FUTURE PLANNING KEY:

EARLY, ACCURATE KNOWLEDGE OF ECONOMIC INCENTIVE TAX CREDITS WILL BE ESSENTIAL FOR REVENUE PLANNING IN THE REDUCED/LOWER REVENUE ENVIRONMENT WHICH WILL BE OCCURRING IN THE NEAR TERM.

PROJECT SUMMARY POINTS:

- An estimated $4.8 million revenue reduction was created by a state HPIP incentive-based tax credit
  - Incentive program certification, review and exemption verification are done by the state

- The ability of the City to be notified of these credits for planning purposes is limited by:
  - Business confidentiality, tax return confidentiality and upcoming disclosures of past activity

- Management and Governing Body communication with State Commerce and Revenue departments may help
  - Options may be identified to provide large credit information sooner

- This is the only tax credit of this magnitude to date, but the likelihood of future significant incentive credits is unknown.
  - There is ‘no cap’ limit on the credit which can be accumulated by a business in a four quarter spending period
  - For planning use, estimates of the economic and incentive credit impact of data centers are provided at Appendix I. Estimated range from $2.4 million for a “typical” data center to $6.6 million for a “hyperscale” data center
  - Other states in the region have economic incentive cap/limit provisions; two states have data center-specific incentive provisions. This information is summarized for informational purposes at Appendix II
AUDITOR’S FUTURE REVENUE PLANNING NOTE:
Since the recent COVID-19 related shutdown of many retail and dining businesses, tax revenues will sustain significant reductions; the Auditor emphasizes that the best and earliest knowledge of economic incentive-based credits will be essential for ongoing budget tax revenue planning. For future tax revenue planning reference, estimates of the potential of significant tax revenue impacts created by data center tax incentive credits is included at Appendix I.

BACKGROUND
In August 2019, City management was notified by the Kansas State Department of Revenue (“Revenue”) of an expected significant compensating use tax credit. Current estimate of this total credit amount (which is still under verification by Revenue) is $4.8 million. The City Council Audit Committee requested an Auditor project to obtain details of the credit and the credit’s related processes and controls.

CONCLUSIONS
• A claim for High Performance Incentive Program (HPIP) sales/use tax exemption credits created an unexpected tax revenue fluctuation for the City.

• HPIP certification, project review, verification of exemption documentation and proof of sales taxes paid is performed by the State of Kansas.

• Several factors significantly limit the City’s ability to obtain timely and detailed information on HPIP for revenue planning – business confidentiality, tax return confidentiality, and upcoming disclosures which will report only past activity.

• City management is proactively communicating with the State Departments of Commerce and Revenue on incentive program activity, in an attempt to reduce potential unanticipated revenue impacts. The Governing Body may wish to pursue discussions with Commerce to determine whether options could exist to notify the City when HPIP applications are received.

• The upcoming estimated $4.8 million use tax credit is the City’s only credit activity of this magnitude to date, but the likelihood of similar activity in the future is unknown. The Commerce Department confirms there is no dollar ‘cap’ limit on HPIP sales tax exemptions.

• Technology-centric companies create desirable economic impacts and can also create significant incentive-driven tax revenue impacts. To assist City tax revenue planning, data center impacts are modeled at Appendix I, from an estimated $2.4 million for a typical center to $6.6 million for a ‘hyperscale’ Google-level center. Other states’ differing economic incentive tax structures, data center provisions and tax credit limits are summarized at Appendix II.
OVERVIEW
This report describes the following aspects of the use tax exemption credit:

- The overall purpose of the High Performance Incentive Program (HPIP), which created the compensating use tax credit (page 4)
- Specific benefits available through HPIP (page 4)
- Requirements which employers must meet for HPIP eligibility (page 4)
- Screening and qualification processes for HPIP participation (page 5)
- Processes to verify HPIP sale/use tax exemption claims and refund payments (page 5)
- The type of notification and revenue planning information available to the City for HPIP project tax exemption applications and sales/use tax refund credit activity (pages 6-7)
- Discussion of state HPIP sales tax exemption provisions vs. City Industrial Revenue Bond (IRB) sales tax exemption provisions (page 7)
- Illustration for revenue planning purposes of the potential for data centers to create significant economic and exemption tax credit revenue impacts (Appendix I - pages 8-10)
- Summary information on significant aspects of the economic incentive tax exemption programs of other states in the region (Appendix II, pages 11-13)

