Alzheimer's Disease Association; Kansas chapters of Parkinson's Association; National Kidney Foundation of Kansas; Heartstrings Community Foundation; Cystic Fibrosis Foundation, Heart of America Chapter; Spina Bifida Association of Kansas; Community Housing Wyandotte County, Inc.; Cross-lines Cooperative Council; Dreams Work, Inc.; KSDS, Inc.; Lyme Association of Greater Kansas City, Inc.; Dream Factory; Ottawa Suzuki Strings; International Association of Lions Clubs; Johnson County Young Matrons; American Cancer Society; Community Services of Shawnee, Inc.; Angel Babies Association; Kansas Fairground Foundation	1997-2009	\$0.79
79-3606 (sss)	Catholic Charities or Youthville	2006	\$0.64
79-3606 (qqq)	TLC for Children and Families, Inc.	2006	\$0.17
79-3606 (uuu)	Kansas Children's Service League	2006	\$0.15
79-3606 (ww)	Habitat for Humanity	1997	\$0.12
79-3606 (bbbb)	Guadalupe Health Foundation	2008	\$0.11
79-3606 (mmm)	Marillac Center, Inc.	2006	\$0.05
79-3606 (xxx)	Booth Theatre Foundation, Inc.	2007	\$0.03
79-3606 (lll)	Special Olympics Kansas, Inc.	2006	\$0.03
79-3606 (nnn)	West Sedgwick County - Sunrise Rotary Club	2006	\$0.02
79-3606 (aaaa)	Victory in the Valley, Inc.	2007	\$0.02
79-3606 (vvv)	Jazz in the Woods, Inc.	2007	\$0.01
79-3606 (cccc)	Wayside Waifs, Inc.	2008	\$0.01
79-3606 (www)	Frontenac Education Foundation	2007	\$0.00
79-3606 (yyy)	TLC Charities Foundation, Inc.	2007	\$0.00
79-3606 (ggg)	Kansas Academy of Science	2000	Minimal
79-3606 (zzz)	Rotary Club of Shawnee Foundation	2007	Minimal
79-3606 (dddd)	Goodwill Industries or Easter Seals of Kansas, Inc.	2009	n/a
79-3606 (eeee)	All Beef Battalion, Inc.	2009	n/a
79-3606 (ffff)	Sheltered Living, Inc.	2009	n/a
SUBTOTAL:			\$2.2
EXEMPTIONS FOR VERY NARROWLY DEFINED ENTITIES OR ACTIVITIES			
79-3606 (qq)	Sales of property and services purchased by a 501(c)(3) non-profit museum or historical society to stimulate public interest in the exploration of space.	1988	\$0.4
79-3606 (ttt)	Property and services purchased by a contractor to restore, construct or reconstruct, equip, maintain, repair, enlarge, furnish, or remodel a home or facility owned by a non-profit museum which is qualified under the Governor Hometown Heritage Act (K.S.A. 75-5071)	2006	\$0.1
79-3603 (e)	Sales of admissions to any cultural and historical event which occurs triennially.	1988	Minimal
79-3606 (tt)	Property and services purchased by or on behalf of a 501(c)(3) not-for-profit corporation for the sole purpose of constructing a Kansas Korean War memorial.	1996	--
SUBTOTAL:			\$0.5
GRAND TOTAL:			\$2.7
Source: LPA analysis of sales tax exemptions in Kansas Statutes Annotated, 2009 supplement			

This issue was discussed as part of the 2007 Special Committee on Assessment and Taxation. A working group within that Committee proposed limiting sales tax exemptions to 501(c)(3) organizations for purchases only if the organizations received at least 50% of their funding from State or federal government sources and fundraising sales. The proposal died because of concerns about fairness, fiscal effect, and elimination of exemptions that had been granted.

Regardless of the merits of the services and activities these organizations are involved in, such exemptions are not consistent with good tax policy because they create inequities within the tax system.

The Legislature hasn't formally adopted a public policy goal regarding the types of services or organizations it wants to exempt from sales tax. As a result, sales tax exemptions often are decided on a case-by-case basis. A number of organizations, including the National Conference of State Legislatures and the Kansas Advisory Council on Intergovernmental Relations, have published handbooks or guidance to assist Legislatures in such matters.

