

Date

MINUTES OF THE SENATE ASSESSMENT AND TAXATION COMMITTEE

The meeting was called to order by Chairman Barbara Allen at 10:40 A.M. on January 11, 2006 in Room 519-S of the Capitol.

All members were present.

Committee staff present:

Chris Courtwright, Kansas Legislative Research
Martha Dorsey, Kansas Legislative Research
Gordon Self, Revisor of Statutes Office
Judy Swanson, Secretary

Conferees appearing before the committee: Steve Stotts, Department of Revenue

Others attending:

See attached list.

Senator John Vratil appeared before the Committee and requested the introduction of two bills; one to repeal the Kansas estate tax that currently exists and the second to create a free-standing Kansas estate tax, which would not be tied to the Federal tax code and is being drafted to be revenue neutral.

Senator Lee moved to introduce both bills that Senator Vratil requested. Senator Jordan seconded the motion, and the motion passed.

Senator Lee made a motion to introduce a bill that would reinstate the two county demand transfers that have been lapsed and funds would go to counties that would lose sales tax locally. Senator Bruce seconded the motion. Motion passed.

Chairman Allen distributed guidelines for conferees who wish to appear before the Assessment & Taxation Committee. (Attachment 1)

Steve Stotts, Kansas Department of Revenue, presented three bill requests from Secretary of Revenue Joan Wagon. 1) E-file readiness; 2) Federal conformity on penalty for failure to file income tax return when refund is later requested and 3) Elimination of caps from refund funds. (Attachment 2) Senator Donovan made a motion to introduce the three requested bills. Senator Lee seconded the motion. Motion passed.

Martha Dorsey, Legislative Research Department, reviewed two issues from the 2005 Special Committee on Assessment and Taxation. (Attachment 3)

The Special Committee recommended the introduction of a bill that would impose an excise tax on sexually oriented businesses, modeled after the enacted Utah law and the proposed Oklahoma legislation. The bill merits review by the House and Senate Judiciary, Senate Ways & Means and House Appropriations, and House Taxation and Senate Assessment and Taxation committees.

The Special Committee recommended no legislation be proposed concerning tax lien certificate legislation. It recommended instead the standing legislative committees examine the interest rate applied to delinquent property taxes.

Chris Courtwright then reviewed four more issues from the Special Committee.

The Special Committee recommended the context within which the Legislature views state tax policy and potential changes should always include consideration of the implications on local tax policy, especially property taxes. Standing tax committees should also monitor the implications of the growing regional differences in local sales tax rates. No legislation was requested.

Because of the concern over long-run state revenue growth issues, the Committee recommended the 2006 Legislature memorialize congress to minimize all federal preemption of state taxing authority.

CONTINUATION SHEET

MINUTES OF THE Senate Assessment and Taxation Committee at 10:30 A.M. on January 11, 2006 in Room 519-S of the Capitol.

The Special Committee found the equity of the current vehicle valuation system remains of serious concern, and recommended the standing tax committees continue to work on developing potential amendments and alternatives.

The Special Committee recommended the standing tax committees develop criteria similar to those utilized in the early 1970s to help the legislature evaluate all future requests for sales tax exemptions. It made no recommendations regarding changes to the property tax treatment of not-for-profit organizations.

The Special Committee found Kansas employs a variety of tools to encourage the renovation of historically significant property and did not recommend the introduction of a constitutional amendment to authorize a different valuation methodology for such property.

Chairman Allen announced there would be no meeting tomorrow, and that committee hearings will resume on Thursday, January 19.

Being no further business, the meeting adjourned at 11:40 a.m.

SENATE
ASSESSMENT & TAXATION COMMITTEE

GUEST LIST

DATE: 01-11-06

NAME	REPRESENTING
Estelle Montgomery	Hein Law Firm
Erik Sartorius	City of Overland Park
Ad Neal	LGK
Amy Billinger	intern
Steve Johnson	Kansas Gas Service / ONEOK
Bill Brady	Capitol Strategos
LARRY R BAKER	CKM
David Corbin	KDOR
Jim Conant	KDOR
BRAD HARRELSON	KFB
Ben Cleaves	Budget
Yvon Durkin	DFB
Hal Hudson	NFIB / KS

**GUIDELINES FOR CONFEREES APPEARING BEFORE THE
SENATE ASSESSMENT & TAXATION COMMITTEE**

1. Cellular phone and pagers with audible tones must be turned off or disabled while in the committee room.
2. Individuals wishing to appear and provide verbal testimony before the committee should **notify** the committee secretary at least **24 hours** in advance of the hearing.
3. Testimony should be in **written form** with 20 copies made available to the committee secretary **by 9:00 a.m. on the day of the hearing**.
4. Conferees should not read their testimony. Rather, testimony should be presented in summary fashion. Conferees should introduce themselves, identify on whose behalf they appear, identify whether they appear as a proponent, opponent, or interested neutral party and should, as briefly as possible, stat the reason(s) for their position.
5. If suggestions for amendments(s) are to be offered, a proposed draft of the amendments(s) must be provided to staff.
6. When the conferee is, or represents, the sponsor of the measure under consideration, the conferee should be prepared to brief the committee on the specific provisions of the legislation.
7. Conferees should address their remarks during testimony to committee members and staff only.
8. When the number of hearings and/or conferees scheduled warrant time limitations, the Chairman may limit testimony to a specific number of minutes.
9. Testimony shall relate to the subject matter of the measure under consideration.
10. The Chairman reserves the right to take such action as may be necessary to prevent disruptive behavior in the committee room during hearings and deliberations.
11. There shall be no recording, audibly, photographically or otherwise, of committee deliberations and/or voting except by the committee secretary.

January 11, 2006

Assessment & Taxation
Date 1-11-06
Attachment # 1



K A N S A S

JOAN WAGNON, SECRETARY

DEPARTMENT OF REVENUE
OFFICE OF THE SECRETARY

KATHLEEN SE ELIUS, GOVERNOR

January 11, 2006

To: Senator Barbara Allen, Chair
Senate Committee on Assessment and Taxation

From: Joan Wagnon

Re: Summary of Department of Revenue Legislative Proposals Requested for Introduction in Senate Committee on Assessment and Taxation

E-file Readiness

Amend K.S.A. 75-5151 to lower the threshold for requiring electronic payment of sales tax liability or employers' withholding tax liability from \$100,000 in total sales or withholding tax liability in any calendar year, to \$32,000 in any calendar year.

Amend K.S.A. 79-3298(c) to provide that if an employer, payer or other person or organization filing a Kansas withholding tax return reports withholding for fifty or more employees or payees, the return shall be filed electronically.

Federal Conformity on Penalty for Failure to File Income Tax Return When Refund Is Later Requested

In conformity with federal income tax law, amend K.S.A. 79-3228(d) to provide a penalty (50% of the refund, up to a maximum of \$250) when a taxpayer claims a refund after failing to file an income tax return (or filing an insufficient return) within 20 days of receiving notice from the Department to file such return.

Eliminate Caps from Refund Funds

Amend various tax refund fund statutes to delete provisions imposing caps on those funds. During certain times of the year, refunds due may exceed the statutory cap imposed on the refund fund. Because the refunds are due and payable and will be paid from the appropriate fund, these arbitrary caps serve no real purpose.