The Auditor appreciates the substantial assistance and expertise which the City of Olathe Resource Management and City Attorney’s Office provided to this project. The Auditor also acknowledges the expertise and information on HPIP incentive program statutes and processes which was provided by:

Richard Martinez, Kansas Department of Commerce HPIP Program Manager
Connie Szocs, Kansas Department of Revenue Audit Services Manager
Justin Stowe, Kansas Legislative Post Auditor
1. **WHAT IS THE OVERALL PURPOSE OF THE HIGH PERFORMANCE INCENTIVE PROGRAM (HPIP)?**

The Kansas High Performance Incentive Program (HPIP) exists per the provisions of K.S.A. 74-50, 133. Since its inception, the program has been amended several times. Current HPIP economic incentives are described by the Kansas Department of Commerce (Commerce) at the department’s kansascommerce.gov website. The website indicates HPIP:

- “provides tax incentives to employers that pay above-average wages and have a strong commitment to skills development for their workers…the program…encourages capital investment in facilities, technology and continued employee training and education.”
- provides “the primary benefits” of investment tax credit for new capital investment in Kansas and a related sales tax exemption

2. **WHAT SPECIFIC BENEFITS ARE AVAILABLE FROM THE HPIP PROGRAM?**

The Commerce HPIP incentive informational materials (also found on the Commerce website) outline 4 potential benefits of the program for employers:

- a sales tax project exemption (STPE) to use in conjunction with a company’s eligible capital investment at a qualified facility
- a 10% income tax credit for eligible capital investment in excess of $1 million at a qualified company facility in five metro counties (including Johnson County)
- a training tax credit of up to $50,000
- priority consideration for access to other company assistance programs offered by the State

The STPE benefit created the estimated $4.8 million reduction in sales/use tax remittances to the City.

3. **WHAT ARE THE BASIC REQUIREMENTS FOR PARTICIPATION IN HPIP?**

Requirements noted on Commerce’s HPIP Overview form, located on the kansascommerce.gov website, indicate an HPIP qualifying employer must meet the following conditions:

- be a for profit company subject to sales taxes
- pay above-average wages as compared to other similar firms in the same area
- make a significant investment in eligible employee training and
- be either a manufacturer OR able to document most of its sales are to Kansas manufacturers and/or out-of-state company or government agencies, OR be a back-office or headquarters operation
4. WHAT PROCESS IS USED TO SCREEN AND QUALIFY HPIP PARTICIPANTS?

Verification of a planned project’s HPIP eligibility, the ultimate actual project’s adherence to HPIP requirements, and establishment of a sales/use tax exemption follows this process:

➢ HPIP investment tax exemption eligibility is reviewed and certified for planned projects, and companies must initially complete and file a Project Description Form with Commerce.
  o This form is required when capital construction, remodeling or expansion investment of $1,000,000\(^1\) or over is anticipated, but prior to any project commitment. It details planned location, capital investment costs, revenue, wage levels and job creation data to ensure the project as planned will meet HPIP tax exemption requirements.
  o If Project Description Form details meet requirements, Commerce issues an HPIP certification letter for the upcoming project. Commerce notifies the Department of Revenue (Revenue) when the construction project certification letter is issued.

➢ When the project is underway, the employer furnishes information on the project worksite to Commerce in a 12-page Kansas HPIP Application.
  o This application contains data and documentation attesting to the active project’s tax status, revenue, company and active project worksite addresses, the number of employees, wage levels, training investments made, and the company/industry classification. Commerce verifies the information to validate the eligibility of the worksite and project now underway.

➢ Eligible HPIP worksite projects claim sales/use tax exemption credits only after an initial ‘measurement period’, which ensures the required investment, training and wage thresholds are consistently met. After measurement, the employer can then claim sales/use tax exemptions on qualifying project purchases made in a four quarter “certification period”.