Establishing and following a clear public policy goal as to which types of organizations, services or activities will be exempt from paying sales taxes would bring Kansas' practices more in-line with good tax policy, and would help the Legislature in deciding which exemptions to grant. Any cost savings or additional costs to the State would depend on which types of services (or service providers) were selected.

***13 Exemptions
Account for
About 96% of the
Total Cost of
Sales Tax Exemptions
To the State***

In fiscal year 2009, the 13 largest sales tax exemptions accounted for an estimated \$4.1 billion, or 96% of the sales tax revenues forgone that year. Those exemptions are summarized in ***Figure 1-4***.

As the figure shows, 6 of these 13 exemptions are considered necessary to avoid double taxation, tax only at the final point of sale, or not tax governmental purchases. These six exemptions accounted for an estimated \$3.4 billion in lost revenues.

The seven remaining exemptions have been adopted as a matter of public policy. Most have been in place for decades, although some were expanded more recently. The following information lists several points to consider on these exemptions:

**Figure 1-4
Most Expensive Sales Tax Exemptions**

Statute	Description of Exemption	Enacted/ Latest Revision	2009 Est. Cost (in millions)
Tax Policy Exemptions			
79-3606 (m)	Ingredient/Component parts: Of items manufactured or produced for sale at retail.	1970	\$2,248.1
79-3606 (n)	Ingredient/Component parts: Property consumed to produce, manufacture, process, etc., by-products or wastes derived from such production processes; or irrigation of crops for ultimate sale at retail.	1970 / 1995	\$295.0
79-3606 (o)	Ingredient/Component parts: Sales of animals, fowl and aquatic plants and animals used in agriculture or aquaculture to produce human food; animal, dairy, or poultry products; fiber or fur; or offspring.	1970 / 1994	\$166.0
79-3606 (a)	Items Already Taxed: Motor fuels and other items on which a sales or excise tax already has been paid.	1937	\$232.5
79-3606 (b)	Mostly governmental entities: Property or services purchased by the State and political subdivisions. (Includes public or private non-profit hospitals, blood banks, tissue and organ banks, and public hospital authorities.)	1937 / 2001	\$330.9
79-3606 (d)	Mostly governmental entities: Property or services purchased by contractors for building or repairing public or private non-profit hospitals, elementary/secondary schools, and non-profit educ. institutions; public hospital authorities; state correctional institution; or any political subdivision.	1970 / 2007	\$119.0
Subtotal:			\$3,391.5
Public Policy Exemptions			
79-3606 (kk)	Machinery and Equipment: Used primarily to manufacture, assemble, process, finish, store, warehouse, or distribute property for re-sale.	1988 / 1998	\$115.8
79-3606 (cc)	Machinery and Equipment: Property or services for constructing or remodeling a qualified business, including the machinery and equipment purchased for installation in the business.	1986	\$65.6
79-3606 (t)	Machinery and Equipment: Farm or aquaculture machinery and equipment and replacement parts or services.	1978 / 2007	\$49.2
79-3606 (c)	Educational/Youth Activities: Property or services purchased and leased by public or private elementary or secondary schools or private non-profit educational institutions that are used primarily for non-sectarian school-sponsored activities or used to build, repair or enlarge buildings, except those for human habitation.	1941	\$58.5
79-3603 (p)	Labor Services: For installing or applying property in original construction of a building or facility, or the construction, reconstruction, restoration, etc., of a residence, bridge, or highway.	1977	\$181.8
79-3603 (c)	Utilities: Gas, electricity, or heat for non-commercial uses delivered through lines or pipes to residential customers or farms after January 1, 2006. Includes propane, LP gas, coal, wood, and other fuel sources.	1979 / 2001	\$135.5
79-3606 (p)	Health Care: Sales of prescription drugs.	1977 / 1999	\$70.4
Subtotal:			\$676.8
Grand Total:			\$4,068.3
Source: Developed by Legislative Post Audit from Kansas Department of Revenue data			

