Approved: February 7, 2003
Date

MINUTES OF THE HOUSE TAXATION COMMITTEE.

The meeting was called to order by Chairperson John Edmonds at 9:00 a.m. on January 16, 2003 in Room 519-S of the Capitol.

All members were present except: Rep. Ted Powers

Committee staff present: Chris Courtwright, Legislative Research Department
April Holman, Legislative Research Department
Gordon Self, Office of the Revisor
Carol Doel, Committee Secretary

Conferees appearing before the committee: Joan Wagnon, Acting Secretary of Revenue
Rick Clellan, Department of Revenue
Richard Cram, Department of Revenue
Alan Conroy, Legislative Research Department
Chris Courtwright, Legislative Research Department
April Holman, Legislative Research Department

Others attending: See Attached List

Chairperson Edmonds opened with the introduction of Richard Cram of the Department of Revenue who in turn introduced Joan Wagnon, Acting Secretary of Revenue. Ms. Wagnon presented testimony to the committee regarding information about sales tax, use tax, and taxation of remote sales (Attachment 1) as well as a summary of Kansas Legislative changes required by a streamlined sales tax agreement. (Attachment 2) Booklets have been ordered which describe the streamlined tax project.

The Department of Revenue also requested the conceptual introduction of a streamlined tax bill. This was accepted by the committee.

Another conceptual bill introduction which was requested from the committee by Secretary Wagnon on behalf of the Department of Internal Revenue was one on the Board of Tax Appeals that would incorporate the governor's recommendation to reduce the Board of Tax Appeals from 5 to 3.

Without objection from the committee, Chairperson Edmonds accepted the conceptual introduction of the bill regarding the membership of BOTA (Board of Tax Appeals) .

Following her presentation Secretary Wagnon along with two representatives from the Department of Revenue, Rick Clellan, the point person on streamlined sales tax, and Richard Cram, stood for questions from the committee.

Chairperson John Edmonds requested the introduction of three bills into the Taxation Committee which are as follow:

1. Removal of premium tax on health insurance policies

2. Reverse the treatment for Class C inheritance tax enacted last year in SB 39

3. Enact conformity with the Federal and State inheritance taxes

There was no opposition to the introduction of these three bills.

Alan Conroy, Chief Fiscal Analyst, appeared before the committee with a summary overview of the Kansas Budget. This review included changes from the end of the 2002 session of the Legislature as well as selected key budgetary decisions for the 2003 Legislature. (Attachment 3)

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

Also presented by Alan Conroy, was the State General Fund (SGF) Receipts from July through December 2002. This report deals essentially with the difference between the estimated and actual receipts in November and December. (Attachment 4)

Following Mr. Conroy's presentation, he stood for questions from the committee.

Representative Huff absorbing the duties of Chairperson in the temporary absence of Representative Edmonds inquired regarding any further bill introductions at this time.

Reports of the Special Committee on Assessment and Taxation to the 2003 Kansas Legislature were presented by Chris Courtwright and April Holman from the Legislative Research Department.

Mr. Courtwright reported on the Family Development Program, Legal Issues Regarding Expansion of Tax Credits to Railroads and Other State Assessed Property, Sunsetting Sales Tax Exemptions and Motor Vehicle Tax. Ms. Holman reported on Property Tax Exemptions for Certain Not-for-Profit Independent Living Centers (SB 479) as well as Sales Tax Parity on the Sale of Firearms, Weapons, and Ammunition. (Attachment 5)

Both Mr. Courtwright and Ms. Holman stood for questions from the committee.

With no further business to come before the committee, Vice-Chairperson Huff adjourned the meeting at 10:30 a.m.

HOUSE TAXATION COMMITTEE

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GUEST LIST

DATE Jan. 16, 2003

NAME	REPRESENTING
Christy Caldwell	Topeka Chamber of Commerce
Todd Johnson	KLA
Ann Durkes	DOB
Haakon Marsden	
Danielle Noe	Johnson County
Tom Bruno	GBBA
Larry R Baer	LKM
Rick Clelland	KDOR
Julie Hein	Hein Law Firm
Cindy Shaw	Kearney & Assoc. Inc
Stuart Little	Westar Energy
Bob Vancrum	Greater KC Chamber
Harriet Lange	KAB
Christi Stewart	KMCA
Bob Kuehhiel	KIOGA
Michelle Peterson	Kansas Gov. Consulting
Bernie Koch	Wichita Area Chamber
Karl Peterjohn	Kansas Taxpayers Network
Randall Allen	Kansas Association of Counties
Martha Jean Smith	KMHA

K A N S A S

JOAN WAGNON, ACTING SECRETARY

DEPARTMENT OF REVENUE
POLICY AND RESEARCH

KATHLEEN SEBELIUS, GOVERNOR

To: **Representative John Edmonds, Chair**
House Taxation Committee

From: **Joan Wagnon, Acting Secretary of Revenue**

Re: **Sales and Use Tax and Taxation of Remote Sales**
Current Status of Streamlined Sales Tax Project

Date: **January 16, 2003**

Sales and Use Tax

The sales tax was first enacted in Kansas in 1937. It became a popular revenue-raising vehicle for many States during the Depression. This popularity has grown. Currently, 45 States have enacted the sales tax. Nationwide, sales tax is estimated to provide approximately a third of total State tax collections. Hellerstein & Hellerstein, *State Taxation*, ¶ 12.01. In Kansas, in FY 2002, state and local sales and use tax accounted for approximately 28% of total State and local tax revenues. The sales tax is an essential financing tool for both State and local governments.

Sales tax is imposed on the gross receipts received from the retail sale of tangible personal property or certain taxable services. K.S.A. 79-3603. It is paid by the consumer. The retailer is obligated to collect the tax from the consumer at the time of the sale, and report and remit the tax to the State. K.S.A. 79-3604; 79-3607. If the retailer does not collect the sales tax from the consumer on a taxable sale, then the State can collect the tax from the retailer or the consumer. As a practical matter, in most situations, the State would collect unpaid sales tax from the retailer. Any retailer making taxable sales in the State must first register with the department. K.S.A. 79-3608.

Use tax is imposed on the use, storage or consumption of tangible personal property in the State. K.S.A. 79-3703. It applies to goods purchased outside the State. The use tax complements the sales tax. Use tax was developed to safeguard State sales tax revenues from erosion by purchases of goods outside the State, and to protect local merchants from loss of business to border and other States that either have no sales tax or whose sales tax rate is lower than that of the merchant's State. Hellerstein & Hellerstein, ¶ 16.01.

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Taxation of Remote Sales

The purchaser is obligated to pay use tax to the State of residence on out-of-state purchases. Except for businesses subject to regular audits, unless the out-of-state retailer collects use tax from the purchaser and remits it to the State, as a practical matter, it will not be paid. The viability of both the sales and use tax depends primarily upon the collection, reporting and remittance functions that retailers perform. In order for States to obtain an acceptable compliance rate on payment of use tax on remote sales to consumers, out-of-state retailers must be obligated to collect and remit use tax on those sales.

Under Kansas law, an out-of-state retailer "doing business" in Kansas is obligated to collect and remit use tax on its sales to consumers in Kansas. K.S.A. 79-3705c. However, United States Supreme Court decisions have restricted the constitutional power of the States to subject interstate sales to sales or use tax. In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the Supreme Court held that the Commerce Clause bars a State from imposing a use tax collection duty on an out-of-state seller with no physical presence (nexus) in the State. Thus, an out-of-state merchant has no legal obligation to collect use tax on its sales to customers located in another State, if the sale is conducted by telephone, mail order, or in recent times, the Internet, and if the out-of-state merchant has no physical presence in that State.

Physical presence, or nexus, is established if the out-of-state retailer has agents, employees or a facility permanently located in the State. Temporary presence can be sufficient to establish nexus under certain circumstances (such as frequent deliveries into the state). However, this is currently a heavily litigated area of the law.