➢ Employers must also file an application for a Project Exemption Certificate (PEC) with Revenue to finalize eligibility to claim the actual HPIP project sales/use tax exemption.

5. HOW ARE HPIP PARTICIPANTS’ SALES TAX EXEMPTION CREDITS CLAIMED AND VALIDATED?

Once the certification period is complete, an employer with a PEC claims HPIP tax exemption credit with Revenue by filing for a refund of sales/use taxes on eligible project purchases.

The HPIP sales/use tax refund filing requires supplier invoices to support the full amount and nature of the tax refund sought. Revenue’s Audit Services group verifies the HPIP tax refunds claimed have complete, accurate invoice documentation to support items purchased are eligible for the credit. Revenue also verifies requested refunds relate to taxes actually paid to vendors by the HPIP filing companies.

A 2019 enacted statute (K.S.A. 46-11, 37) requires Kansas Legislative Post Audit to conduct “a systematic and comprehensive review, analysis and evaluation…of economic development incentive programs… selected by the Legislative Post Committee” every 3 years. Programs which may be evaluated by Post Audit are under assessment at this report date. If HPIP is selected, additional review of program activity by Post Audit could occur.

\(^1\)This required investment level applies to the 5 Kansas metro counties: Douglas, Johnson, Sedgwick, Shawnee, and Wyandotte.
6. **HOW AND WHEN DOES THE CITY RECEIVE NOTICE OF HPIP TAX EXEMPTION CREDITS CLAIMED?**

Commerce is not legally required to and does not provide notification to the City when HPIP applications are received or tax exempt project certifications are granted. HPIP applications can relate to activity which companies desire to keep confidential.

Although sales tax remittance data is furnished by Revenue monthly to the City, tax credit refund information is provided in the month it is deducted from remittances. Revenue is not required to notify the City of exemption credit filing activity or estimated amounts before they are deducted. The August 2019 notification from Revenue of a future substantial, multi-million dollar refund credit was voluntary, occurred due to the significance of the potential credit amount, and was the only such notice received by City management in the last 8 years. Updated estimates for this credit were received in March 2020.

Recently enacted Kansas statutes require additional disclosure of information on economic incentive program claim activity on the kansascommerce.gov website, but this information will relate to the past 6 months’ activity, rather than notification of HPIP exemption claim activity as it is occurring. See further discussion at 7., below.

7. **CAN THE POTENTIAL AMOUNT OF HPIP TAX EXEMPTION CLAIMS BE ESTIMATED OR KNOWN FOR CITY BUDGET PLANNING?**

There are several challenges to obtaining detailed HPIP tax exemption credit information within relevant timeframes for tax revenue budget planning.

- Although 2019 changes to Kansas law require Commerce to provide online disclosure of incentive program recipients, addresses, and program claim amounts, the tax revenue planning value of this information is limited by several factors:
  - Kansascommerce.gov website information indicates this claim information will be disclosed twice a year (after calendar and fiscal year end) for the prior 6 months’ activity; it therefore is unlikely to be optimal for planning of future revenues.
  - Online incentive program database information will not include claim amounts until 2021, pending 2020 tax return data processing, according to the kansascommerce.gov website.
  - Tax return amendments can change originally filed HPIP exemption refund credit amounts in the amendable tax years after the initial filing. Also, much tax return detail information is confidential per K.S.A 79-32, 34(b).

- HPIP project sales/use tax exemption claims occur after a project’s purchases are made in the certification period and are deducted in one lump sum from City tax remittances.
  - After verification by Revenue, these refund credits immediately reduce tax remittances lump sum until the full refund amount is satisfied. For large HPIP projects, this creates a substantial reduction to budgeted sales tax revenue in a concentrated period. Gradual adjustments to budgeted revenue over time are not occurring for these credits.