- **Machinery and Equipment exemptions (estimated \$230.6 million cost to the State).** These exemptions significantly erode the tax base for both State and local units of government. However, economic development officials say they create a favorable business climate and are a valuable tool for keeping Kansas competitive. The exemptions are applied to a broad class (non-farm and farm businesses), so they treat similar taxpayers and services similarly, and don't set up unfair competition. The farm machinery and equipment exemption essentially gives farmers the same break as those in manufacturing or other businesses. All surrounding states exempt sales related to certain farm machinery and equipment. They all exempt non-farm machinery equipment to some extent, but it's difficult to know how comparable those are without studying each state's entire tax structure in detail.
- **Educational/Youth Activity exemption (estimated \$58.5 million cost to the State).** This exemption significantly erodes the State and local tax base, and allowing the exemption for non-profit educational entities but not their for-profit counterparts could lead to unfair competitive advantages. However, the exemption reduces costs for public and private elementary and secondary schools and private non-profit educational institutions, and similar exemptions appear to exist in our neighboring states.
- **Labor Services for Building and Remodeling Homes, Facilities, Bridges, and Highways exemption (estimated \$181.8 million cost to the State).** This exemption significantly erodes the State and local tax base. Based on our reviews of sales tax exemptions and discussions with officials in Colorado, Missouri and Nebraska, these neighboring states don't have a similar sales tax exemption. However, in these three states labor services aren't taxable so there's no need for an exemption. Taxing labor services would be a significant policy shift in Kansas. It potentially would raise the price of homes and remodeling, and could have a dampening effect on the construction industry.
- **Utilities exemption (estimated \$135.5 million cost to the State).** This exemption significantly erodes the State and local tax base. As regulated entities, utilities could pass on the cost of paying sales taxes to their customers through regulated rates approved by the Kansas Corporation Commission. However, this exemption makes the tax system less regressive because lower-income people spend a higher percentage of their incomes on utilities. Colorado, Missouri, and Oklahoma also appear to have a similar exemption for utilities used for residential purposes.
- **Health Care exemption (estimated \$70.4 million cost to the State).** This exemption significantly erodes the State and local tax base. However, it makes the tax system less regressive because lower-income people and the elderly on fixed incomes spend a higher percentage of their incomes on prescription drugs. All four neighboring states allow a similar sales tax exemption.

The Legislature will need to consider whether these exemptions are in line with its current public policy goals, in light of the estimated costs of these exemptions.

Recently, Exemptions Have Been Added to Exempt “Purchases Made On Behalf of” and “Sales By” Many Entities Historically, when sales tax exemptions were granted for specific organizations they applied only to items purchased directly by the exempt organization. There’s been a recent trend, however, toward allowing sales tax exemptions to apply to goods or services purchased by someone else “on behalf of” the organization. In addition, several recently enacted exemptions allow the entity (or individuals connected to the entity) to sell items without charging sales tax. *Figure 1-5* summarizes these types of exemptions.

As the figure shows, the largest dollar items include sales made by (or on behalf of) such entities as Boy Scouts and Girl Scouts, Meals on Wheels, Catholic Charities, Youthville, parent-teacher associations or organizations, and the 24 individually named non-profit groups discussed earlier in this report.

In total, the entities with these broader types of sales tax exemptions accounted for an estimated \$6 million in forgone revenues for the State in fiscal year 2009. Unfortunately, data doesn’t exist to allow us to isolate the dollar impact of just the “purchases on behalf of” or “sales by” provisions of the law.

Regardless of the merits of granting sales tax exemptions to these organizations, several issues arise with the use of this new language:

- Department of Revenue officials have indicated that the trend toward allowing purchases “on behalf of” an entity reduces the control over whether the purchase is related to an organization’s purpose, and could lead to abuses. Department officials also point out for the “sales by” issue that it’s important to distinguish whether the sale is an isolated sale related to fund-raising (e.g., an annual fundraising dinner and silent auction), or whether the sales are being made on a regular, ongoing basis (such as maintaining a concession stand or food cart at all fairs).
- When organizations don’t have to charge sales taxes on the things they sell, the direct benefit goes to the purchaser of the product, rather than to the organization itself. An often-cited and highly contentious example is girl scouts cookie sales. Some argue that imposing sales tax would increase the cost of cookies and thus diminish sales. Others argue that sales of girl scouts cookies shouldn’t get a selling advantage over those sold in grocery stores.