A "brick and mortar" retail store located in the taxing State obviously establishes nexus. What about an out-of-state dotcom affiliate of the in-state retail store? Will the retail store create nexus for the out-of-state affiliate dotcom business? So long as the retail store and dotcom affiliate are separate entities and the retail store does not act as an agent or representative of the dotcom business for purposes of establishing or building a market, these types of businesses have maintained that the physical presence of the in-state retail store does not establish nexus for the out-of-state dotcom affiliate. See, *e.g.*, *SFA Folio Collections, Inc. v. Tracy*, 652 N.E.2d 693 (Ohio 1995). If the retail store accepts returns from retail sales of the dotcom affiliate under the same terms that it accepts returns of merchandise purchased from any other retailer, the argument is made that the retail store is not operating as an agent or representative of the dotcom affiliate. However, if the retail store discriminates in its acceptance of returns from the dotcom affiliate sales, in comparison to its acceptance of returns from sales by other retailers, or if the retail store promotes the dotcom affiliate with such things as coupons, then the risk that the retail store activities will establish nexus for the dotcom affiliate escalates. See, *e.g.*, *In re Borders Online, Inc.*, Docket No. SC OHA 97-638364 (California State Board of Equalization 2001) (retail store provided cash refunds for returns of merchandise sold by dotcom affiliate, but would not provide cash refunds for returns of merchandise sold by competitors—nexus established); *In re Barnes & Noble.com*, Docket No. SC OHB 97-

732835 (California State Board of Equalization) (retail store distributed discount coupons for purchases made through dotcom affiliate; dotcom affiliate logo appeared on shopping bags of retail store—nexus established).

State governments and local merchants have long been concerned about the fact that mail-order consumer retail sales by out-of-state merchants essentially escape use tax. The rapid growth of remote retail sales over the Internet have heightened those concerns.

Streamlined Sales Tax Project

The Streamlined Sales Tax Project (SSTP) responds to the concerns of merchants about the difficulties in dealing with different States' sales tax laws, and to State and local government concerns about loss of revenues from remote retail sales by mail-order, telephone and the Internet. The SSTP also seeks to "level the playing field" between in-state and out-of-state merchants regarding the tax burden on retail sales to customers in the taxing State. The SSTP's goal is to make administration of State sales and use tax laws more uniform, efficient, and less burdensome on multi-state merchants. The SSTP seeks to provide incentives for multi-state merchants to voluntarily collect and remit use tax on sales to customers in States where they may not have any physical presence or legal obligation to collect and remit. If the SSTP is successful in demonstrating to Congress significant reform in making sales tax laws more uniform and less administratively burdensome on multi-state retailers, then Congress may decide to authorize those States to impose use tax collection duties upon remote retailers. The SSTP enjoys the strong support and active involvement of 34 participating States, as well as the National Governors Association (NGA), National Conference of State Legislatures (NCSL), Federation of Tax Administrators (FTA) and the Multistate Tax Commission (MTC). More information on this Project is available by visiting the following website: www.streamlinedsalestax.org.

Phase 1

Phase 1 of the Streamlined Sales Tax Project began in March, 2000 and involved the drafting and approval of the Uniform Sales and Use Tax Administration Act ("Act") and Streamline Sales and Use Tax Agreement ("Agreement") (available on the website) by the participating States. The Act and Agreement were submitted to the participating States for consideration by their respective legislatures, beginning in January of 2001. However, two versions of the Agreement existed at that time, one version approved by the SSTP, and another, containing several changes, approved by the NCSL.

Phase 2

Phase 2 encompassed the efforts by the legislatures of the participating States in adopting the Act and making the legislative changes necessary to conform to the uniformity requirements of the Agreement. At present, at least 32 States (including Kansas, after passage of Senate Bill 472) and the District of Columbia have passed some form of the Act and are now considered Implementing States. South Carolina most

recently joined this group (July 2002). Wyoming, Minnesota, Illinois and North Carolina have adopted both the Act and the Agreement.

Phase 2 also involved consideration and approval by the Implementing States of various amendments and additions to the Agreement, in order to produce one version of the Agreement acceptable to all. An inaugural meeting of the Implementing States of the Streamlined Sales Tax Project was held November 28-29, 2001, in Salt Lake City, Utah. The NCSL and National Governors' Association (NGA) worked closely with this group. The Implementing States finalized and approved the amendments, and one version of the Agreement was adopted at the Chicago meeting held November 12, 2002. Senator David Corbin and Rick Clelland from the Department participated in that historic meeting. Now that the Agreement has been finalized, participating States' legislatures will be need to consider the sales tax statutory changes needed to conform to the uniformity requirements of the Agreement by the spring or summer of this year. Attached is a summary of the legislative changes that will need to be made for Kansas sales tax law to conform to the Agreement.

The Streamlined Sales Tax Project group, which serves in an advisory capacity to the Implementing States and consists largely of tax administration officials from participating states, will be meeting in Tampa, Florida on January 23-24 to study issues involving proposals for future additions to the Agreement. Rick Clelland of the Department will be attending the Tampa meeting. Although future additions to the Agreement will be discussed, the Agreement will not be changed further until participating State legislatures have had the opportunity to adopt legislation conforming to it this year.

The Department is currently finalizing a draft legislative proposal for presentation to the Kansas Legislature early in this session, containing the sales tax law changes that will need to be made in order for Kansas to join the Agreement.

Phase 3

Phase 3 will involve implementation of the Agreement. Under the governance language in the Agreement recently approved by Implementing States, the Agreement will take effect once at least 10 States with at least 20% of the total population of States imposing sales tax have adopted the Act, made the necessary legislative changes to meet the uniformity requirements, and joined the Agreement. Those States will make the Streamlined Sales Tax System operational. The goal of the participating States is to have the Agreement implemented by the fall of this year, with the required number of States having joined the Agreement by then.

Moratorium on Internet Taxation

The Internet Tax Freedom Act (ITFA), passed by Congress in 1998, placed a moratorium on State and local government taxation of Internet access fees and imposition of multiple or discriminatory taxes on electronic commerce. Although the moratorium

expired on October 21, 2001, Congress re-imposed the moratorium in H.R. 1552 in November 2001, for two years until November 1, 2003. Several legislative proposals were introduced in Congress during the months leading up to the October 21, 2001 expiration date, raising two issues: (1) whether States' progress on streamlining sales tax laws should be coupled with Congressional authorization for States to impose use tax collection duties on remote retailers; and (2) whether Congress should legislate higher nexus standards for various state business taxes. Neither of these issues were resolved and both will likely continue to be debated during the current two-year moratorium. Legislation was introduced by Representatives Cox and Wyden in Congress on January 7 to make the moratorium permanent.

During the debate over whether to extend the ITFA moratorium, the lobbying efforts of the NGA, NCSL, MTC and FTA, as well as retail organizations and various States, communicated to Congress the current tight fiscal situation of the States, the serious loss of uncollected tax revenues occurring with Internet and other remote retail sales, and the importance to the States of linking progress on sales tax simplification with Congressional authorization for States to impose use tax collection duties on remote retailers. With the two-year re-imposition of the moratorium, the States have the opportunity to show Congress significant progress on sales tax simplification by the time the moratorium approaches expiration next November. The groundwork has been laid for Congress to address the authorization issue then. Implementation of the Agreement by a sufficient number of States prior to November will go a long way toward making the necessary demonstration of sales tax simplification reform to Congress.

The report entitled "State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates" (and its earlier version) by Donald Bruce and William F. Fox, Center for Business and Economic Research, University of Tennessee, dated September 2001 (copy available), has been cited to Congress by those testifying in support of the SSTP and the need for Congress to authorize States to require remote retailers to collect and remit use tax on retail sales. This report estimated that for 2001, States would collectively lose $7 billion in new sales/use tax revenue from e-commerce retail sales. Of that $7 billion figure, the report estimates that $71.2 million is Kansas' loss.

Conclusion

The Implementing States finalized and approved the Agreement last fall. State legislatures will need to consider sales tax law changes to conform to the Agreement in this year, in order to be able to join the Agreement. Congress has approved a new two-year moratorium on Internet access fees and discriminatory taxes, which expires November 1, 2003. States involved in the SSTP now have the opportunity to demonstrate progress in the sales tax simplification effort by implementing the Agreement and raising the issue of Congressional authorization for States to impose use tax collection duties upon remote retailers.

SUMMARY OF KANSAS LEGISLATIVE CHANGES REQUIRED BY STREAMLINED SALES TAX AGREEMENT

State Administration of Local Sales and Use Taxes
Already in place in Kansas.

State and Local Tax Bases Identical
After December 31, 2005, state and local tax bases must be identical. With the provision allowing for multiple rates for food and food ingredients, and excepting out sales of electricity, gas, other heating fuels, motor vehicles, aircraft, watercraft, modular homes, manufactured homes and mobile homes from the "one rate" requirement, the only state vs. local tax base disparity that will need to be legislatively addressed concerns water utility sales. Water utility sales for residential or agricultural use are exempt from state sales tax but are not exempt from local sales tax.

