

M I N U T E S

SPECIAL COMMITTEE ON ASSESSMENT AND TAXATION

August 6, 1976

The meeting was called to order by Vice-Chairman Thiessen shortly after 9:00 a.m. All members were present. Staff present: Bill Edds, Revisor of Statutes Office, Roy Johnson, Legislative Research Department, and Robert Taylor, Legislative Research Department.

Hearing on Proposal No. 5 - Sales Tax Revisions

House Bill No. 3057

Representative Kenneth Francisco spoke in favor of H.B. 3057 and presented a statement to the Committee in support of his position. (A copy of this statement is in Committee notebooks.)

Representative Francisco stated that all contractors should be treated equally in regard to the applicability of the sales tax. He further stated that the apparent inconsistency in the current law between K.S.A. 1975 Supp. 79-3602(d) and 79-3603(1) results in a handicap to a business that operates as both a contractor and a retail outlet to the advantage of those firms operating only as contractors.

In presenting the results of a recent survey he conducted, Representative Francisco noted, in his opinion, there were many contractors purchasing tangible personal property tax exempt in violation of existing law and regulations.

A member of the Committee asked if H.B. 3057 would help this problem. Representative Francisco replied, probably not, the existing law was sufficient, what was needed was more audit and administrative effort from the Department of Revenue. He felt this bill would provide the department additional support in this area.

Mr. Ben Neill, Department of Revenue General Counsel, responded that some audits do reveal the apparent existence of the tax avoidance situation referred to by Representative Francisco. However, he further stated that in most instances the non-payment of the tax was through ignorance or misunderstanding of the law. If a material wholesaler is presented an exemption number by the contractor, and in "good faith" assumes the contractor will levy and collect the sales tax on the ultimate sale to the consumer, there is nothing the Department can do in addition to what is being done now. However, more audits in this area would probably insure greater compliance with existing law. The problem is that more audits will cost more.

House Bill No. 2734

Frank Morrow, Accountant for Beech Aircraft, Wichita, presented a statement and spoke favorably for the adoption of both H.B. 3057 and H.B. 2734. (A copy of Mr. Morrow's statement is in Committee notebooks.)

On H.B. 3057, Mr. Morrow indicated he spoke only as an interested taxpayer. On H.B. 2734, he stated he spoke for the Beech Aircraft Corporation.

Mr. Morrow stated that labor services provided on aircraft used in interstate commerce should be exempted from the Kansas sales tax. He asked if sales of aircraft and parts made to foreign customers are exempt, why should not labor also be exempt? He stated the 1970 law which applied the sales tax to labor services works at a disadvantage to Kansas firms by giving an indirect concession to foreign businesses.

A Committee member asked if any documented evidence existed to show that Beech Aircraft had lost business as the result of this current law. Mr. Morrow stated Beech Aircraft had not yet lost business in Kansas, to his knowledge, as the result of these current provisions. However, he stated that a recent similar provision in the State of California had resulted in a loss of business to his company in that state. Given the significant percentage of interstate and international business conducted by Beech Aircraft Corporation, the continuance of the application of this law could, in Mr. Morrow's opinion, mean a significant loss of business and jobs for Kansas.

House Bill No. 3111

Wilson Cademan, representing Kansas Gas and Electric, Wichita, presented a statement and spoke in opposition to the enactment of H.B. 3111. (A copy of Mr. Cademan's statement is in Committee notebooks.)

The basis for Mr. Cademan's opposition to this bill is in the compounding burden the sales tax would have when added to the utility's rate base. In this way, if the sales tax were to apply to "structures", taxpayers would pay the sales tax as many as eight times over an average capitalization period of 30 years, according to Mr. Cademan.

A member of the Committee asked if this capitalization feature was unique to the sales tax or would any cost of business included in the rate base have the same effect over time? Mr. Cademan said it was not unique to the sales tax. If, for instance, labor costs within the rate base increased three percent, the same effect would occur. Any additional cost included in the rate base would have the same effect of increasing annual rates over time.

Another Committee member asked if this capitalization of taxes was unique to utilities or would it apply to any business with a fixed rate of return applied to its capital base? Mr. Cademan responded that there were probably other businesses where the same effect would occur.