Assessment & Taxation
Date 1-11-06
Attachment # 2

Reports of the
Special Committee on Assessment and Taxation
to the
2006 Kansas Legislature

CHAIRPERSON: Senator Barbara Allen

VICE-CHAIRPERSON: Representative Kenny Wilk

RANKING MINORITY MEMBER: Representative Tom Thull

OTHER MEMBERS: Senators Pat Apple, Les Donovan, Janis Lee, and Roger Pine; and Representatives Virginia Beamer, Pat George, Tom Holland, Kasha Kelley, Bruce Larkin, and Arlen Siegfried

STUDY TOPICS

Property Tax—Valuation of Historic Property

Tax Treatment of Not-for-Profit Entities

Motor Vehicles Taxes

Excise Tax or Licensure Tax—Sexually Oriented Businesses

Analysis of State and Local Tax Policy

Tax Lien Certificates

December 2005

Assessment & Taxation
Date 1-11-06
Attachment # 3

Special Committee on Assessment and Taxation

ANALYSIS OF STATE AND LOCAL TAX POLICY

CONCLUSIONS AND RECOMMENDATIONS

The Committee encourages the Legislature to provide property tax relief by authorizing the restoration of sales tax demand transfers to local units of government. If it is determined that the demand transfer program need to be restructured, special emphasis should be placed on additional funds for local units in rural areas.

The Committee finds that the overall elasticity of tax receipts, especially State General Fund (SGF) tax receipts, appears to be declining. The Committee expresses its concern about legislation earmarking future sales, income, and property tax revenue streams from specific industries or businesses. The Committee therefore recommends that a more rigorous fiscal review be applied to future legislation seeking to earmark revenues historically placed in the SGF. The Committee further asks staff to develop a new monthly receipts report that disaggregates taxes and other receipts relative to the amount placed in the SGF compared to the amount placed in all other funds. The Committee also recommends that the 2006 Legislature memorialize Congress to minimize federal preemption of state taxing authority.

The Committee recommends that the Department of Revenue report to the standing tax committees on policy options regarding modernization and structural changes to the corporation income tax. The Committee further recommends that the Legislature attempt to provide a property tax exemption for commercial and industrial machinery and equipment.

The Committee recommends copies of a number of ongoing studies, including those on the implications of the expansion of state and local debt; and on sales and property tax base erosion, be made available to all appropriate committees when completed in June 2006. The Committee anticipates the need to give these reports in-depth review and therefore requests that a special committee on assessment and taxation again be established to study the same state and local tax policy topic during 2006.

Proposed Legislation: None.

BACKGROUND

During the 2004 and 2005 sessions, the House Taxation Committee frequently discussed a number of changes that had occurred in state and local tax policy over the last two decades. Included among those important changes were the 1992 school finance law and its impact on the overall tax burden; tax cuts enacted during the mid-1990s; the continued proliferation of tax exemptions; the elimination of demand

transfers to local units of government; and the 2002 tax increases.

The Legislative Coordinating Council in July therefore approved a request from Representative Wilk, chairman of the House Committee, and directed the Special Committee to review the current state and local tax structure, focusing on the shifts in reliance on sales, property, and income taxes since 1990. The Special Committee also was charged with studying the impact on the tax

structure of the ongoing shift in the Kansas economy to a more service sector-driven economy; and with reviewing the impact of: (1) property tax relief in the 1990s; and (2) the 2002 tax increases on the Kansas economy and tax structure. Finally, the Special Committee was asked to study the future of Kansas tax policy for the next 10 to 20 years, and recommend which tax structure components would be most equitable to the taxpayers of Kansas; and would improve Kansas' competitiveness with other states.

COMMITTEE ACTIVITIES

At the September meeting, staff reviewed Kansas Tax Facts with a particular emphasis on the previous 15 years. The presentation included a discussion of the composition (tax mix) of the Kansas state and local tax structure; revenue elasticity of the major tax sources; the progressivity of the major tax sources; and the extent to which economic development competition with surrounding states influences tax policy.

With respect to the elasticity of the sales tax, staff noted that while Kansas does apply the sales tax to more services than many states, one of the reasons the elasticity of the tax has been declining relates to the fact that as incomes go up, people tend to spend more of their disposable income on services which are exempt (such as tax-preparation, tanning-salon, and pet-grooming services).

Several committee members expressed concern about mill levy increases in rural areas and the impact of the elimination of demand transfer funds on property taxes. The Committee discussed the fact that many of the rural areas experiencing large property tax increases have very limited ability to provide any local property tax relief through the imposition of local sales taxes.

Secretary of Revenue Joan Wagnon reviewed several major topics she said were imperative to consider when thinking about

the future of tax policy for the next 10 to 20 years. She said that if the erosion of the tax base were to continue into the future, the result would be higher tax rates and less equity among various groups of taxpayers; less competitiveness and more taxpayer discontent; and more special interest groups' requesting exemptions—creating a vicious cycle. She said that the Legislature may wish to look at some of the work of the "Hodge Committee" of the early 1970s and seek a return to the basic principle that "taxation is the rule, and exemption is the exception." Having a broader tax base means tax rates can be lower and taxes can be more equitable and competitive, according to the principle.

Secretary Wagnon said that tax base erosion had been occurring because of the enactment of a number of exemptions and tax credits; and because of economic shifts in consumption and business practices, many relating to new technologies. She also said that the authorization of sales tax and revenue (STAR) bonds and the propensity of the Legislature to earmark future revenue streams threatened the elasticity of tax receipts relative to the State General Fund (SGF). She said that once a special practice or tax treatment had been established, it was often difficult for the Legislature to backtrack and stop that process. Faced with a similar situation more than three decades ago, the Hodge Committee formed a special commission to review tax policies and make decisions on which special exemptions, exceptions, and credits should be restructured or totally eliminated. She said the Department of Revenue was working on a number of the major tax policy issues in conjunction with the Kansas Advisory Commission on Intergovernmental Relations, Wichita State University, and the Department of Commerce. Major studies on sales and property tax base erosion currently are scheduled for completion in June 2006. She pointed specifically to a number of issues likely to be in front of the tax committees in upcoming years, including:

- Federal preemption of state taxing authority;
 - Over-reliance on debt financing;
 - Potential modernization of corporation income taxes;
 - Deciding whether to exempt commercial and industrial machinery and equipment from property taxation;
 - Potential elimination of a number of sales tax exemptions;
 - Potential taxation of services;
 - Whether to continue to allow withholding taxes to be earmarked;
 - Whether to maintain a Kansas estate tax once the federal tax is eliminated; and
 - Maintaining the uniformity of the local sales tax law as it relates to cities and counties.
- Kansas should maintain its enviable reputation as a fiscally responsible state.
 - A tax system should produce revenues that are adequate to finance an agreed-upon level of public services over time.
 - A tax system should produce adequate revenue during economic downturns and also respond to economic growth.
 - State and local taxing and spending decisions should be consistent with economic growth and development.
 - Administration of the tax system should be fair and efficient.
 - Fiscal accountability should be strengthened by making taxpayers aware of their true tax liabilities.
 - Tax revisions should not unduly erode the tax base.
 - State fiscal policy should advance the interests of the state as a whole, while facilitating the fiscal autonomy of local governments.
 - Policymakers must recognize that tax policy influences economic behavior, and not always in the desired manner.
 - Kansans should be able to rely upon a stable tax policy.
 - The state and local tax system should be balanced and diversified.

