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Corporate Tax Reform Will Enhance Kansas Competitiveness

by Chris Atkins and Jonathan Williams

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I. Introduction

Occasionally, politicians get the big questions right. In no place is that more evident in 2007 than in Kansas, where lawmakers are currently debating a package of corporate tax reform plans.

The Kansas tax burden is ripe for reduction, as Kansas taxpayers face the 18th highest burden of any state in the U.S., and the second highest looking just as Kansas' border states. Reducing corporate tax rates, as Governor Sebelius and legislative leaders are working to do, is also exactly the right way to reduce the burden, as Kansas' corporate franchise and income tax rates are also higher than most other states.

As the old saying goes, however, the devil is in the details. While Kansas lawmakers are correct to focus on corporate tax reform, several of the proposals on the table will not achieve the goal of increasing the competitiveness of the Kansas tax system. How far do lawmakers need to go in reducing corporate taxes to truly become competitive?

This study answers that question by presenting data on the Kansas tax burden, Kansas' business tax structure, and examining the Kansas corporate franchise and income taxes in detail. It concludes, based on the data, that Kansas needs to eliminate the franchise tax and reduce the corporate tax rate to at least 6.25 percent. Stopping short of these goals would not significantly enhance the competitiveness of the Kansas tax system and may, in the case of a failure to eliminate the franchise tax, actually lead to a decrease in competitiveness since Kansas' neighboring states are ripe to repeal or reduce franchise taxes as well.

II. Kansas' Tax Burden

In both real and comparative terms, Kansas' state and local tax burden has increased since 1970. By "burden" we mean the fraction of state income taken by taxes of any kind. Kansas' 2006 tax burden of 10.7 percent of income is average and ranks 18th highest nationally. However, when compared regionally, taxpayers pay the second highest tax

burden among bordering states; - only residents of Nebraska pay more at 11.6 percent (see Table 1).

Table 1. Kansas' State-Local Tax Burden Has Increased Since 1970

State	2006 Burden	2006 Rank (1 is highest)	1970 burden	1970 rank (1 is highest)
Colorado	9.80%	38	10.00%	25
Kansas	10.70%	18	10.00%	24
Missouri	9.90%	34	8.70%	39
Nebraska	11.60%	6	10.30%	17
Oklahoma	9.60%	40	8.00%	48

Source: Tax Foundation

In 1970, Kansas' tax burden was in the middle of the pack nationally and second highest in its region. In 2006, the Kansas tax burden has crept into the top 20 nationally, but is still second-highest in the region behind Nebraska, which now has the 6th highest tax burden in the U.S. It should be noted, however, that Colorado, which in 1970 was third highest in the region with a tax burden almost as high as Kansas, dropped to 38th highest in 2006. Missouri now occupies the third spot in the region, though its tax burden (34th highest) is well below the state average.

Table 2. Kansas Tax Rankings at a Glance

<i>From the Tax Foundation (2006)</i>		
Tax Freedom Day 2006	April 22nd	(26th latest)
Federal Tax Burden	19.7%	(29th highest)
State and Local Tax Burden	10.7%	(18th highest)
<i>From the Census Bureau (2004)</i>		
Personal Income Tax Collections Per Capita	\$701	22 nd highest
Corporate Income Tax Collections Per Capita	\$61	36th highest
Sales Tax Collections Per Capita	\$908	15th highest
Property Tax Collections Per Capita	\$1187	14th highest

Source: Tax Foundation

III. Kansas' Tax Structure

Policymakers often concentrate a large portion of their attention on their state's tax burden, which is the percentage of income that individuals pay in taxes. Because state tax systems diverge so widely tax burden data does indeed provide a valuable basis for comparison. However, tax burden data does not offer policymakers specific guidance about which taxes should be reduced if the tax burden is deemed to be too high.

Therefore, when seeking to create sound tax policy at the state level, analyzing tax burdens exclusively is not sufficient. Evaluating state tax structures is also a fundamental tool to produce good public policy.