Adoption of Broad Local Use Tax
Many states have adopted a local use tax, along with a state use tax. In Kansas, the local use tax applies only to out-of-state purchases of boats and motor vehicles. In order to level the playing field between in-state "brick and mortar" retailers and remote retailers concerning the tax burden on retail sales to Kansas customers, a broad local use tax should be enacted (although not an Agreement requirement). This would also permit local governments to benefit from use tax collections from remote sales.

Seller Registration
Provide for electronic seller registration, registration by an agent for the seller, and no written signature requirement on the seller, no registration fees for voluntary registrations.

State and Local Tax Levies
Provide advance notice of state sales tax rate changes to retailers, limit effective date of rate change to first day of the calendar quarter (no June 1 effective dates). Kansas law currently provides no notice requirement for state rate changes.

Provide uniform rule for effective dates of rate changes on services for period starting before and ending after rate change.

Local sales tax rate changes will not apply to printed catalog purchases until 1st day of calendar quarter after 120 days notice to sellers.

State must provide and maintain database of all boundary changes for taxing jurisdiction, including effective dates of local rate changes.

State must provide and maintain database of all sales and use tax rates for all taxing jurisdictions in state, using Federal Information Processing Standards in format jointly agreed to by states.

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The database must assign 5 and 9 digit zip codes within State to proper rates and taxing jurisdictions.

State must participate with other member states in developing address-based system for assigning taxing jurisdictions, meeting federal Mobile Telecommunications Sourcing Act requirements.

Sellers are relieved of liability for charging incorrect rates, if they relied on State's database for the rates/boundaries.

The database development requirements of the Agreement will involve significant administrative costs for the Department. However, these database requirements do not need to be implemented prior to the State joining the Agreement.

Uniform Sourcing Rules
This will require a major change to Kansas sales tax law, which generally sources retail sales to the retailer's business premises. The Agreement requires that sales be sourced to the seller's business location if the product is received at that location, if not, to the location where the product is received by the purchaser, if known, or if not, to the address provided by the purchaser to the seller. There are special rules for sourcing telecommunications services. The Agreement excepts out sales of motor vehicles, aircraft, watercraft, modular homes, manufactured homes or mobile homes from the sourcing provisions.

Administration of Exemptions
Purchasers can claim sales tax exemptions at the time of purchase using electronically filed exemption certificates that need not be signed if electronically filed. So long as the seller collects the information required on the exemption certificate at the time of purchase and maintains that information for the state to audit, the seller is relieved of liability for the tax, if the purchaser has improperly claimed the exemption. Kansas law currently imposes a "good faith" obligation on the seller in accepting an exemption certificate and only provides for signed exemption certificates. The "good faith" acceptance obligation is eliminated under the Agreement.

Uniform Tax Returns
The Agreement requirements can possibly be dealt with administratively without statutory changes.

Uniform Rules for Remittances of Funds
Most of the Agreement requirements can possibly be dealt with administratively without statutory changes. However, a state has the option of requiring all remittances from Model 1, 2 and 3 sellers to be electronic.

Uniform Rules for Recovery of Bad Debts
Uniform procedures for bad debt recovery are provided. States retain the option of allowing parties other than the seller (such as a third party financier) to recover bad debts. Kansas law does not provide bad debt recovery for third parties other than the seller.

Confidentiality and Privacy Protections
Confidentiality requirements must be imposed on Certified Service Providers. Existing law confidentiality requirements remain in place.

Sales Tax Holidays
The Agreement imposes certain restrictions on sales tax holidays. Since Kansas law does not provide for any sales tax holidays, no legislation is necessary. Should a sales tax holiday be enacted at some point, it will be subject to those restrictions.

Caps and Thresholds
The Agreement restricts caps and thresholds after December 31, 2005, but these restrictions do not apply to sales of motor vehicles, aircraft, watercraft, modular homes, manufactured homes or mobile homes. Kansas law currently has no caps or thresholds, except with respect to manufactured homes. No legislation should be necessary.

Rounding Rule
Rounding to the third decimal; tax may be computed on an item or invoice basis. Bracket systems must be eliminated; rounding rules should be applied to aggregated taxes. Kansas currently follows the rounding rule proposed in the Agreement. Legislation would only be needed to codify existing practice.

Uniform Definitions
Definitions in the Agreement of terms that are used in Kansas statutes must be adopted. Tangible personal property—the Agreement does not include custom software in the definition, although it does include prewritten (canned) software. Apparently, custom software must be defined as a service under the Agreement, if it is to be taxed, creating the anomaly that canned software is tangible personal property, but custom software is apparently a service. This past session, the Kansas legislature included custom software in the definition of tangible personal property and imposed sales tax on it.

The following other definitions in the Agreement are currently used in Kansas sales tax statutes: food, drug, prescription, durable medical equipment, prosthetic device, mobility enhancing equipment, lease or rental. The following definitions in the Agreement are not used in Kansas sales tax statutes, so would not need to be added: food ingredients, candy, prepared food, soft drinks, dietary supplement, clothing, clothing accessories and equipment, sport or recreational equipment, protective equipment, over-the-counter-drug, grooming and hygiene products.

Seller Registration
Uniform seller registration provisions are required. A newly registering seller must be given amnesty for uncollected sales tax for periods prior to registration, absent fraud. Kansas sales tax law currently has no amnesty provisions.

Provider and System Certification
Certification procedures are provided.

Monetary Allowances (Subject to Cost of Collection Study)
Certified Service Providers under Model 1, and sellers under Models 2 and 3 must be provided a monetary allowance by the state (base rate and for first 24 months a percentage or revenue collected from retailers registering and collecting voluntarily). States have the option of providing vendor discounts on a permanent basis. Kansas law currently does not provide any compensation to sellers for collecting sales or use tax.

Kansas Legislative Research Department January 13, 2003

Summary Overview of the Kansas Budget

I. Changes from the End of the 2002 Session of the Legislature:

A. **Actual FY 2002 State General Fund receipts** for the fiscal year that ended on June 30, 2002 were $212 million or 4.9 percent **below** the revised FY 2002 estimate made in March 2002 (the largest amount (above or below the estimate) that the Consensus Revenue Estimating Group has missed the final estimate, when compared to actual receipts).

B. The State General Fund ending balance on June 30, 2002 was $12.1 million or 0.3 percent of expenditures.

C. The State Finance Council authorized the **largest Certificate of Indebtedness** ever (internal borrowing from other state funds) of $450 million on July 1, 2002, the first day of Fiscal Year 2003.

D. The Governor in August, 2002 **imposed State General Fund allotments** (reductions) in the amount of $41 million against the authorized FY 2003 executive branch budget. In general, the reductions were 2.0 percent, with K-12 education and the Regents system receiving an allotment of 0.75 percent. The K-12 reduction resulted in a base state aid per pupil reduction of $27 ($3,890 to $3,863 per pupil).

E. On November 5, 2002, the State General Fund Consensus Revenue Estimating Group **revised downward the current year estimate by $363.5 million** or 8.0 percent. The reduction is the largest dollar amount for a current year revision since the Consensus Group began meeting in the 1970's.

F. In late November, 2002, Governor Graves announced **another round of State General Fund allotments** (or reductions) totaling $126.1 million. The allotments included:

- 3.9 percent reduction ($78.1 million) to all agencies except K-12, School for the Blind, School for the Deaf, Board of Indigents' Defense Services, Legislative Branch, and Judicial Branch.
- Stop local demand/revenue transfers ($48.0 million) in the current year (Local Ad Valorem Tax Reduction Fund; County-City Revenue Sharing Fund; and Special City-County Highway Fund).

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II. Selected Key Budgetary Decisions for the 2003 Legislature:

A. Governor Graves has recommended the State General Fund **not repay a loan from the Department of Transportation** of $94.6 million in FY 2003.

B. Governor Graves has also **recommended the transfer** of $35.1 million in various special revenue fund balances (i.e., Kansas Endowment for Youth Fund; Senior Services Trust Fund; etc.,) to the State General Fund in the current year.

C. Funding of $56.5 million in **current State General Fund supplementals** - General and Supplemental State School Aid ($28.6 million); KPERS-School ($6.2 million); and SRS and Aging caseloads ($21.7 million). Governor Graves latest budgetary proposal did not address funding these supplementals.