At the October meeting, staff outlined statistics from the Kansas State Treasurer relating to the growth of Kansas state and local bonded indebtedness from \$7.581 billion in June, 1990 to \$21.138 billion in June 2004. Staff also reviewed the recently released FY 2005 version of Kansas Tax Facts. In comparison with all other states based on the latest federal statistics, Kansas had the 29th highest state taxes per capita and also the 29th highest state taxes as a percent of personal income. The recent rate of growth in local taxes, especially property taxes, rebounded somewhat in FY 2005 after coming off two years of more modest growth. Property taxes in FY 2005 increased by about 6.5 percent, or \$187 million, with schools accounting for \$120 million of the increase.

Secretary Wagnon distributed eleven tax policy objectives recommended by the 1995 Governor's Tax Equity Task Force:

She then asked how the rapid expansion of state and local debt over the last 15 years could be reconciled with these objectives, noting that a third major study on debt also was scheduled for completion in June 2006. The Committee asked that this latter study be made available to the Legislative Budget Committee as well as the tax committees once it is released.

The Secretary said that she hoped the Committee would strongly recommend that the Legislature in the future protect the withholding tax and not allow any other circumstances wherein major tax sources could be diverted from the SGF.

Dr. John Wong of Wichita State University made a presentation on the extent to which the elasticity of the major tax sources has declined over time. He said that one reason behind the declining elasticity relates to the fact that the economy today is much different than it was in the 1930s when the sales and income taxes were imposed. He said that as the economy and technology continue to change, government should keep an eye on those things generating economic activity and recognize the reallocation of resources in the private market. When the economy changes and the tax structure does not, a lag in revenues is likely to occur until the tax policies have been modified.

Dr. Wong also said that the declining elasticity of major taxes was indicative of the rapid changes occurring in the Kansas economy. He observed that Kansas was currently in a transitional period and was seeing agriculture and manufacturing become relatively less important while services were becoming more important. He also said that the ability of the tax structure to keep pace could be eroded even further as the next transition to a technology-based economy occurs. He said that states had not been able to adjust their sales tax structures to tax most services because of the potential mobility of services and because of the power of special-interest groups. If Kansas is unable to begin taxing more services, the elasticity of the sales tax is expected to continue to decline, based on the expectation that the relative economic contribution of services in comparison to goods is expected to continue to grow.

During the public hearings, a conferee representing the Wichita Metro Chamber of Commerce recommended that the

Legislature consider eliminating the property tax on commercial and industrial machinery and equipment, noting that eleven states already have such an exemption.

A conferee representing the Kansas Chamber encouraged the Legislature to develop a pro-growth business tax policy that would encourage capital investment and job creation.

A representative of the League of Kansas Municipalities asked for new consideration of three bills introduced during 2003 that would have allowed local units of government to diversify their revenue diversify portfolio and reduce reliance on property taxes.

Representative Wilk also distributed a chart on estimated growth in real Gross Domestic Product from 2004 through 2015 for twelve countries and observed that the forecasted rate of growth was much faster for China than it was for the United States.

CONCLUSIONS AND RECOMMENDATIONS

State and Local Tax Policy Linkage

The Committee recommends that the context within which the Legislature views state tax policy and potential changes should always include consideration of the implications on local tax policy, especially property taxes.

The Committee strongly encourages the 2006 Legislature to provide property tax relief by authorizing the restoration of sales tax demand transfers to local units of government. If it is determined that the demand transfer program need to be restructured, the Committee recommends that special emphasis be placed on providing additional funds for local units in rural areas.

The Committee also asks that the standing tax committees monitor the

implications of the growing regional differences in local sales tax rates.

Long-Run Growth and the SGF

The Committee finds that the overall elasticity of tax receipts, especially SGF tax receipts, appears to be declining to the point that the ability of the state to fund ongoing and necessary expenditures without periodic tax increases has been imperilled. The Committee expresses its concern about the recent trend of legislation to earmark future sales, income, and property tax revenue streams from specific industries or businesses, including legislation associated with the development of sales-tax-and-revenue bonds and the neighborhood revitalization program.

The Committee therefore recommends that a more rigorous fiscal review be applied to future legislation seeking to earmark revenues historically placed in the SGF and asks that all such bills be referred to the standing tax committees.

Because of the proliferation of legislation associated with the diversion of revenues, the Committee asks that the standing tax and appropriations committees work with staff at the Division of Budget and the Legislative Research Department to develop a new monthly receipts report that disaggregates taxes and other receipts relative to the amount placed in the SGF compared to the amount placed in all other funds.

Also because of the concern over long-run state revenue growth issues, the Committee further recommends that the 2006 Legislature memorialize Congress to minimize all federal preemption of state taxing authority.

Business Tax Recommendations

The Committee expresses its concern about the volatility of corporation income tax receipts over the last decade. The Committee therefore recommends that the Department of Revenue report to the standing tax committees on policy options regarding modernization and structural changes to the tax that would help assure that it continues to be viable revenue source well into the future.

The Committee recommends that the Legislature attempt to provide a property tax exemption for commercial and industrial machinery and equipment and notes that options under consideration would include a full statutory exemption; expansion of the existing income tax credit to 100 percent; or a constitutional amendment authorizing the Legislature to phase in a full exemption over a period of years.

Forthcoming Studies and the Future

The Committee recommends that the Legislative Budget Committee receive copies in June of the study on the implications of the rapid expansion of state and local debt. The Committee further recommends that additional studies being conducted by the Department of Revenue, including those on sales and property tax base erosion, be made available to all appropriate committees when completed in June 2006. Finally, the Committee anticipates the importance of the need to give these reports in-depth review and therefore requests that the Legislative Coordinating Council again approve a Special Committee on Assessment and Taxation to study the same state and local tax policy topic during the summer and fall of 2006.

Special Committee on Assessment and Taxation

MOTOR VEHICLE TAXES

CONCLUSIONS AND RECOMMENDATIONS

The Committee finds that the equity of the current vehicle valuation system remains of serious concern and therefore recommends that the standing tax committees continue to work on developing potential amendments and alternatives, including changing the current depreciation rate or replacing the entire system with a statewide fee proposal.

The Committee further acknowledges that any major change to the motor vehicle taxation system may have to be phased in over a number years.

Proposed Legislation: None.

BACKGROUND

During the 2003 interim, the Special Committee on Assessment and Taxation, in response to a legislative post audit released earlier that year, reviewed motor vehicle sales tax collections by both dealers and by private individuals relative to isolated sales of used vehicles.

That interim committee recommended the introduction of legislation in 2004 that would "provide clear statutory guidance with respect to when the amounts reported for certain private sales are deemed to be questionable and should be replaced by a proxy estimate of the vehicle's value."

The legislation that ultimately was introduced and enacted in 2004, SB 372, amended the sales tax law to provide that in the case of isolated sales of motor vehicles or trailers, the tax was to be charged on the greater of the stated selling price or to valuation of the motor vehicles or trailers pursuant to the motor vehicle (property) tax law (KSA 79-5105 et seq.). An exception was provided for "damaged or wrecked" vehicles, for which the sales tax was to be charged on the actual selling price. Also excluded from the new sales tax requirement were certain kinds of vehicles which were not valued

pursuant to the motor vehicle tax law in the first place, which continued to be taxed on the stated selling price.

Amid public concern following the implementation of this new sales tax system on July 1, 2004, the Legislative Coordinating Council again asked the Special Committee to review the law. The 2004 interim committee subsequently recommended that the main provisions of SB 372 be repealed retroactively to July 1, 2004, and that refunds be provided to taxpayers who had paid sales taxes based on the valuations utilized in the motor vehicle tax law. (The 2005 Legislature ultimately did repeal the 2004 law and provide for refunds, pursuant to the enactment of SB 23.)

