Approved Feb. 12, 1987
Date

MINUTES OF THE Senate COMMITTEE ON Assessment and Taxation.

The meeting was called to order by Senator Fred A. Kerr at
Chairperson

11:00 a.m./~~p.m.~~ XXX on February 9, 1987 in room 519-S of the Capitol.

All members were present except:

Committee staff present:
Tom Severn, Research
Chris Courtwright, Research
Don Hayward, Revisor's Office
Sue Pettet, Secretary to the Committee

Conferees appearing before the committee:
Don Schnacke, Kansas Independent Oil & Gas Association
Robert A. Anderson, Mid Continent Oil & Gas Assoc.
Secretary Harley Duncan, Department of Revenue

Chairman Kerr called the meeting to order and said that the committee agenda today would to be have a hearing on Senate Bill 75.

SENATE BILL 75

Don Schnacke, KIOGA, confirmed that his organization asked for the bill to be introduced and he testified in support of S.B. 75. He stated that the need for the bill arose out of a sales tax audit by the State Department of Revenue. He said that the bill would confirm that cement, casing and drill bits used in the drilling of a well would be included under the definition of consumables which would make them exempt from the state sales tax. He said that a recent decision by the department changed past policies in that drill bits and cement had not been previously taxed and that casing had only been taxed in certain instances. He said that statutes makes it clear that the original construction of an oil or gas well is intended to be exempt.

Mr. Schnacke said that the application of the sales tax to oil field activities is still very confusing to the industry. He said that the audit concerning Frontier Oil Company, a small independent company based in Wichita, resulted in the decision for the first time that cement drill bits and pipe used in the oil field were not consumables as defined under KSA 79-3602 (m).

Mr. Schnacke did say that he would support an amendment in line 0129 to clarify that "casing" in this instance means "unrecoverable casing, pipe and tubing that is cemented in place." (See Attachment 1)

Robert Anderson testified in support of S.B. 75. (Attachment 2) He stated that KSA 79-3602 (m) refers to "property which is consumed" meaning tangible personal property which is essential or necessary to and which is used in the actual process of and immediately consumed or dissipated in drilling. He feels that cement, drill bits and casing should be included in that definition.

Secretary Harley Duncan expressed concern about S.B 75 in its present form. He said his testimony is not to address the merits of the exemption but instead to address the manner in which the exemption would be accomplished. The Department's primary concern is with changing a definition section to include something that the courts through applying legal tests have ruled are not within the definition. This could lead to one or more of three possible problems.

1. It could be held as invalid as an unreasonable classification.
2. It could be interpreted to indicated legislative intent to broaden the meaning of "consumed" to include other types of machinery, equipment and property which wears out and cannot be reused and recovered. This could greatly broaden the exemption.
3. It opens a path for owners and users of other types of property to claim that their property now also falls within the meaning of consumed.

He said that if the committee desires to exempt drill bits, casing and cement used in oil exploration and production that the Department recommends that KSA 79-3606, the normal sales tax exemption statute, be amended by adding a new subsection (gg) to cover the desired property. (See Attachment 3)

Senator Karr asked if there would be a Fiscal Note. Secretary Duncan stated that it would be difficult to determine a fiscal note but would try to bring some information back to the committee.

Senator Montgomery made the motion to accept the minutes of February 4th meeting. Senator Hayden seconded. Motion carried.

Meeting adjourned.

ASSESSMENT AND TAXATION

OBSERVERS
(PLEASE PRINT)

DATE	NAME	ADDRESS	REPRESENTING
2-9-87	Don Schnacke	Topeka	KIOGA
2/9/87	Jeff Chanay	Topeka	KIOGA
"	Rebecca Crenshaw	"	Mesa
"	Ken Peterson	"	KS Petroleum Council
"	Ross Martin	"	"
2-9-87	Robert G. Cochrane	Ottawa	MidCont Oil & Gas
2-9-87	TREVA POTTER	TOPEKA	PEOPLES NAT. GAS
2-9-87	WALTER DUNN	✓	EKOGA
"	Terry Humphrey	Topeka	KMHI
2/9/87	BEV BRADLEY	TOPEKA	KS Assoc of Counties
2/9/87	Alvie L. Price	Topeka	KBA

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February 9, 1987

TO: Senate Committee on Assessment & Taxation

RE: SB 75 - Sales Tax
on Oil & Gas Wells

SB 75 addresses a problem that arose out of a sales tax audit by the State Department of Revenue. The net effect of what happened is that our industry got a tax increase when it is supposed to be exempt from sales tax in the drilling of an oil and gas well.