D. To meet the current statutory 7.5 percent State General Fund **ending balance requirement** for FY 2004 approximately $315 million will be needed.

E. **Comprehensive Transportation Plan** - No State General Fund financing was provided in FY 2003 (although a motor fuels tax and motor vehicle registration fees increased). The FY 2004 amount is estimated to $183.4 million.

F. The FY 2004 budget will need to **replace approximately $94 million of one-time money** (i.e., federal Inter-Governmental Transfer Fund) that was used to finance the FY 2003 budget.

G. **Caseloads in SRS and Aging** will increase $56 million in FY 2004 (most of these caseloads are entitlements).

H. **Higher Education Reform Act** in FY 2004 will need a minimum of $16.8 million to fund an additional year, based on the original (adjusted) estimated funding schedule.

I. **Kansas Public Employees Retirement System** (KPERS) will increase at least $15 million in FY 2004 ($9.0 million for the full year costs of the death and disability - FY 2003 there was a 6 month moratorium and $6 million for the statutorily required increase in the employer's contribution).

J. **State employer costs for employee health insurance** will increase an estimated $12 million in FY 2004.

K. **The total estimated shortfall in FY 2004, based on the preceding additional funding items, total approximately $750 million.**

STATE GENERAL FUND PROFILE*
REFLECTING NOVEMBER 2002 CONSENSUS REVENUE ESTIMATES

	FY 02	FY 03	FY 04	Difference FY 03-04
Beginning Balance	$ 369.2	$ 12.1	$ -	
Receipts (Nov. 2002 Consensus)*	$ 4,108.9	$ 4,329.7	$ 4,525.7	$ 196.0
FY 2004 Demand/Revenue Transfer Adj.	0.0	0.0	(155.0)	(155.0)
Total Available	$ 4,478.1	$ 4,341.8	$ 4,370.7	$ 28.9
Expenditures	4,466.1	4,341.8	4,065.8	**(276.0)**
Ending Balance	$ 12.1	$ -	$ 304.9	
Ending Balance as a % of Exp.	0.3%	0.0%	7.5%	

*Assumptions:

FY 2003 receipts reflect the November consensus revenue estimates, not making the KDOT repayment ($94.6 million), transfering fee fund balances of $35.1 million, and stopping selected local demand/revenue transfers ($48.0 million), all as recommneded by Governor Graves.

FY 2003 expenditures reflect amount approved by 2002 Legislature as adjusted by allotments reductions of $41.5 million in August and $78.1 million in November for a 3.9 percent reduction to most agencies and the shifting of $15.4 million in expenditures from FY 2002.

FY 2004 receipts reduced by $155 million for treating FY 2004 demand transfers as revenue transfers in the same manner as in FY 2003.

FY 2004 expenditures reflect expenditure level necessary to maintain 7.5 percent ending balance.

Known Major Current Year (FY 2003) Supplementals (in millions):

K-12 Education:		
General State Aid	$6.6	
Supplemental State Aid (LOB)	22.0	
KPERS - School	6.2	
SRS and Aging Caseloads	21.7	
Total Major Supplementals	$56.5	Not addressed in above profile.

KANSAS LEGISLATIVE RESEARCH DEPARTMENT

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January 7, 2003

To: Legislative Budget Committee

STATE GENERAL FUND (SGF) RECEIPTS
July through December, 2002

This is the second monthly report based on the revised estimate of the SGF receipts in FY 2003 made by the Consensus Estimating Group on November 5, 2002. The figures in both the "Estimate" and "Actual" columns under FY 2003 on the following table include actual amounts received in July-October. Thus, the report essentially deals with the difference between the estimated and actual receipts in November and December.

Total receipts through December of FY 2003 were $22.2 million or 1.1 percent below the estimate. The December year-to-date amount reflects a positive change of $0.8 million from the November year-to-date amount. Total receipts through November of FY 2003 were $23.0 million or 1.4 percent below the estimate.

Generally, a comparison of only two months is of little value in identifying a trend for the remainder of the year, as the timing and processing of receipts substantially can affect comparisons of the estimate with actual receipts over such a short period of time. In addition, receipts through the end of January will include sales tax receipts on Christmas business and individual income tax estimated payments due in January. Both of these factors will make the January report more helpful in ascertaining a picture of SGF receipts.

Taxes that **exceeded** the estimate by more than $1.0 million were: individual income ($5.3 million), insurance premiums ($1.1 million), and estate ($1.0 million). It is interesting to note that December individual income tax receipts exceeded the monthly estimate for that source for the first time since March, 2001 (FY 2001). Concerning estate taxes, a payment of $3.2 million from a single estate was made in December. Taxes that fell **below** the estimate by more than $1.0 million were: corporate income ($20.6 million), compensating use ($5.9 million), retail sales ($5.3 million), and financial institutions privilege ($1.9 million). Corporation income tax receipts for the month were 45.7 percent below the estimate and 24.5 percent below the same period last year. In addition, corporation income tax refunds were higher than anticipated for the month.

Interest earnings exceeded the estimate by $0.4 million while agency earnings fell below the estimate by $0.5 million. Net transfers out of the SGF were $3.1 million less than the estimate. Two separate events impacted the net transfer amounts out of the SGF. The estimate assumed that in December an amount of $16.7 million would be transferred from the SGF to the County-City Revenue Sharing Fund. Because of Governor Graves' allotment of SGF expenditures in November, 2002, the December revenue transfer to the County-City Revenue Sharing Fund was not made. The December estimate also assumed that the SGF

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Date 1-16-03

would receive $11.5 million in a transfer from the Kansas Endowment for Youth Fund (tobacco proceeds). As of the end of December, that transfer had not been made. These two items partially cancel each other, in terms of impacting total December SGF transfers.

Total SGF receipts through December of FY 2003 were $69.8 million or 3.7 percent above FY 2002 for the same period. **Tax receipts only for the same period exceeded FY 2002 by $77.6 million or 4.0 percent.** Retail sales taxes increased by $52.4 million and cigarette taxes by $40.0 million when comparing this period to the same period in FY 2002. However, both of those sources in FY 2003 reflect an increase in tax rates. Sales taxes from 4.9 percent to 5.3 percent and a cigarette tax increase of $0.46 per pack, from $0.24 per pack to $0.70 per pack. On the other hand, it is noteworthy that compensating use taxes were $14.8 million below fiscal-year-to-date collections from FY 2002, notwithstanding the 4.9 to 5.3 percent rate increase.

This report excludes the July 1 deposit to the SGF of $450.0 million pursuant to issuance of a certificate of indebtedness. This certificate will be discharged prior to the end of the fiscal year.

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STATE GENERAL FUND RECEIPTS
July-Dec, FY 2003
(dollar amounts in thousands)

	Actual	FY 2003			Percent Increase-- FY 2003 Over	
	FY 2002	Estimate*	Actual	Difference	FY 2002	Estimate
Property Tax:						
Motor Carriers	$ 10,786	$ 9,500	$ 9,968	$ 468	(7.6) %	4.9 %
Income Taxes:						
Individual	$ 867,927	$ 858,000	$ 863,331	$ 5,331	(0.5) %	0.6 %
Corporation	32,374	45,000	24,438	(20,562)	(24.5)	(45.7)
Financial Inst.	11,494	14,000	12,051	(1,949)	4.8	(13.9)
Total	$ 911,796	$ 917,000	$ 899,820	$ (17,180)	(1.3) %	(1.9) %
Estate/Inher Tax	$ 30,575	$ 26,900	$ 27,939	$ 1,039	(8.6) %	3.9 %
Excise Taxes:						
Retail Sales	$ 742,267	$ 800,000	$ 794,711	$ (5,289)	7.1 %	(0.7) %
Comp. Use	121,436	112,500	106,628	(5,872)	(12.2)	(5.2)
Cigarette	24,695	65,100	64,703	(397)	162.0	(0.6)
Tobacco Prod.	2,149	2,300	2,290	(10)	6.6	(0.4)
Cereal Malt Bev.	1,245	1,285	1,188	(97)	(4.6)	(7.5)
Liquor Gallonage	7,332	7,775	7,589	(186)	3.5	(2.4)
Liquor Enforce.	18,100	18,700	19,102	402	5.5	2.1
Liquor Dr. Places	3,190	3,275	3,316	41	3.9	1.3
Corp. Franchise	6,147	8,400	8,200	(200)	33.4	(2.4)
Severance	31,452	29,850	30,542	692	(2.9)	2.3
Gas	23,519	21,600	22,157	557	(5.8)	2.6
Oil	7,933	8,250	8,384	134	5.7	1.6
Total	$ 958,012	$ 1,049,185	$ 1,038,268	$ (10,917)	8.4 %	(1.0) %
Other Taxes:						
Insurance Prem.	$ 23,365	$ 33,500	$ 34,554	$ 1,054	47.9 %	3.1 %
Miscellaneous	520	1,675	2,073	398	298.7	23.8
Total	$ 23,885	$ 35,175	$ 36,627	$ 1,452	53.3 %	4.1 %
Total Taxes	$ 1,935,054	$ 2,037,760	$ 2,012,623	$ (25,137)	4.0 %	(1.2) %
Other Revenue:						
Interest	$ 25,434	$ 10,100	$ 10,498	$ 398	(58.7) %	3.9 %
Transfers (net)	(78,580)	(73,370)	(70,310)	3,060	(10.5)	4.2
Agency Earnings and Misc.	28,997	28,350	27,858	(492)	(3.9)	(1.7)
Total	$ (24,150)	$ (34,920)	$ (31,955)	$ 2,965	32.3 %	8.5 %
TOTAL RECEIPTS	$ 1,910,904	$ 2,002,840	$ 1,980,669	$ (22,171)	3.7 %	(1.1) %