Mr. Cademan was asked what the approved rate of return was for the Kansas Gas and Electric Company. He replied, 8.8 percent.

Louis Stroup, Jr., representing the Kansas Municipal Utilities, Inc., presented a statement to the Committee and spoke in opposition to H.B. 3111. (A copy of this statement is in Committee notebooks.)

Charles Nicolay, representing the Kansas Builders Association, General Contractors of Kansas, Topeka, spoke in opposition to H.B. 3111. Specifically, Mr. Nicolay expressed concern over the alleged inconsistency in the administration of K.S.A. 1975 Supp. 79-3603(p), relating to the taxation of labor services and the definition of "retailer" for sales tax purposes. He stated that there needs to be more definition of the terms "new construction" and "repair." He also stated he thought action by the legislature in this area might be premature, and recommended delay until the Kansas City Millwright Company, Inc. vs. Kansas Department of Revenue case can be heard and decided by the State Supreme Court.

A Committee member posed a rhetorical question as to whether new rules and regulations might not be more appropriate than changes in the law. Mr. Nicolay responded that this was the point he was trying to make.

Ed. Weilepp, representing the Kansas Contractors Association, Topeka, spoke in opposition to H.B. 3111. Mr. Weilepp relayed an experience which frustrated several members of his association where alternate rulings of the Department of Revenue allegedly determined materials and labor charges on the installation of water lines to be taxable, a second ruling found them to be non-taxable, and a third ruling found them to be taxable again. Mr. Weilepp maintained that waterlines are "structures" and the materials and labor charges on new construction of water lines should be tax exempt. Mr. Weilepp requested the Committee to leave the term "structure" in K.S.A. 1975 Supp. 79-3603(p) and have the rules and regulations interpreting this term broadened to include more things than are currently included under present Department of Revenue rulings.

Bill Gough, representing the Kansas Association of Commerce and Industry, Topeka, spoke in opposition to H.B. 3111. Mr. Gough stated there is no need to broaden the sales

tax base by making a more restricted definition of "structure" when there is a surplus in the state treasury. He stated the Department of Revenue was not following the rulings of the Attorney General in this area. He further stated, in his opinion, the rules and regulations adopted by the Department of Revenue relating to K.S.A. 1975 Supp. 79-3603(p) and the rulings stated in the Department of Revenue Bulletin in this area exceeded the intent of the legislature in defining the sales tax base.

Mr. Gough stated the reason this matter had not been resolved was the failure of the Board of Tax Appeals to deal with "legal" questions in specific appeals. To this end, he recommended that the Committee consider the establishment of a "tax court" in Kansas.

In closing, Mr. Gough stated the legislature should abolish all sales tax provisions applying to sales of machinery and equipment to enable Kansas to be more competitive in attracting business. He stated that with the original enactment of the sales tax, the legislature had intended to tax "consumable goods" only. He urged the Committee to reconsider this philosophy.

Harold Shoaf, representing the Kansas Electric Cooperatives, spoke in opposition of H.B. 3111 and presented a statement to the Committee. (A copy of this statement is in Committee notebooks.)

In response to a question from a Committee member, Mr. Shoaf stated that he would also oppose the enactment of H.B. 3057 which, in its present form "will create problems to REC's."

Robert Anderson, representing Mid-Continent Oil and Gas Association, spoke in opposition to H.B. 3111. He urged the Committee to take no action of amending K.S.A. 1975 Supp. 79-3603(p), until the Supreme Court has had the opportunity to decide Kansas City Millwright Company, Inc. vs. Kansas Department of Revenue.

A Committee member asked when the Supreme Court would hear the case. Mr. Kent Kalb, Secretary of Revenue, replied the briefs would be filed soon and the case would be heard during the fall term.

Mr. Anderson said the entire matter had been blown out of proportion by the improper administration of the Department of Revenue in prior years. He said he felt the current administration was just trying to remedy the mistakes of the past.

A Committee member asked why Mr. Anderson thought the Committee should wait on the Supreme Court to decide, since tradition, and the legislature's policy role, indicated a clarification of the law on this point was in order. Mr. Anderson, after some discussion, said he desired the delay to keep from paying the additional tax if the term "structure" was removed from the current law or redefined by new legislation or regulations.

