Approved March 27, 1984
Date

MINUTES OF THE HOUSE COMMITTEE ON ASSESSMENT AND TAXATION.

The meeting was called to order by Representative Jim Braden at
Chairperson

9:00 a.m./~~p.m.~~ on March 14, 1984 in room 519S of the Capitol.

All members were present except: Representative Lowther who was excused.

Committee staff present:
Wayne Morris, Legislative Research Department
Tom Severn, Legislative Research Department
Don Hayward, Revisor of Statutes' Office
Nancy Wolff, Secretary to the Committee

Conferees appearing before the committee:

Harley Duncan, Secretary, Department of Revenue
Senator Ben Vidricksen
Bill Edds, Department of Revenue
Phil Martin, Director, Property Valuation Department

Hearings were continued on Senate Bill 467 which would restrict the use of trended cost factors in the preparation of personal property appraisal guides by the Department of Property Valuation.

Harley Duncan, Secretary of the Department of Revenue, testified in opposition to Senate Bill 467. (Exhibit I and II) He stated that the Department of Revenue felt that the restrictions in Section 1 of the bill could be made to work. He stated, however, that the Department had several concerns. One, that the use of multiple or specific industry indices will make the local appraisers job more cumbersome and difficult. Second, that the Department feels that being required to use multiple indices will cause different values to be assigned to identical pieces of property simply because they are used in different industries. He also stated that the Department feels that many industry indices will very likely result in higher values than are currently being assigned through the use of CPI trending factors, especially with the 15% discount that the Department made in the CPI in 1983.

Secretary Duncan testified that the Department of Revenue opposes the new language in Section 2 of the bill prohibiting the Department from using the "going concern" value of a business in valuing or prescribing guides for valuing personal property. When asked by a committee member what types of businesses the Department included the going concern value or blue sky in valuing the personal property of a business, Secretary Duncan mentioned cable television companies, bowling alleys, and refineries. The Department was asked why they did not include the going concern valuation of newspaper publishing companies in valuing their machinery and equipment and Phil Martin, Director of the Property Valuation Division stated that the division is looking into including the going concern value in other types of businesses such as newspaper publishing companies. Some members expressed concern about the negative affect the high valuations were having on the ability to keep industry and attract new industry to Kansas.

The Chairman then asked the committee to direct their attention to Senate Bill 477. Senator Vidricksen appeared in support of the bill and explained that it was introduced by the Special Committee on Efficiency in State Government which he chaired during the 1983 Interim.

Bill Edds of the Department of Revenue stated that the Department supports the concept of Senate Bill 477.

The Chairman stated that the hearing on Senate Bill 731 would be postponed to Friday, March 16, 1984.

The meeting was adjourned.

DATE: 3-14-84

GUEST REGISTER

HOUSE

ASSESSMENT & TAXATION
COMMITTEE

NAME	ORGANIZATION	ADDRESS
Bill Edds	Revenue	Topeka
Harley Duncan	"	"
Phil Martin	"	"
D. Ferrell	Budget	"
J. Marcum	Dept of Rev	"
Kathy Yonachew	intern	"
Jim Patterson	Legislature	Independence
Kim C. Dewey	Sedgwick Co.	Wichita
Rob Marshall	Mid-America Cable Network	Lawrence
Chip Wheelen	KLPG	Topeka
Richard Thiessen	Kan. CATV Assn.	Manhattan
Ralph Skoog	KCATV	Topeka
Gary Smith	Shawnee Co.	Topeka
Christy Young	Topeka Chamber of Comm	Topeka
Ron Gaches	KCCI	TOPEKA

Kansas
DEPARTMENT OF REVENUE

State Office Building
Topeka, KS 66625

MEMORANDUM

March 13, 1984

TO: The Honorable James Braden, Chairman
House Committee on Assessment of Taxation

FROM: Harley T. Duncan
Secretary of Revenue

SUBJECT: SB 467 As Amended by the Senate--Relating to Trending Factors and the Valuation of Personal Property

Thank you for the opportunity to appear before you today on Senate Bill 467 relating to the use of trending factors in valuing certain personal property for tax purposes.