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2 K.S.A. 74-50, 227
7. CAN THE POTENTIAL AMOUNT OF HPIP TAX EXEMPTION CLAIMS BE ESTIMATED OR KNOWN FOR CITY BUDGET PLANNING? continued…

➢ Kansas Department of Commerce personnel confirmed there is no ‘cap’ limitation on the dollar amount of HPIP sales tax exemption which can be claimed on eligible purchases made in the four quarter certification period. This makes the upper limit of tax revenue exposure for such exemptions difficult to assess.
   o The anticipated approximate $4.8 million use tax credit communicated to City management in August 2019 illustrates the magnitude these exemptions may have.
   o HPIP tax credit amounts can be substantial for technology-centric companies with high cost computer equipment – see additional information on data centers, a recently developed business model which fits this investment profile, at Appendix I.
   o For reference and analysis purposes, the structure of significant provisions of investment economic incentive tax exemption programs in nearby states in the region is summarized at Appendix II.

8. HOW DO CITY INDUSTRIAL REVENUE BOND (IRB) TAX EXEMPTIONS AFFECT HPIP TAX EXEMPTIONS?

➢ The IRB and HPIP programs are mutually exclusive.
   o If a company participates in the City IRB program, it is eligible for sales tax exemptions on construction/expansion materials. If the same company is also an HPIP participant, exemption sales tax refunds through HPIP cannot be claimed in the future – since such taxes were not paid due to the initial IRB-granted exemption. Also, Revenue verifies that any sales/use tax exemption refund claims relate to taxes actually paid to vendors – see 5., above.
   o As a result, employers disclosed as HPIP participants in the new Commerce database who also received Olathe IRB funding, do not pose future large sales tax exemption credit risk through HPIP. These companies do remain eligible for income tax and training cost credits through HPIP, which do not affect City tax remittances.
CITY AUDITOR SPECIAL PROJECT
HIGH PERFORMANCE INCENTIVE PROGRAM:
SALES/COMPENSATING USE TAX EXEMPTION REVENUE IMPACT

APPENDIX I: REVENUE AND CAPITAL INVESTMENT PATTERNS OF DATA CENTERS:
POTENTIAL IMPACT OF SALES/USE TAX EXEMPTION CREDIT LEVELS FOR TAX REVENUE MODELS

Kansas High Performance Incentive Program (HPIP) sales/use tax exemption credit refunds are given to HPIP participant companies for tangible personal property investments made in construction, remodeling or expansion projects. These credits are calculated by applying statutory sales/use tax rates to eligible property investments made in the four quarter HPIP certification period. No maximum amount is set for these credits.

Business models which rely heavily on technology have different investment levels than more traditional companies. As an example, data centers invest heavily in technology and have experienced rapid recent growth. A 2017 study published by the U.S. Chamber of Commerce Technology Engagement Center (“Chamber”) reported the following information on the economic impact of a typical data center:

| TABLE 1:  
ECONOMIC IMPACTS OF TYPICAL DATA CENTERS |
<table>
<thead>
<tr>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>CONSTRUCTION PHASE</td>
</tr>
<tr>
<td>Local jobs</td>
</tr>
<tr>
<td>Wages</td>
</tr>
<tr>
<td>Local economic activities</td>
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<tr>
<td>State and local taxes</td>
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</tr>
<tr>
<td>Local economic activities</td>
</tr>
<tr>
<td>State and local taxes</td>
</tr>
</tbody>
</table>

The above amounts from the Chamber study used multipliers to calculate direct economic activity from initial spending for construction and operation. Indirect impacts for subsequent rounds of spending by industries along the affected supply chain are also included. Induced impacts are included as well, which represent changes in spending by workers who benefit from these direct and indirect impacts.

K.S.A. 79-3606 (cc) provides eligible HPIP projects’ tangible personal property/services are exempt from sales tax. For this illustrative estimate, IT equipment in the above Table 2. is assumed to be such property.


Page 8 of 13
The related **investment expenditures** by the same ‘typical’ data center in the U.S. Chamber study report are shown below:

![Table](https://example.com/table.png)

This level of investment can create significant tax exemption refund credits. The following basic calculation is furnished as an illustration, to support revenue planning and further analysis of the potential tax revenue impact of HPIP sales/use tax exemptions for a ‘typical’ data center:

\[ \$157,100,000 \times 1.5\% \times \text{Olathe sales tax rate} = \$2,356,500 \]

For consideration in planning the **potential maximum levels of HPIP tax exemption credits**, it is relevant to analyze a possible future data center development recently reported in the Kansas City metropolitan area. In August 2019, the Kansas City Business Journal reported Google executed a deed in the Hunt Midwest Business Park for a data center with an estimated $600 million footprint. No firm building commitment has been made.