KSA 79-3603 imposes the sales tax on the sale, rendering, or furnishing of services defined under the act. KSA 79-3603 (P) specifically indicates that "no tax shall be imposed upon the service of installing or applying tangible personal property in connection with the original construction of a ... facility..." . Under KSA 79-3603 (P)(3) the legislature defines a "facility" as an "oil or gas well". It is clear that the original construction of an oil or gas well is intended to be exempt.

There are no rules or regulations that help further define the many oil field transactions and services. There have been a few Department of Revenue letters written. There have been audits, appeals, and limited court decisions. The application of the sales tax to oil field activities is still very confusing. Most taxpayers complain of this confusion and want clarification so they will know when to collect or pay the sales tax.

The Department and the industry long ago developed a list of 105+ transactions and services commonly found in the oil field. Each transaction is identified as "taxable" or "exempt". That list has only been a source of continued confusion.

If you study the list of 105 transactions and services, it boils down to a simple application - a new well - old well concept. New well activity and services are generally exempt and old well activities are taxable. We have always thought if the Department could draw up simple rules and regulations relating to the new well-old well concept, relating to the transactions and services, the average taxpayer could understand and follow them.

We asked your committee January 21, 1987 to urge the Department of Revenue to clarify by rules and regulations the application of the 105+ oil field transactions and services into simple definitions that the taxpayers will know how to apply to the sales tax.

The failure of the Department to issue rules and regulations is a real problem. (See article - 1/30/87)

SB 75 was brought on as a result of an audit concerning Frontier Oil Company, a small independent company based in Wichita. The audit and subsequent appeals resulted in the decision for the first time that cement, drill bits and pipe used in the oil field were not consumables as defined under KSA 79-3602 (m), which states:

> "'Property which is consumed' means tangible personal property which is essential or necessary to and which is used in the actual process of and immediately consumed or dissipated in (1)...drilling...but the listing of such property shall not be deemed to be exclusive nor shall such listing be construed to be a restriction upon or an indication of, the type or types of property to be included within the definition of 'property which is consumed' as herein set forth:..."

The audit and the findings of the Department and the confirmation by the courts had the effect of imposing the sales tax on these items when they have been considered by the taxpayers to be exempt. The Department, in 1986 following the decision, started going back to taxpayers to collect back sales taxes they believed were owed. (Sun Cementing Company of Eureka, Ks.)

We think the legislature exempted drilling of oil and gas wells from the sales tax and we feel all services, supplies and materials that go into those wells should be exempt. Further, we feel cement, bits, and pipe used in drilling an oil and gas well are exempt and, additionally, are economically consumed when they are not retrievable and are lost forever. That is the basis for SB 75.

We would suggest you modify the definition of "casing" on line 0129 to be "unrecoverable casing, pipe and tubing that is cemeted in place."

Donald P. Schnacke

DPS:pp

Tax Law Is Costly Surprise

Wichita Eagle-Beacon
January 30, 1987

By Bill Bartel
Staff Writer

Sometime in the past two years a group of Kansas revenue officials quietly changed the state's rules to require a sales tax on the services of commerical photographers and graphic designers.

Trouble is, they never told the photographers and designers.

One by one, the business owners discovered the new rule when they were audited and ordered to pay thousands of dollars in back taxes — some more than 10 years' worth — and penalties.

Revenue auditors told the owners they should have charged their clients — ad agencies or companies — a sales tax on their labor.

For Gail Hendry, who runs a one-person ad graphics shop, the revised policy has meant cashing in savings to come up with $1,700 in back sales taxes and penalties.

"I don't mind collecting it if this is what the law says," Hendry said. "But just to spring it on us isn't fair."