F. Kent Kalb, Secretary of Revenue, explained the Department of Revenue's past and present position on the application of the term "structure" as used in K.S.A. 1975 Supp. 79-3603(p). He stated the Department, with one minor exception, has been constant in the application of rules and regulations in this area of the sales tax law. He felt the one exception was irrelevant to the matter before the Committee and the question before the Supreme Court, and that it was being used by some parties to divert attention away from the real issue. In response to a question from a Committee member, he stated he thought the Supreme Court would agree with the Department's position.

When asked about the status of formal regulations in this area, Mr. Kalb said they had been drafted but that it would be inappropriate to file them at this time. If, as the department anticipates, the Supreme Court finds K.S.A. 1975 Supp. 79-3603(p) to be constitutional and remands the case for further district court proceedings, regulations limiting the definition of "structure" to something resembling more of a building, which would place the sales tax on materials used in such things as electric transmission lines and pipelines, will be filed.

When asked to expand upon his earlier comments concerning the case before the Supreme Court on the taxation of services, Mr. Kalb stated he thought the Supreme Court would not rule that the law was unconstitutionally vague in what was taxable and what was not taxable. The court could, however, rule that the application of the law by the department may have been vague in several minor areas but not so as to make the law unconstitutional.

A Committee member asked if the Department was taking its position in an attempt just to protect the state's sales tax base. Mr. Kalb responded that was one reason. The Department should, he stated, take a conservative position in protecting the state's revenue sources. He said the Supreme Court has consistently ruled over the years that tax exemption provision laws are to be strictly construed, and until directed otherwise by the courts or the legislature, the Department would continue to give a narrow definition to the term "structure."

A Committee member asked if Mr. Kalb thought the Committee and the legislature generally should wait until the Supreme Court decides the Kansas City Millwright case before taking any action in this area. Mr. Kalb responded that the legislature has historically acted to provide more definition to taxation laws when issues were being adjudicated and he gave the recent clarifications of the bingo laws and the school finance laws as examples. He further stated that it seemed a plan of action needed to be developed in this area regardless of what the Supreme Court did, which is why the Department is proceeding with detailed regulations. He suggested that the legislature at least have a stand-by plan prepared.

Ernie Mosher, Kansas League of Municipalities, Topeka, appeared in opposition to H.B. 3111. Mr. Mosher stated that cities should be exempt from payment of all sales taxes for any purpose. The burden of collecting sales taxes on proprietary service sales (gas, lights, water, refuse collection), and the burden of paying sales taxes on tangible personal property and labor services included in the construction and maintenance of these proprietary services are, according to Mr. Mosher, seriously escalating the critical financial plight of all Kansas cities. Mr. Mosher stated, in his opinion, the current law could be administered without change to K.S.A. 1975 Supp. 79-3603(p).

Charles Carey, representing the Mechanical Contractors of Kansas, Topeka, spoke in opposition to H.B. 3111. Mr. Carey urged consideration of H.B. 2932, which would further expand tax exemptions in K.S.A. 1975 Supp. 79-3603(p) by exempting the sales tax on all labor services for improvement, reconstruction or repair, as well as new construction as now provided. He urged the Committee members to refer to a letter he had sent to them on June 28, 1976. Under the current law, Mr. Carey stated the Mechanical Contractors face cost discrimination and an undue record keeping burden. He urged the Committee to take corrective action.

Robert H. Graham, representing the Kansas City Power and Light Company, gave no oral testimony but provided for Committee consideration an illustration of the compound effect of the sales tax when included in the rate base of a utility. (A copy of this illustration is in Committee notebooks.)

Other Matters Relating to Proposal No. 5

House Bill No. 2526. As directed at the July 9, 1976 meeting, Committee staff reported on an attempt to get input from city officials on the sales tax treatment of purchase and lease agreements pursuant to the issuance of industrial revenue bonds. Seven city managers or administrators were contacted. While most of these indicated support for the bill, they did not report any particular problems with the present provisions. Several stated that details like this are handled by the underwriters and fiscal agents and the cities are not directly involved.