This project would substantially exceed the U.S. Chamber’s ‘typical’ data center investment. These facilities are referred to as ‘hyperscale’ data centers. **Hyperscale center investments trigger significantly higher HPIP tax exemption credits than the previously illustrated ‘typical’ facility.**

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Again, as an illustrative starting point for tax revenue estimation and further analysis of the potential impact from HPIP sales/use tax exemption credits for a data center of this magnitude, the following basic calculation is furnished. This calculation uses reported costs for the Google potential development and U.S. Chamber reported investment patterns to construct an estimate:

Table 2.
AUDITOR CONSTRUCTED ESTIMATE FOR ILLUSTRATIVE PURPOSES: HYPERSCALE DATA CENTERS’ POTENTIAL HPIP TAX EXEMPTION IMPACT

<table>
<thead>
<tr>
<th>Initial Capital and Operating Patterns of a Typical Data Center Applied to a Known Potential Large Scale Data Center Project in the Kansas City Area</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reported potential Google KC data center investment</td>
</tr>
<tr>
<td>Potential estimated level of HPIP <strong>tax exempt IT equipment capital expenditures</strong> in reported potential KC data center project (using U.S. Chamber IT equipment 'typical' spending pattern of 72.9% capital expenditures and reported potential Google KC data center investment)</td>
</tr>
<tr>
<td>1.5% Olathe City tax rate applied to $437.4 million modeled U.S. Chamber IT expenditure level = estimated HPIP tax exempt credits for a hyperscale data center</td>
</tr>
</tbody>
</table>

As estimated in the above illustration, a hyperscale data center investing the U.S. Chamber-estimated 72.9% in HPIP-exemption eligible IT equipment **could potentially create an estimated $6.6 million HPIP exemption credit at the 1.5% Olathe City sales tax rate.**
APPENDIX II: SUMMARY OF ECONOMIC INCENTIVE TAX EXEMPTIONS IN REGIONALLY COMPARABLE STATES

HPIP sales tax exemption requires $1 million of metro county investment, above average employee wages, minimum employee training investment and job creation for manufacturing, manufacturing sales, or headquarters/back office facilities. In a four quarter period, there are no tax credit limits.

The following summary of significant tax exemption economic investment incentives of other states in the region is provided for reference. Provisions similar to HPIP incentives are included; this summary does not provide details and requirements for all incentive programs in these states. Nebraska and Texas have tax exemption incentive programs which establish separate requirements for data centers. The sources for this information were applicable states’ departments of commerce/economic development websites, and relevant state statutes where necessary.