But the 2004 Special Committee also made a finding "that taxpayer concern over using the property tax values for sales tax purposes has highlighted the fact that the property tax values are far too high in many cases. The Committee therefore strongly encourages the 2005 Legislature to review the vehicle valuation schedules used for property tax purposes and enact whatever recommendations are deemed appropriate to provide for a more equitable tax system."

Legislative staff was directed during the 2005 Session to work with the Department of Revenue in developing potential legislation on this topic, but because of the complexity of the issue and the time constraints facing the 2005 Legislature, Senator Donovan subsequently asked for an interim study on the motor vehicle tax valuation issue.

The Legislative Coordinating Council approved that request and directed the Special Committee to review the recommendation of the 2004 Special Committee about the equity of the valuations used for motor vehicle tax purposes. The charge also asks the Committee to consider various options regarding replacing the valuation-based system with a fee structure; and to make recommendations as to whether school finance local effort could be enhanced by reinstating the distribution of motor vehicle tax receipts to school district general funds.

Total Motor Vehicle Tax Collections

Motor vehicle tax collections in calendar year 2004 were \$294.2 million. Alternative taxes to the motor vehicle tax, the recreational vehicle tax, the rental excise tax, and the 16- and- 20-thousand-pound truck tax, also produced \$3.2 million, \$2.8 million, and \$6.5 million, respectively. Thus total vehicle taxes were approximately \$306.7 million.

Motor Vehicle Taxes and School Finance

As part of a broad package of motor vehicle tax reductions enacted in 1995, the distribution of such taxes to school district general funds was phased out by calendar year 2000. As such, the current countywide average mill levy utilized for motor vehicle tax purposes is exactly 20 mills lower than the actual countywide average mill levies. The Department of Revenue has estimated that restoration of the 20 mills to the countywide average levies such that school district general funds would again receive

motor vehicle tax distributions would produce approximately \$73.9 million in additional local effort throughout calendar year 2007.

Depreciation versus Fee-Schedule

One issue discussed frequently during the vehicle sales tax debates of the last two years related to the fact that the statutory depreciation rate of 15 percent was inadequate to reflect the true depreciation for many kinds of vehicles and subsequently left motor vehicle tax valuations at significantly higher levels relative to the fair market value of the vehicles.

COMMITTEE ACTIVITIES

At the September meeting, staff reviewed the history of the 1995 motor vehicle tax changes; the 2004 and 2005 motor vehicle sales tax provisions; and the current valuation procedure for vehicles. The Department of Revenue was asked to prepare a fee schedule option for consideration by the Committee in November that would be revenue neutral relative to current law.

At the October meeting, the Department of Revenue presented a fee schedule proposal based on the age and original value that would produce roughly the same amount of statewide motor vehicle tax revenue in 2007 as current law. The fees ranged from \$24 to \$720, depending on the original class code of the vehicles. The proposal analyzed how the tax under current law would compare with the fee for four sample vehicles in three counties. The proposal also estimated current taxes in five counties under current law and compared that with the fees that would be received. Several committee members observed that the 2006 Legislature could consider a fee schedule that would be effective in 2007 that would utilize a higher top fee than \$720.

During the public hearing, a conferee representing the Kansas Automobile Dealers'

Association, said that the history of motor vehicle taxes in Kansas often had an impact on the number of vehicles sold and registered in the state.

At the November meeting, the Committee made its final conclusions and recommendations.

CONCLUSIONS AND RECOMMENDATIONS

The Committee finds that the equity of the current vehicle valuation system remains of serious concern.

The Committee therefore recommends that the standing tax committees during the 2006 Session continue to work with the Department of Revenue on developing potential amendments and alternatives, including changing the current depreciation rate or replacing the entire system with a statewide fee proposal.

The Committee further acknowledges that any major change to the motor vehicle taxation system may have to be phased in over a number years, as was the case in the 1990s.

Special Committee on Assessment and Taxation

TAX TREATMENT OF NOT-FOR-PROFIT ENTITIES

CONCLUSIONS AND RECOMMENDATIONS

The Committee strongly recommends that the standing tax committees develop criteria similar to those utilized in the early 1970s to help the Legislature evaluate all future requests for sales tax exemptions.

The Committee does not at this time recommend expanding sales tax exemptions to all 501(c)(3) entities in the state.

The Committee makes no recommendations regarding changes to the property tax treatment of not-for-profit organizations.

Proposed Legislation: None.

BACKGROUND

During the 2003 session, the House Taxation Committee conducted a review of all sales tax exemptions and held public hearings on several pieces of legislation that would have removed most exemptions. The hearings represented the first comprehensive review of extant sales tax exemptions since the early 1990s. During the 2005 Session, at least 18 bills were introduced dealing with the subject matter of sales tax exemptions. Many of those bills would have extended exemptions for sales or purchases, or both, of groups designated as not-for-profit entities pursuant to section 501(c) of the federal Internal Revenue Code.

Property owned and operated by not-for-profit groups in some cases is totally exempt from taxation. Not-for-profit property which is in fact taxable may, under certain circumstances defined by the Legislature, qualify for a special reduced assessment level.

The Legislative Coordinating Council in July approved a request from Representative Wilk and directed the Special Committee to

review the sales and property tax treatment of not-for-profit entities and make any policy recommendations deemed appropriate to the 2006 Kansas Legislature.

Sales Tax Treatment

In response to a request from the House Taxation Committee, the Department of Revenue in 2004 estimated that there were more than 8,000 501(c)(3) organizations in the state. At that time, the Department estimated that exempting all such organizations not previously exempt would reduce state sales tax receipts by about \$19 million and local sales tax receipts by about \$4.8 million.

Certain 501(c)(3) entities do have sales tax exemptions under current law, including: museums and historical societies; five health related organizations; zoos; religious organizations; food distribution programs; and medically underserved clinics and health centers.

A number of other not-for-profit groups and organizations which may not necessarily be chartered as 501(c)(3) entities

also qualify for various exemptions, including: hospitals and blood, tissue, and organ banks; educational institutions; nursing homes or intermediate care homes; nonsectarian comprehensive multidiscipline youth development programs; public health corporations; Kansas Korean War memorial organizations; parent-teacher associations and organizations; and noncommercial educational television and radio stations.

Property Tax Treatment

Property tax exemptions are normally based on the use of the property, not on the ownership. In other words, property generally has to be used exclusively for a religious, benevolent, scientific, governmental, or charitable purpose in order to be exempt. Although some statutory exceptions to the exclusive-use test have been provided to assure that certain non-exempt uses which are minimal in scope or insubstantial in nature will not disqualify the property for exemption, much of the property owned by not-for-profit groups such as fraternal or veterans' groups is taxable. Out of slightly over 1.552 million parcels of real property in 2004, about 64,000 (or roughly 4%) were exempt from taxation for one reason or another, including exemptions which were effectively granted by local units of government pursuant to the issuance of industrial revenue bonds and the granting of economic development exemptions.