Senate Bill No. 1019. Mr. Ben Neill, General Counsel, Department of Revenue, presented information concerning the sales tax status of irrigation districts. A recent audit assessed sales tax to purchases made by an irrigation district under K.S.A. 1975 Supp. 79-3603(c) and K.S.A. 1975 Supp. 79-3606(b) which provide that political subdivisions of the state are subject to the tax when engaging in a business of furnishing utility services such as water. As such, irrigation districts are clearly subject to the tax according to Mr. Neill. However, all sales by these irrigation districts to farmers are tax exempt under K.S.A. 1975 Supp. 79-3606(m). Previously, the irrigation districts thought their purchases were also exempt under K.S.A. 1975 Supp. 79-3606(m). The Department of Revenue has held that there is no connection and they are subject to the tax.

The policy question for the Committee, as posed by Mr. Neill, is whether or not purchases by these irrigation districts should be tax exempt. In the absence of specific legislation, as proposed in S.B. 1019, the Department will continue to tax purchases of tangible personal property by these irrigation districts.

Use Tax "Freeport" Provision. In another area Mr. Neill pointed out an inconsistency in the current use tax law the Committee may want to consider for a possible change in policy. Under K.S.A. 79-3702(e), no use tax is payable on tangible personal property, such as pipe or construction materials, warehoused in Kansas, if that property is brought into the state for subsequent shipment outside the state for ultimate use. If the material is ultimately used in Kansas a use tax is paid. This provision, according to Mr. Neill, provides an unfair advantage to out-of-state suppliers over Kansas suppliers, who must collect the sales tax if the product is to be warehoused in Kansas following purchase. Mr. Neill stated, most states levy a use tax on inventory temporarily warehoused in the state to avoid discriminating against resident firms.

The Committee Chairman requested the Revenue Department to prepare a draft of a proposed bill for the Committee to consider at the September 17 meeting. The staff was directed to provide Committee members and affected taxpayers with copies of the draft prior to the meeting and include on the agenda a hearing on the question.

Proposal No. 7 - Mineral Interests Taxation

Pursuant to an invitation from the Committee, George Erickson presented background material on the general subject of mineral estates and the tax treatment of this type of property. He also directed his comments to the proposed bill draft before the Committee.

Mr. Erickson defined a mineral estate as the real property right to one or several sub-surface horizons. The owner of this mineral estate could further subdivide or sell parts (or horizons) of this estate to others. In addition, the owner of a mineral estate may assign or sell a working or production interest (personal property) in this mineral estate to another party. The working interest gives one the right to drill into the mineral estate to extract tangible personal property (minerals). The royalty interest (personal property) is the right to receive compensation for the use of, or production on, a mineral estate. Initially, this may be the property of the owner of the mineral estate. However, it may be sold or subdivided in any number of ways, just as the surface property may be sold and subdivided.

Mr. Erickson said there was nothing in existing law that would give adverse possession of any mineral estate, working interest or royalty interest to the surface owner. In the case of the mineral estate, it cannot be abandoned just as no other real property can be abandoned. Under the law, real property can be passed on either by tax sale or succession to heirs.

Mr. Erickson said a mineral estate is no different than any other form of real estate. However, it may be more complicated by several interest ownerships at several horizons. Mr. Erickson asked, if the Committee considered forfeiting mineral estates to the surface owner, what more right does that person have than the owner of another horizon, for instance?

As an alternative to taxing mineral estates, Mr. Erickson suggested that the mineral estate not be taxed at all, as is the case in some counties now, and that instead only the "fruit" of the mineral estate i.e., the production therefrom, be taxed.

A Committee member asked if Mr. Erickson was referring to a severance tax. Mr. Erickson replied that one could call the tax anything one desired. We now are taxing production as personal property and as income for income tax purposes. He said why not eliminate the real property tax on mineral estates and make up any difference, if needed, from these existing tax sources. In this way, according to Mr. Erickson, the problem of what to do with unpaid taxes on mineral estates would be eliminated.

A Committee member asked what would happen if a mineral estate were put up at a tax foreclosure sale and there were no bids. Mr. Erickson replied that the property would revert to the county.

A Committee member responded that the public purpose might better be served by reuniting the severed mineral interest with the surface interest. Mr. Erickson asked what that public purpose is. The Committee member replied that perhaps the public purpose in this case would be the reduction in administrative costs for the county in

recording deeds and the "cleaning up" of titles with severed mineral interests noted in the abstract.