Provisions of the Bill

As amended, SB 467 no longer prohibits the use of trending factors in establishing fair market value for certain items of personal property as it did when it was introduced. Instead, it places several restrictions on the use of trending factors, including:

-- It requires the use of indices for a particular industry or type of property rather than allowing the use of the Consumer Price Index (CPI) as we do currently.

-- It requires a study to be made to determine the economic life to assign to a particular category of property.

-- It prohibits a trended value that is greater than original cost unless there is specific evidence to justify that it could be sold for more than its original cost.

In addition, the bill was amended to revise the current statutory definition of fair market value (K.S.A. 79-503a). That amendment prohibits use of the "going concern value" of a business in appraising personal property.

Background

In the interest of time, I would prefer to direct my remarks to the bill as it has been amneded, rather than revisiting the debate over whether trending factors should be retained as an appraisal tool in Kansas. By way of background,

EXHIBIT I 3/14/84

however, I have included the testimony presented by Mr. Phillip Martin, Director of Property Valuation, to the Senate Assessment and Taxation Committee on this subject. The highlights of that testimony can be summarized as follows:

-- Trending factors are simply a percentage multiple which when applied to the original cost of a piece of equipment are intended to reflect the replacement cost less depreciation, or fair market value, of that equipment. That is, the original cost of the equipment is first inflated by the change in CPI since the year of acquisition and then depreciated on a straight line basis over its useful life (with a retained salvage value) to arrive at its market value.

-- If property has been valued in error or is in other than "average condition" the county appraiser has the authority to view the item and determine if sufficient reason exists to use a valuation other than that found in the guide or determined by the trending factor.

-- Trending factors are used because the income approach to valuation is often inappropriate for a single piece of equipment, and there are insufficient sales data upon which to develop a comparable sales valuation. Furthermore, it is unreasonable to expect that anything resembling uniform and equal valuations could be achieved statewide if each county appraiser were required independently to determine fair market value without the use of a prescribed formula and guide.

-- The trending factor approach of replacement cost less depreciation is necessary because Kansas case law and Attorney General Opinions (79-50 and 80-82) have consistently held that straight line depreciation from original cost does not meet the required tests for fair market value.

-- The bulk of the increased valuation occasioned by statewide use of the trending factors was the result of two factors: (a) most of the property was previously being rendered on the value of the depreciated asset as determined under Internal Revenue Service depreciation schedules; and (b) a significant amount of property was not being rendered because it was no longer being carried on the taxpayer's IRS schedules, even though it had at least some salvage value.

SB 467 Restrictions on Trending Factors

As stated, the amended version of SB 467 requires that in the continued use of trending factors, the Department is to use an inflation index that is "reasonably applicable" to the industry or property affected, rather than the Consumer Price Index. Also, the Department is to conduct a study to determine the economic life to assign an asset and must document specifically the propriety of any factor which produces a fair market value that is greater than original cost.

It is the opinion of the Department that these restrictions can be made to work within certain limits. There are, however, several concerns of which the Committee should be aware.

First, the use of multiple or specific industry indices will make the local appraiser's job more cumbersome and difficult. A representative list of equipment cost indices for particular industries prepared by Marshall Swift Co. is attached in Table I. A separate table of trending factor multiples will have to be developed for each industry, and the appraiser will have to assign each business to a particular industry group. Where data are not available for a particular industry, the appraiser will have to choose that industry he/she feels is most representative of the particular business. Extensive debate and some loss of uniformity among counties are likely to ensue.

Second, the use of multiple indices will cause different values to be assigned to identical pieces of property simply because they are used in different industries. This results because the indices are a composite for all equipment used in a particular industry. Probably the most common example of where values for the same property will differ among industries is for office equipment. The existence of different values for the same type of property also will likely cause a greater deal of debate and concern.