* Consensus estimate as of November 5, 2002.

(Excludes $450 million to SGF due to issuance of certificates of indebtedness.)

NOTE: Details may not add to totals due to rounding.

Reports of the Special Committee on Assessment and Taxation to the 2003 Kansas Legislature

CHAIRPERSON: Representative John Edmonds

VICE-CHAIRPERSON: Senator David Corbin

OTHER MEMBERS: Senators Barbara Allen, Les Donovan, Janis Lee, and Mark Taddiken; Representatives Jerry Aday, Deena Horst, David Huff, Nancy Kirk, Bruce Larkin, Bill Light, and Bonnie Sharp

STUDY TOPICS

Family Development Account Program

Tax Credits for Property Taxes

Sunset Provision—Sales Tax Exemptions

Motor Vehicle Fuels Tax (SB 537)

Property Tax Exemptions for Certain Not-for-Profit Independent Living Centers (SB 479)

Sales Tax Parity on the Sale of Firearms, Weapons, and Ammunition

December 2002

House Taxation
Attachment 5
Date 1-16-03

Special Committee on Assessment and Taxation

Family Development Account Program

Conclusions and Recommendations

The Committee endorses the concept of FDA legislation and encourages proponents to develop a bill for introduction in the House early in the 2003 Session.

Proposed Legislation: None

Background

SB 231, which would have enacted the Family Development Account Program, was approved by the Senate during the 2001 Session and referred to the House Taxation Committee. During the 2002 Session, the Senate again approved a version of the legislation as part of the Senate Committee of the Whole version of SB 403, though the family development account provisions were removed by a conference committee. The Legislative Coordinating Council subsequently approved a request to have the Special Committee further study the issue and make whatever recommendations it deemed appropriate to the 2003 Legislature.

Under SB 231, as amended by the Senate Committee of the Whole during the 2001 Session, would have established a program under the Department of Commerce and Housing which would have enabled eligible families and individuals to establish tax-advantaged accounts for the purpose of funding specific purchases. (Under the 2002 Senate Committee of the Whole version of SB 403, the program would have been placed under the State Treasurer.)

Families or individuals with household income less than or equal to 200 percent of the federal poverty level would have been eligible to open family development accounts (FDAs) earmarked for higher educational expenses; job training costs; purchase of primary residence; major repairs or improvements to a primary residence; or start-up capitalization costs for small businesses.

The Secretary of Commerce and Housing would have been required to adopt rules and regulations and prepare a request for proposals from nonprofit or charitable community-based organizations seeking to administer the Family Development Account Reserve Fund (FDARF). The FDARF would have been created to fund administrative costs of the program incurred by financial institutions or community-based organizations, and also to provide matching funds for moneys in FDAs. No more than 20 percent of all funds in the FDARF could have been used for administrative costs during the first two years of the program, and the limitation

would have been set at 15 percent in subsequent years.

The following tax provisions would have been effective for two tax years before sunsetting. Moneys deposited into FDAs by account holders would have been exempt from Kansas income tax unless withdrawn for an unapproved use. Interest earned on FDAs also would have been exempt from income taxes. Financial institutions also would have received a privilege tax exemption for earnings attributable to FDAs. A program contributor, defined to include "a person or entity who makes a contribution" to an FDARF, would have been allowed income tax credits up to $25,000 per contributor or 25 percent of the contribution amount, whichever was less. The total amount of all such tax credits authorized could not have exceeded $0.5 million in any fiscal year.

Account holders making nonqualified withdrawals from FDAs would have been required to forfeit all matching moneys in the accounts, which would then be returned to the FDARFs of the contributing community-based organizations.

FDA funds, including accrued interest, would have been disregarded when determining eligibility for public assistance or benefits.

During the 2001 hearings, proponents included Senator Haley, Heart of America Family Services, and the Washington University's Center for Social Development.

The fiscal note provided by the Department of Revenue during the 2001 Session suggested that the bill would have been expected to reduce receipts by about $519,000 and would have necessitated expenditures of an additional $59,889 in administrative costs.

Committee Activities

At the September meeting, the Committee held public hearings on the issue. Proponents for the Family Development Account legislation included El Centro, Heart of America Family Services, the Kauffman Foundation, the Emporia State Bank, and an individual FDA participant. The proponents generally argued that establishing the tax-advantaged accounts at the state level would encourage low to moderate income families to save and build long-term assets. No one appeared in opposition to the concept. The Chair requested that Senator Haley and other proponents work with staff to develop proposed legislation that could potentially be introduced as a recommendation to the 2003 Legislature. Among the issues to be resolved were where the program should be housed and the maximum amount of credit available to program contributors.

At the October meeting, staff presented a draft committee report discussing policy options; information on the federal poverty level; and amendments that were prepared after consultation with Senator Haley. The Committee voted to recommend the concept of FDA legislation to the 2003 Legislature.

Conclusions and Recommendations

The Committee endorses the concept of FDA legislation and recommends its enactment by the 2003 Legislature. The

Committee agrees with the argument of proponents that establishing the tax-advantaged accounts will encourage low to moderate income families to build long-term assets through saving.

The Committee encourages Senator Haley and other proponents with suggested amendments, including El Centro, to develop a single legislative proposal that would be introduced as a House bill early in the 2003 Session.

LEGAL ISSUES REGARDING EXPANSION OF TAX CREDITS TO RAILROADS AND OTHER STATE-ASSESSED PROPERTY

CONCLUSIONS AND RECOMMENDATIONS

The Committee recommends the introduction of legislation that would clarify the intent of the 2002 Legislature by assuring that income tax credits for certain personal property taxes be extended to railroads beginning in 2005 but not other state-assessed public utilities.

Proposed Legislation: One bill is recommended.

BACKGROUND

Legislation enacted in 1998 provided refundable income, premiums, and privilege tax credits beginning in tax year 1998 to offset 15 percent of property taxes accurately, and timely paid on commercial and industrial machinery and equipment and certain mineral leasehold machinery and equipment.

Major tax legislation enacted in 2002, SB 39, provided for an increase in such credits to 20 percent beginning in tax year 2005; and to 25 percent beginning in tax year 2007. The bill also made the credits initially available in 2005—at the 20 percent level—for taxes actually and timely paid on railroad property. These new credits also are scheduled to increase to the 25 percent level beginning in tax year 2007.

The following paragraphs are taken directly from explanatory information the Legislature had in its possession at the time the bill was adopted.

Business Machinery and Equipment Credits. The tax credits available for property taxes timely paid on business machinery and equipment are increased from 15 to 20 percent beginning in tax year 2005; and to 25 percent beginning in tax year 2007.

Tax Credits Extended to Railroads. The machinery and equipment tax credits for property taxes paid will for the first time be made available for railroad property beginning in tax year 2005 (when the credit amount will be 20 percent). The railroad property also will qualify for the subsequent credit increase in tax year 2007. The Joint Committee on Economic Development will be required to conduct an interim study regarding the necessity of extending the tax credits to railroad property.