Another Committee member suggested that perhaps requiring a certificate of value to be filed on all transactions involving severed mineral interests would help in this alleged administrative problem.

In concluding his remarks Mr. Erickson offered several observations and suggestions for technical adjustments to the proposed bill draft. In summary, he observed that the proposed bill would work as the Committee seemingly intended, but he doubted it would ease any administrative problems or make titles of surface interests any "clearer."

Mr. Fred Allen, Kansas Association of Counties, Topeka, introduced the following county officials who were available for questions from Committee members:

Verne Lee Dukan, Meade County Treasurer, President, Kansas County Treasurers Association

Rose Mary Moore, Reno County Register of Deeds, President, Kansas Register of Deeds Association

Helen Jagers, Saline County Register of Deeds

Susie Parmer, Leavenworth County Register of Deeds

Timothy Hagemann, Haskell/Lane/Stevens County Appraiser

Walter J. Staab, Ellis County Appraiser

A Committee member asked the three Registers of Deeds to explain the problems they have with severed mineral interests in recording and abstracting titles with particular reference to K.S.A. 1975 Supp. 79-420. All of the Registers of Deeds replied that there was no particular problem in this area to their knowledge. In Reno County, it was reported that no assessment is made against severed mineral interests.* One of the registers of deeds indicated being unaware of the requirements of K.S.A. 1975 Supp. 79-420 for the past 12 years, which seemed to cause no problems.

Mr. Staab, Ellis County Appraiser, noted he had been directed by his county commissioners not to place a value on severed mineral interests. However, he stated that no one, to his knowledge, would be willing to sell such interests. He stated that severed mineral interests had a separate value or they would not be severed. He stated this type of property should be taxed.

The County Treasurer from Meade County stated that collection of delinquent severed mineral interest property taxes was no problem in that county, but that the collection of property taxes on subdivided royalty interests did present problems.

A Committee member noted that perhaps a solution in this area would be to have the production company owning the working interest to withhold the tax prior to making a royalty disbursement as is now currently provided under K.S.A. 1975 Supp. 79-2017, for the collection of delinquent personal property taxes. Mr. Hagemann, Haskell/Lane/Stevens County Appraiser, noted that based upon the number of tax statements processed by his office, this withholding proposal would save the counties in the Hugoton field area from processing over 100,000 tax statements annually. The Chairman directed the staff to secure more information on this possibility for consideration by the Committee at the next meeting.

* Staff note: In 1975 a total of 73 counties assessed severed mineral interests, amounting to \$5.4 million in assessed valuation or .07% of the total statewide tangible assessed valuation for that year.

Proposal No. 6 - Classification of Soils

Staff presented additional information on possible funding mechanisms should the Committee recommend state participation in the completion of the soils survey as proposed at the June 4, 1976 meeting and discussed further at the July 9, 1976 meeting. A letter from C. F. Bredahl, stating the willingness of the State Conservation Commission to serve as the agency through which to support this program with additional funds (a copy is in Committee notebooks) was presented to the Committee.

Mr. Hagemann noted that the soil classification survey was a most valuable tool to local appraisers and urged the Committee to recommend the additional funding. However, he noted in addition to completing those counties which have had no soil survey, consideration might be given to providing annual funds for updating the survey data in those areas experiencing significant environmental change in recent years. As an example, Mr. Hagemann noted the intensive irrigation projects in Southwest Kansas would make the results of a soil survey in his county significantly different than one taken 20 or even 10 years ago.

The Chairman suggested that perhaps this Committee was not the best arena for discussion of this latter problem, and recommended that Mr. Hagemann bring it before the appropriate legislative committee during the next session.

After more discussion, Senator Simpson moved that the Committee recommend that the Ways and Means Committees take affirmative action on the proposal for funding an acceleration of the soil survey program. Representative Hineman seconded. Motion carried.

The Chairman directed the staff to prepare a draft of an appropriate Committee report and recommendation for consideration at the September 17, meeting.

Agenda for Next Meeting

Further Committee discussion and consideration of Proposals No. 4, 5 and 7.
Review of draft of Committee report on Proposal No. 6.

Prepared by Robert Taylor

Approved by Committee on:

September 17, 1976
(Date)