Hendry is one of many Wichita business operators who in the past year have been ordered to come up with the tax money because they and their accountants never had been told the state was changing its interpretation of tax laws.

Some, like Ron Christie, who owns Airtight Studios, have been audited and still are waiting to hear how much they owe. State officials are projecting his unpaid sales taxes back nine years.

"I can't pay. I don't have it," said Christie, who thinks he'll be forced out of business. "If they

● TAX, 4B, Col. 1

Businessmen Decry Tax Bills, Penalties

● TAX, From 1B

want me to collect a tax, they ought to tell me."

The issue centers on how revenue auditors interpret what portions of a bill to another business should be covered by the sales tax.

In the past, the seller was required to charge a sales tax on the materials sold, but didn't have to charge the tax on personal services.

But after what revenue officials call an in-house "clarification" of that rule, those same businesses now have to charge a tax on their services.

"That's true: We never issued revenue ruling or regulation on this point," said Cleo Murphy, the revenue department's sales tax bureau chief. "That is something we need."

The department routinely notifies many business taxpayers or their accountants when the Legislature changes tax laws, but not always when the changes are made by department staff members, Murphy said.

Because state records of the audits are kept confidential, most businesses had no way of finding out about the policy change until they were audited and slapped with the overdue tax bills and penalty charges, said Joan Faust, an accountant for several businesses affected by the new policy.

"It's extremely difficult for someone to know what their (revenue officials) views are because they're not published," Faust said.

> "I can't pay. I don't have it. If they want me to collect a tax, they ought to tell me."
> — Ron Christie, Airtight Studios owner

Roland Smith, head of the Wichita Independent Business Association, said the issue has become public in recent months because business owners, who normally keep quiet about their own audits, have found others have the same problem.

"If the revenue people get their way, it's going to put quite a few small independent businesses out of business," Smith said.

Many businesses are appealing the audit rulings through the state Board of Tax Appeals, but it doesn't matter if the owners were unware of the department's interpretation of the tax code, said Carol Bonebrake, the department's director of taxation.

"There's not really any negotiations," Bonebrake said. "There's nothing in the statute that gives anybody in revenue or the Board of Tax Appeals or the courts any discretion on ignorance ... Ignorance is no excuse."

Statement of Robert A. Anderson on behalf of
Oklahoma-Kansas Division
Mid-Continent Oil and Gas Association
at a hearing before the
Seneate Assessment Taxation Committee

Monday, February 9, 1987

1. The new language in Senate Bill Number 75 is at line 129 and 130 page 4 of the bill. The language concerning drill bits and cement is probably alright. But it was not intended that all casing be exempted, only casing which was cemented in the hole and could not be removed. All other casing which is removable would be taxed for sales tax.

2. Section 79 -3603 (p) states in part, except that no tax shall be imposed upon the service of installing or applying tangible personal property in connection with the original construction of a building or facility."- - - Section 79-3603 p (3), defines a facility as a "mill, plant, refinery, oil or gas well" and so forth.

3. 79-3602 (m) K.S.A. "Property which is consumed" "means tangible personal property which is essential or necessary to and which is used in the actual process of and immediately consumed or dissipated in (1) the production, manufacture, processing, mining, drilling, refining or compounding of tangible personal property, (2) the providing of services or (3) the irrigation of crops, for sale in the regular course of business, and which is not reusable for such purpose."

4. In the case of R. L. Polk and Company vs Harold A. Armold, director of taxation. The Supreme Court of Kansas held that, "Lithoplates used in printing of City Directories were, "consumed in production" "and manufacture of tangible personal property within retailers sales tax act exemption for sales of tangible personal property consumed in production or manufacture of personal property."

5. As mentioned by Mr. Schnacke, the Court of Appeals recently held in a case involving the tax department and Frontier Oil Company, that cement drill bits and pipe used in the oil fields were not consumables as defined under K.S.A. 79-3602 (m). As we understand it the Supreme Court refused to accept this case, the Frontier Case will therefore be the law of the land unless the legisature give the industry some relief. We don't believe it was ever the intention of the legisature to tax these items based on the statutory language, however, we must accept the fact that the issue went against us in Court.