Finally, and most importantly, the Committee should be aware that if indices such as the Marshall Swift equipment cost indices are used (and they tend to be the most complete, specific data available), they could very likely result in higher values than are currently being assigned through the use of the CPI-driven trending factors, especially with the 15 percent discount made in the CPI in 1983. The right-hand column of Table I expresses each index as a percent of the effective CPI (after the 15 percent discount) being used by the Department. As shown, the index for all industry groups except two is higher than the effective CPI being used by the Department. Even if the Department were to discount these indices similarly, the index would be higher in approximately 15 industry groups (those above CPI-U in the table). I should note that with specific industry equipment cost indices, any further discount would be difficult to justify.

I would also note that the Department has reviewed other broad-gauged inflation measures (see Table II). Here again, with one exception, all the measures exceed the effective CPI being used and are within roughly 10 percent of the unadjusted CPI.

In sum, while the first set of amendments to Senate Bill 467 can be made to work, they present several problems the Committee should consider, not the least of which is the potential effect on taxpayers.

Going Concern Value

The second amendment (lines 94-98, page 3) to SB 467 revises the current definition of fair market value to prohibit the Department from using the "going concern" value of a business, whether derived from capitalization of earnings, comparable sales or otherwise, in valuing or prescribing guides for valuing personal property. This amendment is considerably more problematic and objectionable to the Department. Adoption of the amendment would effectively eliminate the methods utilized currently in valuing certain specialized classes of property such as oil and gas, oil refineries, grain elevators and cable TV systems.

In valuing these properties, the Department tends to view the property as part of integrated whole rather than on a piece-by-piece basis and attempts to arrive at a valuation methodology which captures the value of the integrated whole. We do this for several reasons:

-- It is impractical or inappropriate to assign a value to a particular piece of equipment because it is so woven into a single process or is so distinct from other types of property that it has little or no value on a stand-alone basis.

-- These types of property, to a greater extent than others, tend to be bought and sold on an integrated or total basis because their equipment is not useable in other industries and has little except salvage value on an individual piece-by-piece basis.

-- Certain of the properties would be difficult, if not impossible, to value by other means.

Some examples may suffice to better explicate the utility of this appraisal methodology. In oil and gas valuation, which is defined by law as personal property, the intent is to ascribe a market value to the reserves underlying the lease as well as the equipment used on that lease. We do this by computing the present worth of an income flow based on the value of production in the prior year with allowances for operating cost and equipment costs. In other words, we look at the value of the lease as an operating unit.

Similarly, in the case of oil refineries, the valuation is established by looking at such items as throughput capacity, present use of that capacity and an industry-established complexity factor which measures costs and the ability of the refinery equipment to process crude oil into various refined products. Through this methodology, the valuation of the refinery equipment, as a whole, is established.

Not only do these methodologies establish a fair market value for a single property, but they also provide for uniform and equalized assessments among similar types of property in different taxing jurisdictions. In the absence of such methodologies, it is very likely that such uniformity would diminish or be non-existent.

In short, prohibiting the use of the going concern value for assessing certain types of personal property will effectively eliminate some of our more established valuation guides, seriously hamstring the Department and county appraisers, subject certain taxpayers to as yet unknown valuation methodologies and values, and likely lead to disparities among counties in the valuation of certain types of property. I ask that you reject the amendment to K.S.A. 79-503a contained in Senate Bill 467.

I would be glad to answer any questions.

HTD:1/2/S427

TABLE I

EQUIPMENT COST INDEXES*
(Converted to 1967 Base)
& CPI-U for 1/83 in Order of Size