**Figure 1-5
Sales Tax Exemptions Allowing PURCHASES ON BEHALF
Or SALES To Be Tax-Exempt for Certain Non-Profit Entities**

Statute	Description of Exemption or Exclusion	Year Enacted/ Broadened	FY 2009 Est. Cost
EXEMPTIONS FOR "<u>PURCHASES ON BEHALF OF</u>" NON-PROFIT ENTITIES			
79-3606 (hhh)	Domestic violence shelters that are member agencies of the Kansas coalition against sexual and domestic violence.	2004	\$60,000
79-3606 (uu)	Rural fire fighting organizations	1997	Minimal
79-3606 (ggg)	Kansas Academy of Science	2000	Minimal
79-3606 (dddd)	Goodwill Industries or Easter Seals of Kansas, Inc.	2009	n/a
79-3606 (eeee)	All Beef Battalion, Inc.	2009	n/a
79-3606 (tt)	501(c)(3) non-profit corporation for the sole purpose of constructing a Kansas Korean War memorial.	1996	--
EXEMPTIONS FOR "<u>SALES</u>" BY (OR ON BEHALF OF) NON-PROFIT ENTITIES			
79-3606 (ii)	Nonprofit organizations for nonsectarian comprehensive multidisc. youth development progs and activities (i.e. boy scouts, girl scouts)	1987 / 1998	\$2,630,000
79-3606 (v)	Food products by contractors preparing meals for delivery to homebound elderly or disabled persons	1978 / 2004	\$830,000
79-3606 (vv)	A group of 24 individually named non-profit medical, educational, and other orgs	1997 / 2009	\$790,000
79-3606 (sss)	Catholic Charities or Youthville	2006	\$640,000
79-3606 (yy)	Parent-teacher association or organizations	1998	\$570,000
79-3606 (qqq)	TLC for Children and Families, Inc.	2006	\$170,000
79-3606 (uuu)	Kansas Children's Service League	2006	\$150,000
79-3606 (rrr)	County law libraries	2006	\$110,000
79-3606 (lll)	Special Olympics Kansas, Inc.	2006	\$30,000
79-3606 (ooo)	Public libraries	2006	\$10,000
79-3606 (vvv)	Jazz in the Woods, Inc.	2007	\$10,000
79-3606 (yyy)	TLC Charities Foundation, Inc.	2007	\$1,000
79-3606 (fff)	Sheltered Living, Inc.	2009	n/a
EXEMPTIONS FOR "<u>PURCHASES ON BEHALF OF</u>" NON-PROFIT ENTITIES <u>AND</u> SALES BY (OR ON BEHALF) OF NON-PROFIT ENTITIES			
79-3606 (ppp)	Non-profit homeless shelters that are 501 (c)(3) exempt	2006	\$110,000
79-3606 (mmm)	Marillac Center, Inc.	2006	\$50,000
79-3606 (aaaa)	Victory in the Valley, Inc.	2007	\$20,000
79-3606 (cccc)	Wayside Waifs, Inc.(purchases and sales related to annual fundraiser)	2008	\$10,000
79-3606 (www)	Frontenac Education Foundation	2007	\$2,000
Source: LPA review of Kansas Statutes Annotated, 2009 supplement			

Conclusion

At up to \$4.2 billion a year, sales tax exemptions account for a sizeable amount of lost revenue for Kansas. About \$3.4 billion of that amount is for exemptions that are required by law or considered necessary by most tax policy literature we reviewed. That still leaves almost \$1 billion in sales tax exemptions that have been granted as a matter of public policy. Once enacted, such exemptions rarely get revisited to determine whether they still reflect the Legislature's policy goals.

Our initial intention for this audit was to learn enough about the State's sales tax exemptions to identify those that weren't effective or had outlived their usefulness. However, unlike tax credits (which were covered in Part I), sales tax exemptions generally don't have a measurable purpose. In essence, they simply subsidize the operations of all entities granted the exemption by lowering their costs of doing business, or by making it "easier" for people to buy their products. Should those entities still receive a sales tax exemption? Ultimately, we couldn't substitute our judgment for the Legislature's.