Table 3. Major Tax Rates in Kansas and Surrounding States

State	Corporate Income Tax	Franchise Tax Rate	Individual Income Tax	Sales and Use Tax	Weighted Average of Local Sales Tax Rates
Colorado	4.63%	n/a	4.63%	2.90%	1.61%
Kansas	7.35%	.125%	6.45%	5.30%	1.52%
Missouri	6.25%	.033%	6.00%	4.225%	1.80%
Nebraska	7.81%	.025%	6.84%	5.50%	0.85%
Oklahoma	6.00%	.125%	6.25%	4.50%	2.38%

Source: Tax Foundation

The 2007 *State Business Tax Climate Index* is a helpful tool for policymakers to use when analyzing state tax structures. The *Index* compares the states in five areas that impact business: individual income taxes; sales taxes; unemployment insurance taxes; and taxes on property, including residential and commercial property. Each year the Tax Foundation publishes this comprehensive study of the 50 state tax systems as a guide to lawmakers who wish to make their state's business tax climate more competitive in the regional, national and international marketplace.

Table 4. Kansas' Rankings in the 2007 *State Business Tax Climate Index* (1 is best, 50 worst)

State	Overall Business Tax Climate Ranking	Component Indices				
		Corporate Tax Index	Individual Income Tax Index	Sales Tax Index	Unemployment Insurance Tax Index	Property Tax Index
Colorado	14	15	14	28	23	18
Kansas	31	38	23	25	12	34
Missouri	15	10	24	12	7	10
Nebraska	44	34	32	44	26	45
Oklahoma	21	13	25	34	1	20

Source: Tax Foundation's 2007 *State Business Tax Climate Index*

The 2007 *Index* gives Kansas' tax structure a below-average score, placing it 31st nationally. However, regionally speaking, Kansas' tax system is much less competitive. Once again, only Nebraska has a worse ranking among bordering states (see Table 4).

Kansas received average marks for its individual income tax system and its sales tax, while receiving less competitive marks for its corporate income tax and taxes on wealth.

The 2007 *Index* provides valuable insight for states that wish to improve their tax structures. Considering Kansas' uncompetitive regional ranking, lawmakers should certainly be looking at ways to improve the state's business tax climate for the future. Kansas has several neighbors that perennially have more competitive business tax structures. Colorado enjoys this competitive advantage even though it has all major taxes and is considered a model for states that do not wish to eliminate a major tax. Colorado can accomplish this because it levies taxes on broad bases with low rates.

The 2007 *Index* also gives Kansas lawmakers an idea of which taxes they should be looking to reduce in order to decrease their tax burden. Kansas' worst rankings are in the area of corporate taxes (38th best) and property taxes (34th best). This means that cuts or eliminations of the corporate income and franchise taxes would be most advisable.

IV. Kansas' Corporate Tax System

The current debate in Kansas is centered on reductions in corporate franchise and income taxation, which is exactly the taxes we would recommend that Kansas eliminate or reduce considering the corporate tax rankings in the 2007 *Index*. This section will explore Kansas' corporate franchise and income taxes in more detail and respond to some of the current debate over their reduction or elimination.

Kansas' Corporate Franchise Tax

Kansas levies a corporate franchise tax on business entities organized in Kansas, exempting financial and insurance companies. The tax is levied on the value of a business' shareholder equity - the portion that is attributable to Kansas.

All but one of Kansas' border states have a franchise tax measured by net worth or capital stock (see Table 5), though Kansas is tied with Oklahoma for the highest rate (.125 percent). Nebraska's and Missouri's rates are much lower (.033 and .025 percent, respectively).

Table 5: Kansas Has the Highest Corporate Franchise Tax Rate in the Region

State	Corporate Franchise Tax Rate	Maximum Annual Payment
Kansas	.125%	\$20,000
Oklahoma	.125%	\$20,000
Missouri	.033%	Unlimited
Nebraska	.025%	Unlimited
Colorado	n/a	n/a
<i>Average</i>	<i>.062%</i>	

Source: Tax Foundation

Many states that use capital stock taxes put a cap on the annual payment. Kansas and Oklahoma set that cap at \$20,000 while Nebraska and Missouri set no limit. The maximum in Kansas is so high that few firms would benefit from the cap - only those with more than \$16 million in Kansas net worth.