Robert A. Anderson

Sen. A & T
2/9/87 Att. 2

MEMORANDUM

TO: The Honorable Fred A. Kerr, Chairman
Senate Committee on Assessment and Taxation

FROM: Harley T. Duncan
Secretary of Revenue

RE: Senate Bill 75

DATE: February 9, 1987

Thank you for the opportunity to appear before you on Senate Bill 75. The Department opposes enactment of the bill in its present form. Our concerns stem not from the intention of the bill, but rather the manner in which it goes about it.

As introduced, Senate Bill 75 amends KSA 79-3602(m) which is the definitional section of the Retailers' Sales Tax Act regarding property consumed in the production, manufacture, etc. of tangible personal property. It does so by adding specific reference to "drill bits, casing and cement actually utilized in the exploration and production of oil or gas" as consumed property.

Background

Presently, the section defines property which is consumed as "property which is essential or necessary to and which is used in the actual process of and **immediately consumed or dissipated** in the production, manufacture" ... etc. of tangible personal property for sale in the normal course of business and **which is not reusable for such purpose.** The section works with KSA 79-3606(n) which provides a sales tax exemption for property consumed in the production, manufacture, etc. of tangible personal property.

The "consummable" exemption is one of several exemptions which exist (along with ingredient and component part and sales for resale) that enable the Retail Sales Tax to accomplish its intended purpose. That being the levy of an excise tax, once and only once, on all retail transactions and to insure that the consumer, not the retailer, bears the burden of the tax. Absent such exemptions, there would by a "stacking" or pyramiding of taxes and any given final product could bear the sales tax several times.

SB 75 is a direct response to a recent Kansas Court of Appeals decision, **In the Matter of the Appeal of George Angle, d/b/a Frontier Oil Company v. Department of Revenue, 11 Kan. App. 2d 62 (1986).** In Frontier Oil, the Court found specifically that drill bits, casing and cement **were not consumed** in the production of oil and gas within the meaning of KSA 79-3602(m). The Court applied its reasoning from a 1974 case (**R.L. Polk and Co. v. Armold**) and determined that all three items are standard products utilized in the drilling of any typical well, that they are not designed for a specific customer to perform a specific job, and that drill bits may be used on more than one drilling job and cement and casing serve a useful purpose for as long as fifty years.

The **Polk** decision held that property which is not standard, is designed solely for a specific customer to perform a specific task and has value only as scrap after performing said task is consumed within the meaning of KSA 79-3602(m). The **Polk** decision barred from exemption items which wear out, depreciate, break, erode or become obsolete.

Department Concerns

The Department's primary concern is with changing a definitional section to include something that the Courts through applying some longstanding tests have specifically ruled are not within the definition. We feel this could lead to one or more of three possible results:

1. It could be held as invalid as an unreasonable classification because it is limited to products used in oil exploration and production where the same products are used for other types of drilling and in other activities. Similarly, KSA 79-3603(p) and (q) impose taxability generally on contractors, subcontractors and repairmen. SB 75 would segregate oil and gas well contractors from these statutes.

2. It could be interpreted to indicate legislative intent to broaden the meaning of "consumed" to include other types of machinery, equipment and property which wears out or cannot be reused and recovered. In this case, the fiscal impact is well beyond that envisioned here.

3. At the very least, it opens a path for owners and users of other types of property to claim that their property also falls within the meaning of "consumed" as rewritten in SB 75. Again, the fiscal and policy impact far exceeds that envisioned in SB 75.

Conclusion

In short, we fear that rewriting the definition of consumed property creates a situation in which a number of unintended consequences could result. The actual determination of what is consumed and what is not is a factual question and a function of the courts applying tests and case law developed over time. The current definition has served well in accomplishing its intended purpose for about 20 years. We would urge you not to amend KSA 79-3602(m). If the Legislature desires to exempt drill bits, casing and cement used in oil exploration and production, we would recommend that KSA 79-3606, the normal sales tax exemption statute, be amended by adding a new subsection (gg) to cover the desired property.

Thank you for the opportunity to appear on this matter. I would be glad to answer any questions