Fiscal information prepared by the

Department of Revenue indicated that the initial provision would be expected to reduce State General Fund receipts by the following:

FY	Business Machinery & Equipment Credit to 20% in tax year 2005; 25% in 2007	Business Machinery & Equipment Railroads to 20% in tax year 2005
	$ in Millions	
2003	--	--
2004	--	--
2005	--	--
2006	$ (10.737)	$ (1.936)
2007	(11.810)	(1.990)
5-Year Total	$ (22.547)	$ (3.926)

Since the conclusion of the session, a concern has been raised that the language amending KSA 2001 Supp. 79-32,206 may appear to expand the credits to all property taxes paid by public utility tangible personal property (subclass 3 of class 2 of Article 11, Section 1 of the *Kansas Constitution*).

The Legislative Coordinating Council has subsequently charged the Special Committee with reviewing a number of the legal and fiscal questions surrounding expansion of the tax credits, including whether federal law may require the railroad property to be eligible, and whether additional state-assessed public utility property must be or should be included. The Department of Revenue also has been asked to report on the fiscal implications beginning in FY 2006 relative to its current interpretation of the law compared with the fiscal implications assumed by the Legislature at the conclusion of the 2002 Session.

Committee Activities

At the September meeting, staff went over the explanatory information available to the 2002 Legislature at the time SB 39 was adopted. The Department of Revenue observed that if the tax credits were to be extended to all state-assessed public utilities beginning in tax year 2005, the unanticipated fiscal impact would be at least $42 million beginning in FY 2006.

At the October meeting, the Property Valuation Division (PVD) presented testimony and analysis on legal implications of the tax credit issue. PVD said that it was not entirely clear that the Legislature was legally compelled by The Railroad Revitalization and Regulatory Reform Act of 1976 (the 4-R Act) to extend the credits—which had been available since 1998—to railroads beginning in tax year 2005. PVD also said that the *Kansas Constitution* did not appear to require that the credits be extended to all state-assessed public utilities even if the Legislature chose to maintain its policy decision to extend the credits to railroads.

A conferee representing Kansas railroads stated his belief that the 4-R Act did require Kansas to make the tax credits available to railroads. The conferee also encouraged the Committee to recommend legislation making the credits available to railroads in tax year 2003. The Committee declined to make such a recommendation.

Conclusions and Recommendations

The Committee finds that the fiscal notes and explanatory information

provided by the Department of Revenue and staff during the 2002 Session in no way contemplated expanding the credits to any state-assessed public utility beyond railroads. The Committee therefore recommends the introduction of legislation that would clarify the intent of the 2002 Legislature by assuring that income tax credits for certain personal property taxes be extended to railroads beginning in 2005 but not other state-assessed public utilities. Enactment of the legislation would provide that clarification.

SUNSETTING SALES TAX EXEMPTIONS

CONCLUSIONS AND RECOMMENDATIONS

The Committee encourages the Legislature to conduct a global study of overall Kansas state and local tax policy and structure. Since the policy implications of sales tax base expansion should be one very important part of that review, the Department of Revenue should continue to update fiscal notes associated with the removal of sales tax exemptions and with extending the tax to previously untaxed services.

Proposed Legislation: None

BACKGROUND

During the 2002 Legislature, elimination of sales tax exemptions was discussed frequently as one way of providing additional revenue. On March 13, for example, an unsuccessful House floor amendment offered by Representative Sharp would have repealed a number of sales tax exemptions and would have provided about $694 million in additional revenue at the 4.9 percent rate. The 2002 Legislature ultimately did eliminate an exemption for customized computer software as part of the final tax package in SB 39.

In the wake of these actions, House Taxation Committee Chair John Edmonds recommended to the Legislative Coordinating Council (LCC) that an interim study analyze the tax policy implications of sunsetting a large number of sales tax exemptions on a date certain in the future. The LCC assigned

the study to the Special Committee.

COMMITTEE ACTIVITIES

At the September meeting, staff distributed the fiscal note associated with Representative Sharp's floor amendment. Staff explained that several sales tax exemptions not on that list were associated with ingredient or component part exemptions (and still others which are mandated by federal law) would not be appropriate to consider for sunsetting or repealing. The Chair said that he hoped the interim activity could assess the concept of a wholesale exemption sunset and not focus on individual exemptions at this time.

At the October meeting, staff distributed additional fiscal information

updating the March 13 floor amendment based on the new 5.3 percent sales tax rate. During the public hearing, the League of Kansas Municipalities spoke in favor of considering a sunset for a number of sales tax exemptions and further encouraged the Legislature to commit to not granting any additional exemptions in the future. The conferee noted that exemptions had narrowed state and local sales tax bases alike and helped to drive up property taxes.

A number of conferees testified in opposition to the sunset concept, including the Kansas Chamber of Commerce and Industry, Farm Bureau, and the Kansas Livestock Association. The opponents generally argued that the uncertainty provided by the threatened sunset of a number of exemptions could provide an economic development disincentive.

The Committee also discussed the potential revenue which could be provided by expanding the sales tax base by extending the tax to previously untaxed services.

At the November meeting, staff provided the Committee with a list of policy options.

Conclusions and Recommendations

The Committee strongly encourages the incoming 2003 Legislature to conduct a global study and analysis of overall Kansas state and local tax policy and structure. Since the policy implications of sales tax base expansion should be one very important part of that review, the Committee asks the Department of Revenue to work on continuing to update fiscal notes associated with the removal of sales tax exemptions and with potentially extending the sales tax to previously untaxed services.

Motor Fuels Tax

Conclusions and Recommendations

The Committee encourages the incoming administration, if "tax-at-the-rack" legislation is still considered a priority, to work with the industry to develop a proposal different from SB 537.

Proposed Legislation: None

Background

During the 2002 Session, the Department of Revenue requested the introduction of SB 537, which would have moved the point of taxation on motor fuel to the supplier level, sometimes referred to as "tax-at-the-rack." The Senate Assessment and Taxation Committee held a public hearing on the legislation.

The bill would have allowed out-of-state terminal suppliers to pre-collect and remit taxes on motor vehicle fuels and special fuels imported

from another state into Kansas in the same manner as taxes would have been paid if the fuels were from within the state. The bill also would have defined blend, blender, export, import, state, supplier, and territory for the purposes of the motor fuels taxation. Additionally, the bill would have changed the bonding requirement for motor fuel suppliers and distributors and would have outlined how these requirements could be met. Bonding would have been required to be between $5,000 and $750,000 for suppliers; and between $5,000 and $100,000 for distributors. The bond amounts could have been used to cover losses sustained by anyone as a result of an act by the licensee which interferes with the collection of taxes.

Because of the change in the imposition of the tax from the distributor to the supplier level, the 2.5 percent handling fee (shrinkage) allowance also would have been amended. Instead of the full amount going to the distributor, 2.25 percent would have gone to the distributor and 0.25 percent would have gone to the supplier. Suppliers would have been added to the list of those having to pay an inventory tax on motor fuels, and the date due for those taxes would have been changed from the 25th of each month to the last day of each month.

Penalties for failure to have a license when required and failure, neglect, or refusal to pay tax, penalties, or interest as outlined in the motor fuels tax law would have been increased. Violations would have been changed from misdemeanors to a severity level 10, non-person felony. The bill was to have taken effect January 1, 2003.

A fiscal note during the 2002 Session indicated that the Department of Revenue believed the bill would have resulted in an additional $1.5 million in collections to the State Highway Fund in FY 2003 and $3.0 million per year beginning in FY 2004.

COMMITTEE ACTIVITIES

At the September meeting, the Committee held public hearings on the issue. Secretary of Revenue Stephen Richards appeared as a proponent and argued that the tax-at-the-rack concept had been recognized nationally as the most efficient and effective method to collect motor fuels tax, dating back to the adoption by the federal government of the methodology in 1994. He said that the benefits for Kansas would include a reduction in the number of taxpayers; simplification for the industry in that the state would be using the same point of taxation as the federal government; and a number of tax evasion schemes would become obsolete.

A conferee representing the Kansas Petroleum Council said that while that group did not oppose the tax-at-the-rack concept, a stalemate had developed in the industry's talks with the Department of Revenue regarding the development of legislation. The conferee suggested that rather than adopting SB 537, the Legislature should "start with a clean sheet of paper" and look closely at tax-at-the-rack legislation adopted by other states.

The Petroleum Marketers and Convenience Store Association of Kansas appeared in opposition, stating that a number of current safeguards exist to stop motor fuel tax evasion and that changing the point of taxation is

unwarranted.