Following the implementation of reappraisal and classification in tax year 1989, a number of not-for-profit groups, whose property was assessed at 30 percent of fair market value, began appealing to the Legislature for some form of property tax relief. When the Legislature in 1992 crafted a revised classification amendment to submit to voters, one provision that was included authorized future Legislatures to provide a reduced (12 percent) assessment level for real property owned and operated by not-for-profit groups exempt from income taxation pursuant to section 501 of the

federal Internal Revenue Code. Although the amendment was adopted by voters in 1992, the Legislature did not avail itself of this new prerogative until 1994, when legislation (H Sub SB 157) was approved that reduced the assessment level from 30 to 12 percent starting in tax year 1994 on:

- Taxable real property owned and operated by groups or organizations chartered pursuant to subsections 501(c)(3), 501(c)(4), 501(c)(8), and 501(c)(10);
- Taxable real property owned and operated by 501(c)(2) organizations if such property is leased to a 501(c)(8) organization; and
- Certain land owned by 501(c)(7) organizations if such land is actually and regularly used for recreational purposes. The assessment level reduction for 501(c)(7) property specifically did not apply to land which accommodates buildings or other improvements associated with the recreational land, nor did it apply to the buildings or improvements themselves. A recapture or clawback provision also was provided which is triggered when 501(c)(7) land which has been assessed at 12 percent is devoted to a nonrecreational use.

Property tax data released by the Property Valuation Division indicate that in tax year 2004 there was approximately \$444 million of appraised valuation of real property that qualified for the special 12 percent not-for-profit valuation subclassification. The \$6.297 million in property taxes paid by the owners of such property would have been \$15.743 million (or \$9.446 million more) if the assessment rate had been 30 percent. The \$1.066 million in local effort for purposes of the school finance formula (attributable to the 20 mill levy) would have been \$2.665 million (an additional \$1.599 million) with the assessment level at 30 percent.

COMMITTEE ACTIVITIES

At the September meeting, staff reviewed the sales and property tax treatment of most not-for-profit entities and distributed a copy of the federal income tax law relating to not-for-profit organizations. Secretary of Revenue Joan Wagnon explained the financial and physical make-up of a typical not-for-profit organization in Kansas and why property tax exemptions are important to such an entity. She said that as a matter of policy, sales tax exemptions are more typically withheld from non-profit groups, since those taxes provided the only real source of revenue that goes back to the community. She also distributed a suggested list of criteria for reviewing proposed sales tax exemptions similar to one used by the tax committees in the early 1970s.

The Department then updated the fiscal note on providing a sales tax exemption for all 501(c)(3) entities, indicating that the loss of state sales tax receipts would be about \$25 million and the loss of local sales tax receipts would be about \$6.6 million. The cost of all not-for-profit entities which currently have sales tax exemptions is \$33.7 million to the state and \$8.9 million to local units. One exemption for religious purchases which was enacted in 1998 and was expected to reduce state receipts by about \$4 million currently is estimated to be reducing state receipts by over \$25 million. (The Department of Revenue reported at the November meeting that there were 5,835 religious organizations registered as exempt entities and observed that construction activities by such groups had been much greater than had been anticipated by the 1998 fiscal note.)

Officials from the Property Valuation Division (PVD) distributed a report on property tax exemptions, noting that the number of exemptions had grown from 12 in 1967 to more than 70 in 2005.

At the October meeting, staff distributed information on mill levies for cities, counties and school districts. PVD also provided information on the relative amount of tax exemptions by reason, with a particular emphasis on governmental exemptions.

A conferee representing the Kansas Library Association spoke in favor of HB 2221, a bill that would provide a sales tax exemption for libraries and friends-of-library groups. A conferee representing the Kansas Commission on Disability Concerns requested that the Legislature maintain existing property tax exemptions for those non-profit organizations that help fill in the gaps left by numerous state programs.

A conferee representing the YMCAs of Kansas defended the group's existing sales tax exemption based on its charitable mission and the fact that most other states also have such an exemption.

A representative of the Girl Scout Councils of Kansas said that the exemption for Girl Scouts amounted to a benefit of approximately \$450,000 to more than 41,000 girls across the state.

Several conferees representing the Kansas Health and Fitness Association and private health clubs testified in favor of HB 2204, legislation that would eliminate the sales tax on membership dues for the clubs. The conferees noted that their clubs were competing directly against the YMCAs, which do not have to collect sales taxes on membership dues.

At the November meeting, the Committee made its final conclusions and recommendations.

CONCLUSIONS AND RECOMMENDATIONS

The Committee strongly recommends that the standing tax committees develop criteria similar to those utilized in the early 1970s to help the Legislature evaluate all

future requests for sales tax exemptions. Specifically, some of those criteria should include whether a proposed exemption (1) helps maintain the sales tax as a final tax on consumption; (2) makes the tax more easily administered; (3) is targeted to a broad class or to a narrow, special interest; (4) establishes an unfair competitive advantage for one group relative to another; and (5) causes the overall public benefit to outweigh the loss of revenue.

The Committee does not at this time recommend expanding sales tax exemptions to all 501(c)(3) entities in the state.

Finally, the Committee makes no recommendations regarding potential changes to the property tax treatment of not-for-profit organizations.

Special Committee on Assessment and Taxation

PROPERTY TAX VALUATION OF HISTORIC PROPERTY

CONCLUSIONS AND RECOMMENDATIONS

The Committee finds that Kansas under current law employs a variety of tools to encourage the renovation of historically significant property and does not at this time recommend the introduction of a constitutional amendment to authorize a different valuation methodology for such property. The Committee does recommend that the standing tax committees review the neighborhood revitalization program during the 2006 Session and consider introducing legislation to provide additional state oversight; limit the amount of territory subject to the program; and limit the amount of time for which property tax refunds may be provided.

Proposed Legislation: None.

BACKGROUND

A constitutional amendment (Amendment 1) adopted by voters in Nebraska in 2004 authorized the Nebraska Legislature to provide statutorily that the increased valuation attributable to the renovation, rehabilitation, or preservation of certain historically significant real estate may be exempted, in whole or part, from property taxation. During the mid-1990s, a special task force on historic preservation had recommended a number of policy initiatives that led to additional legislative studies and ultimately to the proposal embodied in Amendment 1. The constitutional amendment was approved in November 2004, by a 58-42 margin.

The Nebraska Legislature in 2005 subsequently availed itself of this newly granted constitutional prerogative and unanimously approved LB 66, which Governor Heineman signed into law on May 31. That legislation, based on similar provisions in place in South Dakota and Illinois, authorizes a different valuation methodology for certain real property: (1) listed in the National Register of Historic Places; (2) located within a district listed in the National Register of Historic Places that is "historically significant" as determined by

the state historic preservation officer; (3) specifically designated by a local unit of government pursuant to an ordinance or resolution and subsequently approved by the state historic preservation officer; and (4) submitted for approval by individual property owners when such property is located within a district designated by a local unit of government pursuant to an ordinance or resolution and subsequently approved by the state historic preservation officer.

Effective January 1, 2006, all qualifying property would be entitled to have its valuation limited for eight years to an amount no more than the "base-year" valuation. Beginning in the ninth year, additional valuation that had been exempt would be phased in until the twelfth year, at which time the property would be taxed based upon its full valuation. At any time during the 12-year period, the property tax break could be rescinded if the state historic preservation officer determines that any repair, renovation, remodeling, or improvement had been conducted in violation of certain specified rehabilitation standards; the property is no longer of historical significance to a qualified historic district; or the property is no longer qualified

to be listed on the National Register of Historic Places.

In addition to similar types of property tax abatements, the other major way states have utilized tax policy to encourage historic preservation relates to providing income tax credits. Kansas since tax year 2002 has provided an income tax credit equivalent to 25 percent of certain expenditures incurred in the restoration and preservation of qualified residential and commercial historic structures, provided such expenditures equal \$5,000 or more. A January 2005 study by the National Trust for Historic Preservation indicated that 30 states authorized some form of state or local property tax abatements; and 24 states, including Kansas, provided some form of income tax credit.