We do think the Legislature should review those exemptions that account for the biggest revenue losses to ensure they continue to provide the proper balance between the Legislature's public policy goals and the State's financial needs. We also think the Legislature should consider repealing or modifying the exemptions we identified that aren't consistent with good tax policy or that raise other issues. Establishing clear public policies regarding which types and classes of services and entities it wants to exempt would give the Legislature a consistent basis for deciding which exemptions have merit and should be continued, even in a modified form.

Recommendations for Legislative Action

1. The Legislature should review the following sales tax exemptions to determine what changes, if any, should be made:
 - a. **exemptions for specifically named organizations or very narrowly defined activities** (listed in *Figure I-3*). Tax policy literature says exemptions should be granted to broad classes of entities or types of services. If the Legislature decides to repeal these exemptions, it also should consider whether any of them fall under broad classes of entities or types of services it wants to exempt from sales taxation, and whether new legislation is needed to establish those broad exemptions. Depending on the Legislature's decisions in this area, the costs to the State could increase or decrease.

- b. exemption for coin-operated laundries** [K.S.A. 79-3603(f)]. This exemption treats other laundry and coin-operated facilities unequally.
 - c. exemptions for non-profit entities, but not their for-profit counterparts** (examples listed on page 26 of the report). These types of exemptions treat similar types of entities differently, and could create an unfair competitive advantage.
 - d. exemptions for some non-profit organizations, but not all of them** (as discussed on page 26). In the absence of an established policy regarding the broad types of services or organizations the Legislature wants to exempt, these exemptions also treat similar types of entities unequally.
 - e. exemptions that account for the biggest revenue losses and are a matter of public policy** (as discussed on pages 28-30). There are pros and cons to having these exemptions. These should be reviewed to ensure they continue to provide the proper balance between the Legislature’s public policy goals and the State’s financial needs.
 - f. exemptions that exempt not just the entities’ purchases from sales tax, but that also exempt “sales made by” or “purchases made on behalf of” the entity** (as discussed on pages 31 of the report). These provisions could significantly broaden some entities’ exemptions (and the resulting loss of State tax revenues), and could lead to a loss of control over whether the purchase is related to the exempt entity’s purpose. If the “sales made by” language is retained, the Legislature should consider modifying it to distinguish between isolated or occasional sales or sales made as a regular part of the exempt entity’s operations.
2. To help ensure that similar entities, groups, or classes of services are treated as equitably and consistently as possible under Kansas’ sales tax exemption laws, the Legislature should consider establishing a broad sales tax policy that outlines the types of sales it wants to exempt and the general rationale for doing so, and developing a set of criteria that fit within that broad policy. That would allow the Legislature and others to measure current and future tax exemptions against those criteria.

APPENDIX A

Scope Statement

This appendix contains the scope statement approved by the Legislative Post Audit Committee for this audit on July 1, 2009. The audit was requested by the Legislative Post Audit Committee.

Kansas Tax Revenues: Reviewing Tax Credits and Exemptions

Kansas has enacted a number of taxes to fund government operations. A few examples are individual and corporate income tax, privilege tax (on financial institutions), sales and use tax, motor fuel taxes, mineral taxes, and the like. According to the Department of Revenue's fiscal year 2008 annual report, the amount the State collected from various taxes that year, before refunds, was nearly \$8.3 billion.

Over the years, the Legislature has enacted a variety of tax credits and exemptions designed to stimulate certain types of economic activity or to achieve other public purposes. For example, a taxpayer who makes a cash donation of \$250 or more in the Kansas Community Entrepreneurship Fund receives a tax credit of 75% of the amount donated.

Some credits are commonly claimed and account for large amounts of foregone tax revenue, while other credits are less frequently used. For example, based on information compiled by the Department of Revenue for the 2006 tax year, nearly 15,000 taxpayers claimed slightly more than \$28 million under the Business Machinery and Equipment Credit. In contrast, only nine taxpayers claimed about \$17,000 from a credit that allows taxpayers to claim up to 50% of the cost of plugging an abandoned oil well.