In response to some of the testimony, Senator Lee asked to what extent industry opposition to the proposal would be lessened by further changes in the shrinkage allowance.

At the October meeting, the Committee discussed the issues raised at the public hearing—including the shrinkage allowance—and voted to encourage all interested parties to keep working on the development of legislation for consideration by the 2003 Legislature.

Conclusions and Recommendations

The Committee does not at this time endorse the reintroduction of SB 537 as it was considered during the 2002 Session. The Committee instead encourages the incoming administration to determine whether a "tax-at-the-rack" proposal should be considered by the 2003 Legislature and, if it is still considered a priority, work with the industry in developing legislation that is acceptable to all parties.

Re-evaluation of KSA 79-201b, *Fifth*, Relating to the Property Tax Treatment of Certain Independent Living Centers

Conclusions and Recommendations

The Committee recommends the formation of a working group to study the issue of the property tax exemption for independent living units owned by not-for-profit nursing homes. This working group will be bipartisan and members will be appointed by the chairmen of the Senate Committee on Assessment and Taxation and the House Committee on Taxation. The working group will use 2002 SB 479 as a basis to develop appropriate legislation by February 1, 2003.

Proposed Legislation: None

Background

Controversy over the policy of providing a tax exemption for property which is owned by a not-for-profit organization and used as housing for elderly persons has existed for many years. During the 2002 Legislative Session, Senator Emler introduced SB 479 which would have eliminated the property tax exemption for this type of property in tax year 2002. The bill received a hearing in the Senate Committee on Assessment and Taxation, but died in Committee at the end of the Session.

KSA 79-201b, *Fifth*, was first enacted in 1975 and it exempts from property taxation the real and personal property of a corporation organized not-for-profit that is used exclusively as housing for elderly persons. In order to qualify for the exemption, the amount charged to residents by the corporation must not produce in aggregate an amount that is more than the actual cost of operation of the housing facility or the services must

be provided to the residents at the "lowest feasible cost." Under the law, any property used in a manner consistent with federal internal revenue ruling 72-124 issued pursuant to section 501 (c)(3) of the federal internal revenue code shall be deemed to be operating at the lowest feasible cost. The provision tying "lowest feasible cost" to the federal revenue ruling was added by the Legislature in 1999.

The federal revenue ruling provides that an organization, which is otherwise qualified for charitable status under section 501 (c)(3) of the federal income tax code, will qualify for charitable status if it operates in a manner designed to satisfy three primary needs of elderly persons. Those needs are:

- **Housing.** The need for housing is satisfied if the organization provides residential facilities that are specifically designed to meet some combination of the physical, emotional, recreational, social, religious, and similar needs of elderly persons.

- **Health Care.** The need for health care is satisfied if the organization either directly provides some form of health care, or maintains a continuing arrangement with other organizations to provide for the physical well-being of its residents.

- **Financial Security.** The need for financial security is satisfied if the organization is committed to maintaining in residence any persons who become unable to pay their regular charges, or the organization is providing its services to the elderly at the "lowest feasible cost." The "lowest feasible cost" takes into consideration such expenses as the payment of indebtedness, maintenance of adequate reserves sufficient to insure the life care of each resident, and reserves for the physical expansion of the facility commensurate with the needs of the community and the existing resources of the organization.

Committee Activities

The Committee held a hearing on this topic at the September meeting. At this time, a variety of conferees offered testimony. Summaries of their testimony are as follows.

A representative of the Property Valuation Division, presented information outlining the administrative and judicial interpretation of KSA 79-201b, *Fifth*, enacted in 1975, which exempts from property taxation the real and personal property of a not-for-profit corporation that is used exclusively for housing for elderly persons. In addition, he discussed the provisions of IRS Revenue Ruling 72-124 relating to the charitable status of organizations, which was amended into the Kansas statute in 1999.

The Reno County Counselor discussed the details of two recent cases decided by the Board of Tax Appeals (BOTA) in which BOTA attempted to interpret the legislative intent in the use of the word "operated" in KSA 79-1439(b)(1)(D) pertaining to the classification rate for commercial property owned and operated by not-for-profit corporations. He emphasized that Reno County believes that the legislative intent was to apply the tax break for not-for-profit entities only when the property is used and occupied by the not-for-profit organization. In his opinion, it is imperative that the

Legislature clarify the statute.

The Reno County Appraiser compared photographs of several independent living units for the elderly in Reno County with photographs of similar duplex dwellings and low-income single family dwellings on tax rolls in the same area. He reported that a total of 269 independent living units in Reno County are tax exempt, resulting in a $289,162 tax loss for the county. In Harvey County, 466 elderly housing units with an appraised value of $34,819,210 are exempt, resulting in an estimated $467,763 tax loss for the county for 2002. He contended that elderly persons living in housing units operated by a not-for-profit corporation under KSA 79-201b, *Fifth*, should be paying property taxes because the units are not part of the nursing home facility proper, are not owned by a municipality, and are not financed with federal funding. He maintained that the issue is a matter of fairness, noting that low-income retired citizens who cannot afford to live in an independent living unit must pay property taxes which subsidize community services also used by higher-income persons living in independent living units.

The Harvey County Appraiser echoed concern with regard to the tax exempt status of several independent elderly housing units in South Central Kansas owned by not-for-profit retirement communities. In his opinion, the sizeable amount of up-front fees included in a typical retirement community life lease and the additional expenses residents must pay for electricity, telephone, meals, and housekeeping clearly indicate that the residents are affluent and can afford to pay property taxes. He emphasized that the issue does not concern raising taxes but concerns sharing the tax burden fairly and equitably.

The McPherson County Appraiser expressed concerns about the tax exempt status of independent living units in McPherson County on behalf of the McPherson County Commission. He noted that the Commission views the tax exemption not as an income issue but as an ad valorem tax issue. He went on to explain that individuals who live in independent living units must construct them with their own funds, and the units must be built according to specifications of the not-for-profit organization. The units are maintained by residents through a monthly lease arrangement. Upon the death of the resident, the not-for-profit organization may keep from 60 to 80 percent of the resale of the life lease. He observed that, due to the costs of construction and maintenance, only a very small segment of the elderly can afford independent living units. He discussed ramifications of the tax exemption extending beyond independent living communities for the elderly. For example, he noted that a not-for-profit organization in Lindsborg has recently acquired older homes not physically attached to the campus and not modified for Americans with Disabilities Act standards. Because the homes are now owned by a not-for-profit organization, the residents are exempt from property taxation. However, residents in similarly constructed homes on either side must pay taxes. As an example of another type of inequity, he noted that one of the residents of an independent living unit in McPherson is a professor at the University of New York who uses the unit for a summer home six

to eight weeks each year and then returns to New York. In his opinion, legislative intent did not include a property tax exemption for a summer home for high income individuals such as the professor. He noted that the removal of independent living facilities from property tax rolls results in a significant increase in the mill levy to meet ongoing public services. The Commission is concerned that private money is being used to build and support independent living units, but the residents do not share the burden of paying for the streets, ambulance service, and several other community services which they use.

The Harvey County Administrator commented that the property tax exemption issue is pitting local governments against retirement communities, splitting communities, and creating ill will between those who pay property taxes and those who do not pay property taxes. He outlined the history of the exemption and discussed the findings of a task force which studied the issue surrounding KSA 79-201b, *Fifth*. In his opinion, the Good Neighbor Program recommended by the task force is fatally flawed and poor public policy. He suggested that exempt independent housing units either be placed on the tax rolls after a three to seven year time period or be placed on the tax rolls in a tiered fashion over a certain number of years

A representative of the League of Kansas Municipalities reported that the League recently conducted a survey in conjunction with the Kansas Association of Counties on the subject of property tax exemptions for independent living centers. He called attention to the results of the survey which were attached to his written testimony, noting that the not-for-profit adult care retirement communities were identified through a directory provided by the Kansas Association of Homes and Services for the Aging (KAHSA). The League found that there are 63 retirement facilities of this type spread over 31 counties. He explained the methodology used to determine the estimated tax loss per year per facility and noted that the total estimated tax loss for the 31 counties is $2.5 million per year. He informed the Committee that the issue will be discussed further during the League's annual conference in October.