In the wake of Nebraska's Amendment 1 and subsequent enactment of LB 66 and some inquiries from the Historical Preservation Corporation, located in Council Grove, Senators Allen and Barnett recommended the issue for interim study. The Legislative Coordinating Council in July approved the request and directed the Special Committee to study a potential Kansas constitutional amendment similar to Nebraska's that would authorize a different valuation methodology for certain property and improvements associated with the renovation, rehabilitation, and preservation of historically significant real estate.

COMMITTEE ACTIVITIES

At the September meeting, staff outlined the history of the issue in Nebraska. During the public hearing, a conferee from the Kansas State Historical Society said that with proper planning, some sort of property tax relief for historic property could dovetail with the existing income tax credit to help make certain projects economically feasible. A conferee representing the Historic Preservation Corporation also spoke in favor of the proposed constitutional amendment.

The conferee said that he had been working on restoring the Terwilliger Home in Morris County and on improving other buildings along the historic Santa Fe Trail and reported that a property tax exemption application for the projects had been denied.

At the October meeting, staff provided additional information on the neighborhood revitalization program, including the fact that cities and counties may establish revitalization zones (to provide for property tax refunds) for improvements to certain property which is historic in nature. The Committee subsequently made recommendations and directed staff to prepare a draft report for review at the November meeting.

At the November meeting, the Committee adopted the draft committee report.

CONCLUSIONS AND RECOMMENDATIONS

The Committee finds that Kansas under current law employs a variety of tools to encourage the renovation and rehabilitation of historically significant property, including the income tax credit enacted in 2002; the neighborhood revitalization program; and the earmarking of a portion of mortgage registration taxes for the Heritage Trust Fund.

The Committee notes that a provision in the neighborhood revitalization program that authorizes refunds to be provided under certain circumstances for historic properties appears to have potential applicability to the situation in Morris County involving the Historic Preservation Corporation properties.

The Committee at this time, therefore, does not recommend the introduction of a constitutional amendment similar to the one adopted in Nebraska in 2004.

The Committee further finds that additional study is necessary with respect to the neighborhood revitalization program and its uses. The Committee expresses concern that increased utilization of the refund program amounts to a form of locally implemented property tax caps that could lead to property tax shifts. The Committee further expresses concern that as many as 14 counties appear to have declared the entire jurisdictions as revitalization zones, notwithstanding Attorney General Opinion 96-38 which suggests that they lacked the statutory authority to do so. The Committee also notes that, unlike the granting of property tax exemptions through the issuance of industrial revenue bonds or economic development abatements, no state approval is necessary when local units authorize property tax relief via the establishment of revitalization zones. Finally, the Committee observes that a major

expansion of the program could have implications for school finance to the extent that property tax revenues are diverted from school districts to pay the refunds.

The Committee therefore recommends that the standing tax committees review the neighborhood revitalization program during the 2006 Session and make recommendations as to whether legislation should be introduced requiring the State Board of Tax Appeals or another state agency to approve local resolutions seeking to establish neighborhood revitalization zones; limiting the territory within a jurisdiction that is subject to being placed in the zones; further limiting the purposes for which zones may be established; or limiting the amount of time for which refunds may be provided.

Special Committee on Assessment and Taxation

EXCISE TAX OR LICENSURE TAX—SEXUALLY ORIENTED BUSINESSES

CONCLUSIONS AND RECOMMENDATIONS

The Committee has concluded the use of sexually oriented businesses by some customers has resulted in negative effects that are serious enough to result in additional state expense. The Committee was presented testimony indicating the incidence of sex offenses committed in this state is alarmingly high. Prosecution of sex offenders and subsequent treatment services for victims and offenders results in the expenditure of a significant amount of valuable state and local resources. The Committee received compelling testimony describing a connection between sexually oriented businesses and sex offenses. According to expert testimony, while it cannot be shown that all users of sexually oriented businesses commit sex offenses, it is the case that many sex offenders use such businesses. The use of these businesses constitutes a high-risk situation for the offender, and such use often becomes part of a deviant cycle that can lead ultimately to sex offending.

The Committee therefore recommends the introduction of legislation that would impose an excise tax on sexually oriented businesses. The bill should be modeled after both the enacted Utah law and the proposed Oklahoma legislation. The Committee believes that the imposition of this modest excise tax on sexually oriented businesses will not be an undue burden on such businesses but rather will provide an essential source of revenue to provide necessary services for victims and offenders of sex offenses from a source that bears a portion of the responsibility for the individual and societal damages caused to Kansans related to sex offenses.

The Committee believes the issue merits review by the following standing legislative committees: House and Senate Judiciary, Senate Ways & Means and House Appropriations, and House Taxation and Senate Assessment and Taxation committees.

The Committee recognizes alternatives were raised through testimony and discussion that offered alternatives with respect to the scope of the taxation and other aspects of the issue. The Committee also recognizes the specific programs or proportions of revenue might need to be adjusted to fit Kansas' programs and appropriations requirements. The Committee therefore recommends the standing committees work with the Kansas Department of Revenue and others to examine various alternatives raised with respect to the scope of businesses covered, program funding, and other related issues.

Proposed Legislation: The Committee recommends the introduction of one bill on this topic.

BACKGROUND¹

As authorized by the Legislative Coordinating Council, the Special Committee

on Assessment and Taxation was directed to study a proposed excise tax or licensure tax on certain sexually oriented businesses, similar to legislation under consideration by the Oklahoma Legislature earlier this year.

¹ This background section was prepared by staff from the Office of the Revisor of Statutes and the Kansas Legislative Research Department.

This proposed tax is in the nature of an excise or service tax on transactions

conducted by certain defined sexually explicit businesses. Such transactions include amounts paid to or charged for services provided and items of personal property sold by such businesses. Such businesses primarily are escort services, nude and semi-nude clubs and adult entertainment facilities, and adult bookstores and adult video stores. It is in the nature of an excise tax since it is a tax based on amount of business done rather than an assessment based on valuation or wealth. Excise taxes are not based on rules of apportionment or equality but instead typically are a fixed, often absolute and direct charge laid on merchandise, products, commodities or services. Excise taxes are an impost for a license or privilege to pursue certain callings or occupations, or to deal in special commodities, or to exercise particular franchises.

The tax in the states that have enacted or are considering enacting this type of legislation is imposed as a set amount per transaction or as a percentage of any amounts paid to or charged by the business for certain specified transactions. The legislation usually provides for the expenditure of revenue collected to be used for general purposes or specific purposes.

Tax on Sexually Explicit Businesses—Other States

Enacted Legislation in Other States: Utah

At least one state, Utah, has passed legislation imposing a tax on sexually explicit businesses and escort services. Enacted in 2004, the legislation imposes the following two taxes:

- A tax on a sexually explicit business in an amount equal to 10 percent of amounts paid to or charged by the business for a number of specified transactions, including admission fees, user fees, retail sale of tangible personal

property made within the state, and food, beverage and service sales.

- A tax on an escort service equal to 10 percent of amounts paid to or charged by the service for any escort-type transaction.

The legislation also created the "Sexually Explicit Business and Escort Service Fund," into which all tax money generated must be deposited. The fund money is to be used to pay for treatment of sex offenders as follows:

- 60 percent to provide treatment services to nonworking or indigent adults who have been convicted of sexual offenses and are not currently incarcerated;
- 15 percent to provide outpatient treatment services to convicted sex offenders who are on parole or probation;
- 10 percent to implement treatment programs for juveniles who have been convicted of sexual offenses; and
- 15 percent to provide funding for any task force administered through the Attorney General's Office that investigates and prosecutes individuals who use the Internet to commit crimes against children.