With the proliferation of credits and exemptions over the years, Kansas legislators have expressed an interest in knowing whether some of those credits and exemptions still are needed or whether they have outlived their original purposes. They also want to know whether transferrable tax credits represent an effective use of taxpayer dollars.

A performance audit of this topic would answer the following question(s).

- 1. Does Kansas have any tax credits or exemptions that aren't accomplishing their intended purpose or have outlived their usefulness?** To answer this question, we would review the statutes and consult with officials in the Department of Revenue, Legislative Research, and others to come up with a complete list of the tax credits and exemptions that currently are offered under the Kansas law, as well as information about when they were enacted, their original purpose, and how much they've been used (number of taxpayers claiming them and total dollar amount) in recent years. If information is available, we would compare the amount of revenue that currently is being foregone to the projected cost of each credit or exemption at the time it was passed. In addition, we would look across the credits and exemptions to identify any that are infrequently used or show a significantly declining level of use. We

would also talk to officials from taxpayer advocacy groups, and business groups to get their opinions about the usefulness of some of the tax credits and exemptions. We would also talk to officials from the Department of Revenue to identify any problematic issues related to credits or exemptions such as difficulty in tracking transferrable credits. For a sample of the more costly tax credits or exemptions, we would determine whether any mechanisms were put in place to determine whether the credit or exemption actually achieved its intended purpose. If there are requirements the taxpayer must fulfill to take the tax credit, such as creating a certain number of jobs, we would look to see what evidence exists to show that the requirements were fulfilled. For the sample of these credits and exemptions, we would contact nearby states to determine whether they offer those same types of tax breaks. In addition, we would find out what types of information other states can and do report to their legislatures about the use of tax credits and exemptions. We would conduct other work in this area as needed.

- 2. What transferrable tax credits exist in Kansas, and are they a cost-effective means of generating money to fund certain types of projects or causes?** To answer this question, we would review the statutes and talk to officials at the Department of Revenue to identify the types of transferrable tax credits allowed in Kansas. We would review testimony that was provided to the Legislature about the anticipated effects of the credits at the time they were proposed. In cases where entities are awarded tax credits that they can sell to third parties to fund projects or activities, we would determine the amount of money generated for projects in relation to the foregone revenue cost to the State. We would review the records at the Department of Revenue to identify the amount of each type of transferrable tax credit that was claimed in recent years and the types of taxpayers who are benefitting from the use of the credits. We would contact officials from a sample of other states or tax policy groups to determine the extent to which these types of credits are used elsewhere, and gather their opinions about whether they think the credits are cost-effective.

Estimated time to complete: 12-15 weeks

APPENDIX B

Agency Response

On February 10, 2010, we provided copies of the draft audit report to the Department of Revenue. Its response is included as this Appendix. The Department concurred with the report's findings, conclusions, and recommendations

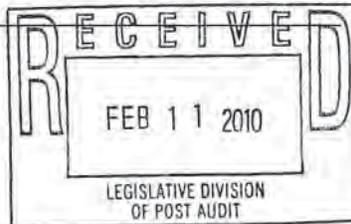
KANSAS
DEPARTMENT OF REVENUE

Mark Parkinson, Governor
Joan Wagnon, Secretary

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February 12, 2010

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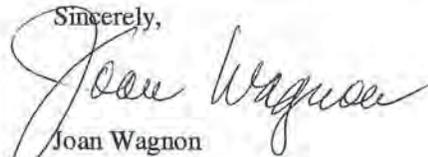
Re: Department Response to Performance Audit Entitled: *Kansas Tax Revenues, Part II: Reviewing Sales Tax Exemptions*

Dear Ms. Hinton:

You have requested the Department's written to the above-referenced draft performance audit report. We agree with the findings of the report and whole-heartedly support the policy recommendations it makes to the Legislature concerning sales tax exemptions.

We believe this report provides valuable information to the Legislature on the recent proliferation of sales tax exemptions. It also gives sound policy guidance that will be useful to the Legislature in evaluating whether certain sales tax exemptions need to be retained, limited, or repealed.

Sincerely,


Joan Wagnon

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