		% of Effective CPI-U
Petroleum	315.6	127.1
Contractor's Equipment	312.3	125.8
Rubber	306.3	123.4
Shipbuilding	304.9	122.8
Logging Equipment	304.0	122.4
Cement Manufacturing	302.7	121.9
Clay Products	302.1	121.7
Metal Working	300.5	121.0
Mining & Milling	300.3	120.9
Paint Manufacturing	299.7	120.7
Brewing & Distilling	299.1	120.5
Steam Power	298.5	120.2
Candy & Confectionery	298.0	120.0
Refrigeration	296.2	119.3
Creamery & Diary	293.2	118.1
Airplane Manufacturing	292.4	117.8
*CPI-U	292.1*	--
Chemical	291.9	117.6
Packing (Meat)	291.6	117.4
Flour, Cereal & Feed	290.4	117.0
Glass Manufacturing	289.8	116.7
Cannery (fish)	288.0	116.0
Paper Manufacturing	287.9	115.9
Cannery (fruit)	287.2	115.7
Hospital	286.1	115.2
Bakery	285.8	115.1
Bottling	285.4	114.9
*Average of All	284.3*	114.5
Garage	284.1	114.4
Printing	282.0	113.6
Elec. Power Equipment	281.1	113.2
Laundry & Cleaning	279.8	112.7
Textile	278.4	112.1
Motion Picture	276.2	111.2
School	274.7	110.6
Woodworking	274.4	110.5
Elec. Equipment Manufacturing	274.1	110.4
Library	274.0	110.4
Packing (fruit)	273.2	110.0
Theater	271.7	109.4
Restaurant	270.5	108.9
Warehousing	267.9	107.9
Store	267.7	107.8
Hotel	265.3	106.8
Banking	264.2	106.4
Church	259.8	104.6
Office Equipment	257.4	103.7
Apartment	238.0	95.9
Dwelling	235.6	94.9

As reported by Marshall Swift

TABLE II

PRESENT INDEX	
CPI-U	
January, 1983:	292.1
Effective CPI (After 15% reduction)	248.3

ALTERNATIVE INDICES TO CPI-U:		ALTERNATIVE INDICES AS % OF EFFECTIVE CPI-U
Gross National Product (GNP), converted to 1967 base 1st Quarter, 1983:		
-Implicit Price Deflator	269.20	108.4
-Fixed Weight Price Index	276.4	111.3
Gross Private Domestic Inv., converted to 1967 base Non-residential, 1st Qtr., 1983:		
-Implicit Price Deflator	261.3	105.3
-Fixed Weight Price Index	286.3	115.3
Producer's Durable Equipment: converted to 1967 base		
-Implicit Price Deflator	215.7	86.9
-Fixed Weight Price Index	258.1	103.9
Producer Prices January, 1983:		
All Commodities	299.9	120.8
Finished Goods, Capital Equipment	285.2	114.9
Durable Goods	282.6	113.8

Kansas
DEPARTMENT OF REVENUE
State Office Building
TOPEKA, KANSAS 66625

January 16, 1984

TO: The Honorable Bud Burke, Chairman Senate Committee on Assessment and Taxation and Committee Members

FROM: Philip W. Martin, Director
Division of Property Valuation

I have been asked to speak to this committee concerning a number of questions which have arisen regarding the use and application of trending factors by the Property Valuation Division. First there seems to be some confusion as to exactly what a "trending factor" is.

What Are Trending Factors?

There is no magic in a trending factor. Trending factors are not devised to "create" high values for machinery. Trending factors are a tool used to determine current market value for machinery and equipment. There are three approaches appraisers may take to determine market value, the income approach, the comparative sales approach, and the cost approach. In many cases, the income approach is inappropriate because it is impossible to determine what portion of total income is contributed by each and every piece of equipment. The comparative sales approach may also be inappropriate if there is not a sufficient number of sales of each type of equipment to establish a market. Therefore, we use the cost approach. Trending factors provide an estimate of what it would cost to replace an item of equipment in todays market after an allowance for depreciation (Fair Market Value). The trending factor prescribed by the Division is the result of several mathematical calculations

EXHIBIT II 3/14/84

which take into account current replacement cost and physical depreciation; beginning in 1983 a 15% reduction was incorporated to recognize functional and economic obsolescence. In addition, trending factors take into account that all machinery and equipment retain a residual salvage value. The resulting factor, when applied to the original cost of an item of equipment, provides our best estimate of market value for that equipment if it is in average condition.

The attached example illustrates the variables which are considered when developing the factors. As shown on this example, any county appraiser or other interested party, could perform the calculations done in each of the six steps and arrive at market value. However, the Division has calculated a single "trending factor" which when applied to original cost produces virtually the same market value.