The Utah law codified at §59-27-101 of the Utah Code Annotated also provides definitions as to the businesses and activities subject to taxation and requirements for such businesses with regard to the filing of returns, maintenance and examination of records, assessment and collection of the tax, audits, claims and refunds and penalties and interest for failure to comply, and provides authority to the Utah Tax Commission to administer the Act.

**States With Proposed Legislation:
Oklahoma and Missouri, 2005**

At least two other states' legislatures, those of Missouri and Oklahoma, have attempted unsuccessfully to pass legislation taxing similar types of businesses. The bills are summarized below:

- Oklahoma-2005 HB 1532 – As engrossed by the House, this bill would have established taxes on sexually explicit businesses, escort services, adult bookstores and adult video stores equal to 10 percent of amounts paid for fees, services or items purchased at these establishments. The bill would have required all such tax revenues to be placed in a revolving fund designated specifically for domestic violence and sexual abuse programs. HB 1532 passed the House of Representatives 76-18. It was received by the Senate in March and referred to the Committee on Appropriations. It never was reported and missed all deadlines. It will be carried over to 2006.
- Missouri-2005 SB 32 – As introduced, the bill would have required sexually oriented businesses to pay a \$5 admission tax for each person entering a sexually oriented business. In addition, it would have created an adjusted gross receipts tax at a rate of 20 percent for all sexually oriented businesses. The revenues from both taxes would have been deposited into the "State Schools Money Fund". In addition to these two taxes, the bill would have imposed restrictions on activities at sexually oriented businesses. As most recently amended, the tax provisions were removed from the bill. Only the provisions related to restrictions on activities remained.

Analysis of Utah/Oklahoma Laws

A member of the Oklahoma House of Representatives indicated the Oklahoma

legislation generally was based on the Utah law. It appears that the Oklahoma legislation was very much based on the Utah law with the following differences:

- 1) The Oklahoma legislation imposes a tax on amounts paid for items purchased from or services provided by adult bookstores or adult video stores but the Utah law does not. The Utah law is limited to escort services and strip clubs.
- 2) Certain definitional differences either related to conformity with Oklahoma law or choices made by the Oklahoma Legislature such as the definition of what constitutes nudity, and the inclusion of adult bookstores and adult video stores.
- 3) Some minor tax collection, reporting and enforcement issues that relate more to individual state procedures rather than substantive policy issues and were probably enacted at the request of the state tax commission or department.
- 4) The revenues from the proposed Oklahoma tax are to be placed in a fund specifically designated for domestic violence and sexual abuse programs. The Utah law provides that the revenue from such tax shall be placed in a fund to be expended for sex offender treatment programs and the prosecution of individuals who use the Internet to commit crimes against children.
- 5) The Oklahoma law also contains a specific statement of legislative intent that the purpose of the tax is to "discourage the general public from engaging in activity or from using economic resources for a purpose the legislature finds to be harmful to the welfare of its citizens and not to have been enacted for the principal purpose or object of raising revenue". No such statement of legislative intent was enacted as part of the Utah law.

Legal Challenges to the Utah Law

The Sexually Explicit Business and Escort Service Tax Act (2004) has been challenged in the Third Judicial District Court of the State of Utah by numerous plaintiffs who are owners and operators of entertainment establishments featuring semi-nude dancers and escort services. The plaintiffs brought suit in 2004 against the Utah State Tax Commission before the law took effect. The plaintiffs have requested the court to grant temporary and permanent injunctive relief against the State Tax Commission from enforcement of the law, and have requested damages and attorney fees.

For the past year, the plaintiffs and the State of Utah litigated whether the district court had jurisdiction or whether the Utah Tax Commission initially should review this action. Recently the Court of Appeals ruled that the District Court had jurisdiction. An official with the Utah Attorney General's Office indicated the plaintiffs are filing another amended complaint. Both the plaintiffs' attorney and a representative of the Attorney General's Office in Utah predict that this case will go to trial.

The complaint and amended complaints filed by the plaintiffs allege that the law is unconstitutional. The plaintiffs claim that the law:

- 1) Abridges and restrains plaintiffs' rights to free expression as guaranteed by the First and Fourteenth Amendments of the Constitution of the United States and constitutes a prior restraint on such free expression.
- 2) Denies equal protection of the law in that the legislation and enforcement thereof is arbitrary, oppressive and capricious and requires plaintiffs to submit to controls not imposed on similarly situated businesses.
- 3) Constitutes an unlawful exercise of the State's taxing power in that the law singles out constitutionally protected businesses for disparate treatment based on improper predicate.
- 4) Allows inspection of plaintiff's records without judicial authority in violation of Fourth and Fifth Amendments of the Constitution of the United States.
- 5) Constitutes an unlawful and unauthorized taking of private property without just compensation, without due process of law and without a public purpose, in violation of the Fifth Amendment of the Constitution of the United States.

General Legal Analysis

Although the plaintiffs have raised many constitutionally-based challenges to the Sexually Explicit Business and Escort Service Tax Act, the primary areas of constitutional concern involve the Free Speech and Free Association Clauses of the First Amendment and the Equal Protection Clause of the Fourteenth Amendment. There does not appear to be a case decided by the United States Supreme Court that addresses the taxation of sexually explicit materials. The Court has decided cases involving taxation on other activities (press) protected by the First Amendment. It is important to note that if the activities or property taxed by the law are found to be obscene, such activities or property are not protected by the First Amendment.

As a general rule, the constitutional guarantees of freedom of speech and of the press are subject to the proper exercise of the government's power of taxation, so that the imposition of uniform and nondiscriminatory taxes is not invalid as applied to persons or organizations engaged in the dissemination of ideas through the publication or distribution of writing.

The spectrum of this legal question ranges as follows: A general tax which only

tangentially impacts constitutionally protected speech is valid but a tax laid specifically on the exercise of one's First Amendment rights is itself unconstitutional. It is apparent that this tax falls somewhere in between these two extreme positions along that legal spectrum.

The two critical points of analysis are:

- 1) Legal precedent set in the Utah case; and
- 2) A Court is most likely to uphold this tax legislation if the tax is necessary to serve a compelling state interest, and that the tax is narrowly drawn to achieve that purpose.

The state interests expressed by the Utah and Oklahoma Legislatures fall into three categories:

- 1) General revenue needs of the state. This state interest, by itself, has not been found by the Courts in First Amendment cases to be a sufficient enough compelling interest.
- 2) Limiting or discouraging activity in an area determined by the state to be harmful to the welfare of its citizens (Oklahoma).
- 3) Providing revenue for treatment of victims and offenders of domestic and sexual violence and abuse (Utah and Oklahoma) and prosecution of sex offenders (Utah).

A Court will determine the constitutionality of this tax based on whether it finds a compelling state interest to justify any infringement of constitutional rights, and whether the legislation is drawn narrowly enough to accomplish the compelling state interest and not unnecessarily infringe upon the rights of individuals any more than is necessary to accomplish such interest.

COMMITTEE ACTIVITIES

At the September meeting, staff outlined the history of legislation in other states and summarized the legal challenges to such legislation. At the October meeting a public hearing ensued, at which time four conferees appeared in support of establishing such a tax, two appeared neutrally to provide information, and one conferee appeared in opposition.