A representative of the KAHSA testified in opposition to SB 479, contending that the current law is good public policy. At the outset, he noted that approximately 14,000 older people reside in not-for-profit retirement communities in Kansas. After describing the typical resident, he listed the benefits that not-for-profit communities provide for their residents, state government, and local communities. He emphasized that not-for-profit facilities must meet strict requirements in order to obtain a tax exemption. He noted that, to address the concerns of some communities regarding the exemption, KAHSA helped create the Good Neighbor Program which provides the framework for local negotiation of voluntary payments by not-for-profit senior housing providers to local units of government and schools. In addition, he noted that, although the Harvey County Commission has rejected the program, several KAHSA members are moving ahead with the program. In conclusion, he discussed the reasons he believes that quality of construction should not be a factor in determining the tax exempt status of independent living units for the elderly.

A representative of Presbyterian Manors of Mid-America, Inc., testified in opposition to SB 479 on the grounds that it would adversely affect not only elderly Kansas residents but also the dedicated not-for-profit organizations providing services to older adults. He argued that SB 479 is not necessary because the Legislature clarified the law which creates the tax exemption for not-for-profit providers, and the Kansas Supreme Court reaffirmed the Legislature's interpretation. For the Committee's information, he said that he has found that residents of independent living facilities do not elect to live there to avoid property tax but enter upon a life changing event. He explained that Presbyterian Manors, Inc., builds independent living units upon demand, and the type of unit built reflects the needs of the community. As the construction of the unit progresses, the applicant begins to make payments but may leave at any point. Generally, the total of the monthly charge and the interest earned from the deposit is what drives the operation of the continuing care retirement community. When individuals can no longer live independently and move to assisted living, the family often receives a 70 to 90 percent refund or the refund is applied to the cost of assisted living arrangements. He noted that, for this year alone, Presbyterian Manors, Inc., will write off over $650,000 due to residents' inability to pay, and over $750,000 will be spent to help support residents. In his opinion, the benefits Presbyterian Manors provides to communities through reinvestment far outweighs the tax revenues that might be generated.

A representative of the City of Inman echoed the opinion of other conferees that KSA 79-201b, *Fifth*, creates a tax loophole and should be amended or repealed. He noted that BOTA's decision to grant a tax exemption for the 88 independent living units owned by Pleasant View Home, Inc., of Inman adversely affected the city's 2003 budget preparation. He further noted that, although Pleasant View Home has made voluntary contributions to pay for city services, the payments do not equal the total that property taxes would produce and cannot be used in the budgeting process because they may be discontinued at any time. He expressed his concern that a sizeable population of affluent people who are not paying property taxes can vote on tax issues affecting the city and the school district. He also reviewed Internal Revenue codes and rulings applicable to Pleasant View Home.

Several residents of Newton expressed their opposition to the property tax exemption for not-for-profit retirement homes. They opined that the county would not need to raise taxes if the statutory loophole allowing not-for-profit independent living facilities a property tax exemption was closed.

The Mayor of McPherson commented that a blanket property tax exemption for all elderly housing operated by charitable organizations is a gross injustice to other elderly citizens who continue to live in their homes and pay property taxes. He contended that the language in KSA 79-201b, *Fifth*, should be amended because it does not adequately address the issue of fairness. He urged the Committee to support an amendment which would require taxation of all elderly independent living units and revoke all exemptions currently granted.

The Vice Mayor of Newton noted that the City of Newton currently has three not-for-profit retirement communities with independent living units off the tax roles. As a result, the City of Newton has experienced a tax loss of $78,514. He complained that, as the number of tax-exempt independent housing units increase each year, it is becoming increasingly difficult for the City of Newton to provide the same high level of service to its citizens.

The Mayor of Hesston urged the Committee to take a stand for tax fairness by permanently eliminating the property tax exemption for independent living units in not-for-profit retirement centers. In this regard, he discussed Showalter Villa, which he described as an upscale, broad range, not-for-profit retirement center with a current appraised value of $15,685,960. He emphasized that Showalter Villa is a tremendous asset to the City of Hesston. However, he believes it is unfair that local property taxpayers living in nonexempt housing provided the funding for a $1 million upgrade of the wastewater treatment plant and sewer line which became necessary due to the development of Showalter. In addition, he discussed Showalter's impact on the city's Emergency Medical Services budget.

A Harvey County Commissioner contended that the demands of funding the infrastructure of the county, city, and schools currently is borne by an unfair and unequal application of the property tax. He observed, "Infrastructure belongs to all, benefits all, and should be supported by all."

A Reno County Commissioner sent written testimony indicating that independent housing units should be subject to full property taxation as a matter of fairness to all property owners.

Written testimony also was submitted by the Kansas Association of Counties, stating that the Association does not question the exempt status of nursing and adult care health facilities but urges the Legislature to amend the law with regard to the issue of duplexes and single family homes for the elderly which escape property taxation.

The Committee discussed the topic at the October meeting and developed recommendations on the topic for the 2003 Legislature.

Conclusions and Recommendations

The Committee recommends the formation of a working group to study the issue of the property tax exemption for independent living units owned by not-for-profit nursing homes. This working group will be bipartisan and members will be appointed by the chairmen of the Senate Committee on Assessment and Taxation and the House Committee on Taxation. The working group will use 2002 SB 479 as a basis to develop appropriate legislation by February 1, 2003.

Sales Tax Parity on the Sale of Firearms, Weapons, and Ammunition

Conclusions and Recommendations

After reviewing the issue of sales tax parity on the sale of firearms, weapons, and ammunition, the Committee concludes that no legislative action is necessary.

Proposed Legislation: None

Background

The topic of sales tax parity on the sale of firearms, weapons, and ammunition was recommended by the Legislative Coordinating Council for study by the Committee. This issue was brought to the Legislature by a retailer expressing concerns that sales tax laws were not being followed uniformly in regard to gun and ammunition sales. In particular, a concern was expressed as to whether vendors at gun shows were collecting and remitting sales tax.

Committee Activity

The Committee held a hearing on the topic at the October meeting. At that time, a pawn shop owner from Ogden, Kansas offered written testimony. He described to the Committee a tax avoidance scheme by which a consumer purchases a gun or ammunition through a catalog or over the Internet, the item is shipped to a Kansas retailer, and then the consumer takes possession from the retailer without paying sales tax. He also expressed concern about the enforcement of Kansas sales tax laws at gun shows and in special sales. He noted that when Kansas consumers can purchase an expensive gun without paying sales tax, this takes business away from legitimate retailers who collect the sales tax, thereby allowing unfair competition.

A representative of the Kansas Department of Revenue also gave the Committee an overview of the current laws in regard to the sale of guns and related items at the October meeting. He noted that the retail sale of firearms, weapons, and ammunition in Kansas is subject to state and local sales tax, whether the sale occurs at a gun show or a store. He also explained that the federal Brady law, 18 USC section 922(t) applies to the sale of all firearms and effectively prohibits the remote sale of firearms. Under that law, a dealer of firearms must obtain a Federal Firearms License and cannot transfer possession of a firearm to any unlicensed person without that person first going through a criminal background check through the National Instant Criminal Background Check System, and without the dealer verifying the identity of that person through a government-issued photo identification. The Kansas Department of Revenue interprets this law to say that, subject to some narrow exceptions, the only legal sale by mail order or the Internet would be from one federal firearms licensee to another one. Consequently, for a licensed firearms dealer located in Kansas, the transfer of possession of a weapon to the ultimate

consumer in Kansas would be subject to sales tax, regardless of how the dealer obtained possession of the weapon (mail, Internet or otherwise).

The Committee also received information regarding the Kansas Department of Revenue's compliance program for gun shows, art fairs, trade shows, and similar events. It was noted that two revenue agents have primary responsibility for implementing the Department's statewide sales tax compliance program for vendors at miscellaneous events such as gun shows. The two agents are assisted by one or more additional agents when necessary. The procedure for compliance agents was described as follows. The agent contacts the coordinator of each miscellaneous event in order to request a list of participating vendors, addresses, and phone numbers at least two weeks in advance of the event. Once the agent has the list of participating vendors, the agent verifies sales tax registration. If a vendor on the list appears not to be registered, the agent will send registration materials to the vendor as soon as possible. Depending on the size of the event and the agent's schedule, the agent will attend the event, make contact with the vendors, check that vendors are registered with the Department, answer vendor sales tax questions, and follow up with vendors who have not registered with the Department.

Conclusions and Recommendations

After reviewing the issue of sales tax parity on the sale of firearms, weapons, and ammunition, the Committee concludes that no legislative action is necessary.