This franchise tax based on capital stock stands out as a barrier to economic growth in Kansas. Tax reformers should not be deterred from repeal by the fact that Oklahoma's is equally bad. Kansas' franchise tax is disproportionately damaging to the state's economy and should be considered low-lying fruit for tax reformers. It is not even clear why the tax is necessary, from a policy perspective, when the state also levies a tax on business income through the corporate and individual income taxes. The tax also generates little revenue: \$46.9 million in FY 2006, less than .5 percent of all tax collections.[\[1\]](#)

For these reasons, franchise tax repeal is a growing trend in the region. Lawmakers in the Kansas House of Representatives voted last year to repeal the corporate franchise tax entirely[\[2\]](#) and did so again last week.[\[3\]](#) A similar move was made last year by lawmakers in the Missouri House of Representatives.[\[4\]](#) In the past two years, the Oklahoma House of Representatives passed partial phase-outs of their franchise tax.[\[5\]](#)

In 2007, there is bipartisan agreement in Kansas that franchise taxes should be reduced, but some (including Governor Sebelius) do not believe that the tax should be eliminated. Sebelius instead proposes exempting companies with \$1 million in assets from the tax altogether.[\[6\]](#)

Considering the fact that Missouri is looking once again to eliminate the franchise tax[\[7\]](#) and Oklahoma is looking to reduce the number of franchise tax filers[\[8\]](#) or repeal the tax entirely,[\[9\]](#) a mere reduction in Kansas' franchise tax would not change the status quo in the region. In fact, if Kansas does not eliminate its tax in 2007 it may soon be the only state in the region (other than Nebraska) with such a tax.

Furthermore, one of the hallmark principles of tax policy is neutrality: taxes should aim to raise revenue with a minimum of economic distortion, and should not attempt to micromanage the economy. Sebelius' proposal, while well intentioned, would narrow the base of the franchise tax and foster more of the burden onto fewer businesses-creating a less neutral tax system. It would also create incentives for businesses to organize in such a way that they avoid the tax altogether (as, for example, shifting their assets to subsidiaries in an attempt to minimize their net worth). Thus, if elimination is not an option a better approach would be a reduction in the franchise tax rate that would give relief to all businesses without adding compliance costs.

Kansas' Corporate Income Tax

In addition to its corporate franchise tax, Kansas levies a progressive corporate income tax using federal corporate adjusted gross income as the starting base. The bottom rate of 4 percent is levied on income up to \$50,000. On all income above that level, the tax rate is 7.35 percent.[\[10\]](#)

Kansas' 7.35 percent rate is the second highest top corporate tax rate in its region (see Table 6). Only Nebraska has a higher rate while Colorado, Missouri, and Oklahoma have lower rates. The average rate in the region is 6.41 percent.

Table 6: Kansas Has the Second Highest Corporate Income Tax Rate in Region

State	Top Rate on Corporate Income	Amount of Taxable Income Where Top Rate Applies
Nebraska	7.81%	> \$50,000
Kansas	7.35%	> \$50,000
Missouri	6.25%	> \$0
Oklahoma	6%	>\$0
Colorado	4.63%	> \$0
<i>Average</i>	<i>6.41%</i>	

Source: Tax Foundation

In deciding the proper rate at which to tax corporate income, state lawmakers must even take international competitiveness into consideration (see Table 7). At 35 percent, the U.S. federal corporate income tax rate is one of the highest in the developed world, leaving precious little in additional tax that a state can add without driving away international business. Kansas adds a top rate of 7.35 percent, so that new investment in Kansas faces a combined federal-state rate of 39.8 percent (state taxes deductible on federal return)-higher than the rates anywhere else in the developed world, including Canada, France and Sweden.