As previously stated, the use of trending factors provides the best estimate of market value in a uniform and simple to use form. However, it must be pointed out that in every case if a taxpayer feels that their property has been valued in error or is in other than "average condition" the county appraiser has the authority and the obligation to view the items in question to determine if sufficient reason exists to change that valuation. The Board of Tax Appeals has ruled that there must be documented reasons for changing values which are found in guides or determined by the use of trending factors.

Why Use Trending Factors?

There are three reasons the Division uses trending factors: First the Constitution requires that like property be appraiserd uniformly state-wide.

Second, Kansas statutes require that all property subject to general taxation be valued at its fair market value in money. Third, the statutes further require the Director to prescribe and furnish guides to be used for valuing property.

It is our opinion that the trending factors published by the Division fulfills all of the above requirements.

The Board of Tax Appeals ruled in the Capital City Rentals Inc. case that use of trending factors insures uniformity and equality. The Board stated:

> ". . .use of the trending factors other than those prescribed by the Director, is arbitrary and contrary to the ad valorem tax statutes of this State. The purpose of the Guides prescribed by the Director is to insure uniformity and equality of assessment of personal property, irrespective of its physical location in this State. Disregard of these Guides destroys that goal."

As we previously stated, there are three approaches to value an appraiser must consider when determining market value; income, comparative sales, and cost. In many cases involving machinery and equipment neither the income nor the comparative sales approach will produce market value. Therefore the only tool left for determining market value is replacement cost as determined by the trending factor.

Finally, as shown in the trending factor example, trending factors are relatively simple to use. When one considers the sheer volume of machinery and equipment that exists in each county you could not reasonably expect a single county appraiser to view each individual piece of property and attempt to establish a market value. This would be unreasonable even if we could assume that each county appraiser had at their command a thorough and complete knowledge of all the variables affecting the value of each and every type of machinery and equipment. Further, meeting the uniform and equal requirements in such a scheme would be virtually impossible.

<u>How Was Machinery and Equipment Valued Before?</u>

Prior to the Board of Tax Appeals order mandating that all counties determine market value by the use of the trending factors, counties used many different methods for determining value. The more common practice was to accept the taxpayers IRS Depreciation Schedule as evidence of both the items of personal property to be taxed and the valuation upon which those items were to be taxed; however, some other forms of original cost less straight-line depreciation rendered by the taxpayer were also used.

The IRS Depreciation Schedule and other taxpayer rendered depreciation listings may well provide much useful information relating to the types of property owned and the year it was purchased; however, it certainly does not provide fair market value. In Opinion Number 79-50, dated April 13, 1979, Attorney General Robert Stephan stated: ". . .it is obvious that 'original price less straight-line depreciation' and 'fair market value' are not equivalent bases on which to assess property." This position was restated in Opinion Number 80-82, dated March 31, 1980, in the following words:

> ". . .original price less straight-line depreciation very frequently will yield a significantly different valuation than that based on "fair market value." We again indicate that straight-line depreciation does not take into account many of the factors implicit in "fair market value," as defined in K.S.A. 79-503."

This problem is compounded by the fact that the IRS schedule does not always use straight-line depreciation. Rather, depreciation schedules are often accelerated to allow more depreciation in the early years an asset is placed in service so that an income taxpayer may recover the investment more rapidly, thereby stimulating further investment. In addition, the 1981 Economic Recovery Tax Act reduced the economic life of many assets in a fashion that is not consistent with the length of time an asset can reasonably be expected to perform and even within these shortened depreciation periods, depreciation is computed on an accelerated basis. Finally, an asset can be depreciated to zero value for income tax purposes.

Obviously, even though an item of equipment has been fully depreciated for federal income tax purposes, if that item remains under the taxpayers control it has a value. This value was not being reported or taxed as long as county appraisers were relying solely upon IRS schedules for valuation.

What Is Our Opinion of a Bill Which Would Prohibit Factoring?

It is our opinion that any bill which would disallow one of the accepted methods of appraisal for one class of property would have serious constitutional questions.