<table>
<thead>
<tr>
<th>STATE</th>
<th>EXPANSION/CONSTRUCTION TAX INCENTIVE PROVISIONS</th>
<th>REQUIREMENTS</th>
<th>LIMITATIONS</th>
<th>ELIGIBLE INDUSTRIES/BUSINESS TYPES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arkansas</td>
<td>Sales/use tax refunds on building materials and taxable machinery/equipment</td>
<td>Metro county minimum investment of $5 million OR Metro county minimum payroll of $2 million; signed job creation agreement. Some sectors must also have specified percentages of out of state revenue.</td>
<td>Benefit limit is 10% of investment amount; local governing authority must endorse the benefit via a resolution.</td>
<td>Manufacturers, software design, computer processing, data preparation, or info retrieval, film/digital productions, distribution centers, intermodal facilities for freight/commerce/passengers, non-retail office sectors, national/regional headquarters, engineering/R&amp;D, scientific/technical services, air transport support, rail transport support</td>
</tr>
<tr>
<td>Iowa</td>
<td>Sales/use tax exemption - see 'requirements' column</td>
<td>Must be sale or rental of computers, machinery, equipment, replacement parts, supplies, and materials used to construct or self construct any of the following: processing by a manufacturer, used to maintain product or environment conditions for the product, used in research/development of new products, used in storage of data or information, used in recycling or reprocessing waste, used in pollution control by a manufacturer; on fuel sold to create heat, power, electricity.</td>
<td>None noted</td>
<td>See 'requirements' column</td>
</tr>
<tr>
<td>STATE</td>
<td>EXPANSION/CONSTRUCTION TAX INCENTIVE PROVISIONS</td>
<td>REQUIREMENTS</td>
<td>LIMITATIONS</td>
<td>ELIGIBLE INDUSTRIES/BUSINESS TYPES</td>
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</tr>
<tr>
<td>Louisiana</td>
<td>Sales/use tax rebate for capital expenses</td>
<td>Minimum # of new full time jobs (5-15), minimum wage levels, full time jobs.</td>
<td>None noted</td>
<td>Must be jobs created in an enterprise zone OR specified % of out of state sales, or specified % of time performing services for an out of state company. Bioscience, manufacturing, software, clean energy, food technology, advanced materials, multistate headquarters, aircraft maintenance/repair/overhaul, oil &amp; gas field service jobs also qualify.</td>
</tr>
<tr>
<td>Missouri</td>
<td>Business opening or expansion annual income tax credits</td>
<td>Minimum 500 average new employees AND minimum 25 new jobs AND $1 million in new investment AND maintain minimum $20 million average facility investment</td>
<td>Greater of: $400/each new employee and 4% of new investment OR $500/new employee and $500 per each $100K of new investment: expansion/construction on or before 12/31/24; credits provided for 10 years.</td>
<td>Must be a headquarters facility</td>
</tr>
<tr>
<td>Nebraska</td>
<td>Sales tax refunds for business investment</td>
<td>Various tiers of investment from $1 million to $200 million (for data centers). Minimum number of jobs ranging from 10-100 in various tiers; data center requirements of 30 jobs. ranging from 50 - 100% of capital purchases (data centers receive 100%)</td>
<td>Attainment periods of up to 7 years for investment and 7 years for use of the credits; carryover period of up to 8 years for higher investment tiers. The data center $200 million tier expires 12/31/24.</td>
<td>Tiers are targeted to various industry categories - among these are: data centers, R&amp;D/Science, manufacturing, export, cloud computing, electric power production, renewable energy, telecom, insurance, financial services, manufacturing, distribution/transportation.</td>
</tr>
<tr>
<td>STATE</td>
<td>EXPANSION/CONSTRUCTION TAX INCENTIVE PROVISIONS</td>
<td>REQUIREMENTS</td>
<td>LIMITATIONS</td>
<td>ELIGIBLE INDUSTRIES/BUSINESS TYPES</td>
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</tr>
</tbody>
</table>
| Oklahoma | Income tax credits for qualified investment  
Sales tax exemptions for machinery, equipment and materials used in manufacturing | Insurance companies locating/expanding regional home office to Oklahoma with 200+ employees  
Manufacturers with new capital improvements and/or job creation of $40 million or net increase in FT employees within 3 years of $40 mil investment  
Manufacturing businesses, generally | 4 year credit carryforward after qualification; then unused credits usable for 15 years after; annual maximum credit allowable capped at $25 million. Credit amount for manufacturing greater of: 1% of cost of property in year placed in service OR $500/new employee | See 'requirements' column |
| Texas | Enterprise Zone Sale/Use tax refunds  
Sale/use exemption for manufacturing, machinery and equipment  
Data center exemption | Investment minimum of $40,000; minimum 10 jobs created  
All machinery, equipment, accessories used in manufacturing or agricultural processing are tax exempt.  
100% exemption on sales tax for computers, equipment, cooling systems, power infrastructure, electricity and fuel for data centers with $200 million in capital investment, 20 jobs created, at 120% of average county salary. | Statewide 2 year limit of 105 projects; refund of $2500-$7500/job based on tiers of investment up to $250 million. Maximum refund is $3.75 million.  
None noted. | See 'requirements' column |

APPLIES TO STATE TAXES ONLY. 10 years for investment of $200-250 million within 5 years; 15 years for investment of at least $250 million within 5 years.