Table 7: Kansas Corporate Rate Plus Federal = 40 percent

State	Top Rate on Corporate Income	Federal Rate	Combined Rate Facing New Investment
Nebraska	7.81%	35%	40.1%
Kansas	7.35%	35%	39.8%
Missouri	6.25%	35%	39.1%
Oklahoma	6%	35%	38.9%
Colorado	4.63%	35%	38.0%
<i>Average</i>	<i>6.41%</i>	<i>35%</i>	<i>39.2%</i>

Source: Tax Foundation

Since Kansas' corporate tax rate is uncompetitive, Governor Sebelius has recommended reducing the top bracket from 7.35 percent to 6.95 percent in tax year 2008 and to 6.75 percent in tax year 2009. This is a sound general recommendation by the Governor. On

competitiveness grounds, however, Kansas will probably have to go further. A top rate of 6.25 percent will be necessary just to equal Missouri.[\[awa1\]](#)

V. Recommended Changes

In the short term, a realistic goal for Kansas lawmakers is to reduce its tax burden through competitive changes to its corporate tax system, which ranks most unfavorably on the 2007 *State Business Tax Climate Index*. The following changes represent sound incremental steps that Kansas can take to accomplish this:

- Eliminate the corporate franchise tax; and
- Reduce the top corporate income tax rate to 6.25 percent (tied with Missouri) with a long-term goal of reducing the rate all the way to 4 percent, which would give Kansas a flat corporate income tax, below even Colorado's 4.63 percent.

Eliminating the corporate franchise tax would reduce the tax code's complexity and reduce the penalties associated with owning and operating a Kansas-based business. A 6.25 percent rate on corporate income would make Kansas more attractive compared to its neighbors and move the state closer to a true flat tax on corporate income.[\[11\]](#)

VI. Conclusion

If Kansas is to compete with the likes of Oklahoma, Colorado and Missouri for new business investment, lawmakers must seriously consider those tax changes that will truly enhance competitiveness. While bipartisan agreement on the need for corporate tax reform is truly a blessing, any compromise that fails to eliminate the franchise tax and reduce the corporate tax rate to at least 6.25 percent will not significantly enhance the competitiveness of the Kansas tax system or provide meaningful relief from the relatively high Kansas tax burden.

Footnotes:

[\[1\]](#) See Kansas Tax Facts, Table 1, located at http://skyways.lib.ks.us/ksleg/KLRD/Publications/TaxFactsSupp_2006.pdf.

[\[2\]](#) KS H.B. 2548 (2006 Sess.).

[\[3\]](#) KS H.B. 2031 (2007 Sess.). A brief description of the Kansas franchise tax and the repeal bill can be found here: <http://www.kslegislature.org/supplemental/2008/SN2031.pdf>.

[\[4\]](#) MO H.B. 1619 (2006 Sess.).

[\[5\]](#) See Nicola Moore, *Franchise Tax Repeal: A No-Brainer for Oklahoma*, Oklahoma Council of Public Affairs (1/1/2007), located at <http://www.ocpathink.org/ViewPerspectiveStory.asp?ID=762>.

[6] See Dan Voorhis, *House to Debate Elimination of the Franchise Tax*, Wichita Eagle (2/10/2007), located at <http://www.kansas.com/mld/kansas/news/legislature/16666884.htm>.

[7] See MO H.B. 458 (2007 Sess.); MO H.B. 219 (2007 Sess.).

[8] See OK H.B. 1695 (2007 Sess.) and OK S.B. 636 (2007 Sess.).

[9] See OK H.B. 1808 (2007 Sess.).

[10] Kansas law lists the 4 percent rate as its only tax rate and refers to the extra 3.35 percent as a surtax. However, a surtax is commonly understood as a rate levied on either tax liability or the top statutory rate. This Kansas "surtax" is levied as a percentage of taxable income, just like the 4 percent rate, so it is better understood as simply another rate in a progressive system.

[11] Note that Kansas currently has a top rate of 6.45 percent on individual income. A reduction in the corporate rate to 6.25 percent would necessitate a plan to reduce the individual income tax rate as well, since many S-Corps and LLCs that pay the individual income tax would be likely to reorganize as C-Corps to pay the lower tax rate.

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Tax Foundation
2001 L Street NW Suite 1050
Washington, DC 20036
Ph: (202) 464-6200
Fax: (202) 464-6201
www.taxfoundation.org