We realize that the bill under consideration, unlike some of its predecessors dealing with farm machinery, does not overtly define fair market value as something other than fair market value. However, by statutorily removing the only tool this Division has for determining fair market value for a particular class of property the ultimate impact is the same. It is our opinion that in this event the courts may find that an unconstitutional classification has been created.

In addition, if each county is placed on its own with the assignment to determine market value any semblance of uniformity among counties is destroyed. Obviously, this creates another serious constitutional question.

To reiterate, it is our position that current procedures are fulfilling both the constitutional and statutory mandates of uniformity and fair market value. Any legislation which is designed to substantially alter those procedures could only be taken as an attempt to force the Division to violate one or both of those mandates.

PWM:b/1076/S269

TRENDING FACTOR EXAMPLE

Assume a piece of equipment was purchase new in 1975; has an economic life of 10 years; and the original purchase price was $15,000.

STEP I — Consumer price index in 1975 = 156.1
Consumer price index in 1984 = 308.0

This is an increase of 97% from 1975 to 1984.

STEP II — Therefore: The machine which cost $15,000 in 1975 would cost $29,550 in 1984.

[$15,000 X 1.97 = $29,550]

STEP III — However: The subject machine is now 9 years old to adjust for this the present cost is first reduced by 10% to reflect salvage value.

[$29,550 - 10% = $26,595]

The $26,595, non salvage value is divided by the 10 year economic life to determine yearly depreciation.

[$26,595 ÷ 10 = $2,659]

STEP IV — As this machine is 9 years old total depreciation can be calculated by multiplying 9 times the annual depreciation calculated above.

[9 X $2,659 = $23,931]

STEP V — Current Value is calculated by subtracting depreciation from current replacement cost.

[$29,550 - $23,931 = $5,619]

STEP VI — The Division recognizes that much, if not most, business machinery is not sold to another direct user but is instead used as a trade-in, or sold at wholesale. Therefore, a 15% reduction in the value calculated above is made both in the printed guides and in the trending factors to recognize these factors of functional and economic depreciation.

[$5,619 - 15% = <u>$4,776 Market Value</u>]

(Continued)

COMPARISON

1984
TRENDING FACTORS

Purchase Year	3 Years	5 Years	7 Years	10 Years	12 Years	15 Years	20 Years	25 Years	30 Years	Purchase Year
					Economic Life					
1984	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1984
1983	.63	.73	.79	.81	.83	.84	.85	.86	.87	1983
1982	.37	.60	.69	.76	.79	.82	.84	.86	.87	1982
1981	.10	.46	.62	.73	.78	.82	.87	.90	.91	1981
1980		.32	.55	.72	.79	.85	.92	.96	1.00	1980
1979		.13	.46	.71	.80	.90	1.00	1.05	1.09	1979
1978			.32	.65	.77	.90	1.02	1.10	1.15	1978
1977			.15	.55	.71	.87	1.03	1.12	1.18	1977
1976				.44	.63	.82	1.01	1.12	1.20	1976
1975				$\boxed{.32}$	.54	.77	1.00	1.13	1.22	1975
1974				.19	.47	.75	1.03	1.20	1.32	1974
1973					.38	.70	1.03	1.24	1.37	1973
1972					.21	.60	.98	1.21	1.36	1972
1971						.48	.91	1.17	1.34	1971
1970						.37	.86	1.15	1.34	1970
1969						.25	.80	1.13	1.35	1969
1968							.72	1.09	1.34	1968
1967							.62	1.03	1.30	1967
1966							.52	.97	1.28	1966
1965							.41	.88	1.20	1965
1964							.28	.79	1.13	1964
1963								.70	1.06	1963
1962								.61	.99	1962
1961								.50	.91	1961
1960								.41	.83	1960
1959								.30	.76	1959
1958									.67	1958
1957									.60	1957
1956									.52	1956
1955									.43	1955
1954									.33	1954

STEP I Trending Factor from the 1984 Guide for machinery purchased in 1975 with an economic life of 10 years = .32.

[Original Cost = $15,000 X .32 factor = $4,800 Market Value]