The major proponent, Representative Shari Weber, addressed the issue of a connection between sexually oriented businesses and the exacerbation of sex offenses. She stated the reason the state has a compelling interest to place an excise tax on sexually oriented businesses specifically is that the behavior choices of sex offenders are fueled with the products available at these businesses. Representative Weber said the state now bears greater costs, which are incurred because of sex crimes. In general, she said the reasoning for adding an excise tax is that of these businesses' adverse effects on the health, well-being and safety of the state's citizens. An official from the Kansas Sentencing Commission appeared neutrally to present the historical trends of sex offenders convicted. A contractor with the Kansas Department of Corrections responsible for the sex offender treatment programs appeared neutrally to discuss programmatic issues, including the connection between sex offenders' behavior and the use of sexually oriented materials. This individual stated that, while it cannot be shown that all users of sexually oriented businesses commit sex offenses, it is the case that many sex offenders use such businesses. The use of these businesses, he said, constitutes a high-risk situation for the offender. It often becomes part of the deviant cycle. While it does not cause the behavior, it frequently sets up a cycle that can lead ultimately to sex offending.

Other proponents discussed related issues, including profitability of the sex industry, negative secondary effects, and

individual and family effects of the use of these businesses. One proponent suggested the tax, if one were enacted, should follow the product as opposed to following the business. Some businesses sell sexually oriented products as a small proportion of their overall inventory.

The opponent noted the proposed excise tax does not address material which is sold through the Internet or through satellite or cable television. He questioned how the proposed excise tax would be enforced against those businesses that sell sexually explicit materials as only a small portion of their inventory. He stated his opinion that any admission fee imposed on the customer entering a video or book store constitutes an unconstitutional prior restraint on free speech. Finally, he predicted the Kansas Legislature will not be able to prove a compelling state interest sufficient to justify the infringement upon constitutional rights.

At the November meeting, the Committee reviewed its policy options and made final decisions.

CONCLUSIONS AND RECOMMENDATIONS

The Committee has concluded the use of sexually oriented businesses by some individuals has resulted in negative effects that are serious enough to result in additional state expense. The Committee was presented testimony indicating the incidence of sex offenses committed in this state is alarmingly high. Prosecution of sex offenders and subsequent treatment services for victims and offenders results in the expenditure of a significant amount of valuable state and local resources. The Committee received compelling testimony describing a connection between sexually oriented businesses and sex offenses. According to expert testimony, while it cannot be shown

that all users of sexually oriented businesses commit sex offenses, it is the case that many sex offenders use such businesses. The use of these businesses constitutes a high-risk situation for the offender, and such use often becomes part of a deviant cycle that can lead ultimately to sex offending.

The Committee therefore recommends the introduction of legislation that would impose an excise tax on sexually oriented businesses. The bill should be modeled after both the enacted Utah law and the proposed Oklahoma legislation. The Committee believes that the imposition of this modest excise tax on sexually oriented businesses will not be an undue burden on such businesses but rather will provide an essential source of revenue to provide necessary services for victims and offenders of sex offenses from a source that bears a portion of the responsibility for the individual and societal damages caused to Kansans related to sex offenses.

The Committee believes the issue merits review by the following standing legislative committees: House and Senate Judiciary, Senate Ways & Means and House Appropriations, and House Taxation and Senate Assessment and Taxation committees.

The Committee recognizes alternatives were raised through testimony and discussion that offered alternatives with respect to the scope of the taxation and other aspects of the issue. The Committee also recognizes the specific programs or proportions of revenue might need to be adjusted to fit Kansas' programs and appropriations requirements. The Committee therefore recommends the standing committees work with the Kansas Department of Revenue and others to examine various alternatives raised with respect to scope of businesses covered, program funding, and other related issues.

Special Committee on Assessment and Taxation

TAX LIEN CERTIFICATES

CONCLUSIONS AND RECOMMENDATIONS

After review and discussion, the Committee has determined not to recommend introduction of tax lien certificate legislation at this time. The Committee recommends instead that the standing legislative committees, namely, the Senate Assessment and Taxation Committee and the House Taxation Committee, examine the interest rate applied to delinquent property taxes. The purpose would be to determine whether changing the interest rate would assist in speeding the collection of delinquent property taxes. Currently, the interest rate is determined by using the rate prescribed in a specific section of the Internal Revenue Code and adding three percentage points. According to that formula, the interest rate is seven percent for 2005 and nine percent for 2006. Before Kansas law was changed to use the Internal Revenue Service (IRS) formula, it was as high as 18 percent annually.

Proposed Legislation: None.

BACKGROUND

Pursuant to Topic 6, authorized by the Legislative Coordinating Council, the Special Committee on Assessment and Taxation is charged with a study of how other states are utilizing tax lien certificates and the potential for application of such a program in Kansas.

What Is a Tax Lien Certificate?

A tax lien certificate (also known by other names) involves the sale of delinquent taxes, interest, and associated charges related to a specified parcel of property. It generally does not constitute, by itself, the sale of the actual property. Instead, in most cases, a party purchases the tax debt and is thereafter entitled to collect that debt, together with ongoing interest charges, until (a) the property owner redeems the debt or (b) the property is actually sold or deeded over, pursuant to laws governing the sale of delinquent-tax properties. The property sale frequently entails transfer of the property to the certificate holder following a specified procedure that includes notification of such to the property owner.

Benefits of tax lien certificates are reported to accrue to both the taxing entity and the certificate holder. First, the taxing entity is relieved of the duty of collecting the delinquent taxes and is paid the delinquent amounts at the time of the sale, hence increasing tax collections and enhancing cash flow. Second, the certificate holder, or investor, accrues interest on the delinquent amount from the time of the certificate sale to the time of redemption or the actual property sale.

Current Law in Kansas

Kansas' statutes do not allow for the sale of the tax debt itself. Once the taxes on a parcel of property become delinquent, a lien attaches to the property. After a specified period of time has elapsed without payment of the taxes and other charges due, the county "bids off" the property. This means the county purchases the real estate for the amount of taxes plus other charges, but the owner remains in possession of the property. An actual sale does not occur at this time.

Beginning on the date the county bids off the property, the property owner has a

specified period of time in which the property may be redeemed. For homesteads, this period is three years. All other properties (with the exception of some abandoned properties) are granted a redemption period of two years.

At the end of the redemption period, a property that has not been redeemed is subject to judicial foreclosure and sale. The process necessarily involves the district court, which determines the amount of taxes and charges for each tract of real estate and attaches a judgment lien. Once filed, payments may only be accepted pursuant to the judicial foreclosure statutes. If payment in full is not received—at any time up to and including the day before the sale—the actual property is sold by public auction for the highest and best bid. The bid amount can be for less than the amount of taxes due, and the county is allowed to bid up to the amount of the judgment lien plus interest and charges.

Other States' Use of Tax Lien Sales or Certificates

A partial review of other states' statutes revealed that at least 20 states employ a process whereby tax debts are sold to investors, thus beginning a period of redemption for the tax-delinquent property owner. Among the states using some form of tax debt sale are:

- Alabama
- Arizona
- Colorado
- Indiana
- Iowa
- Maryland
- Missouri
- Montana

One such state, Iowa, was examined in greater detail. In Iowa, the issuance of the "tax sale certificate" begins the redemption period, during which time the property owner may pay the taxes and other charges

due. The total bill for redemption includes interest, which accrues continually until the bill is paid. After a specified time period (one year and nine months for most properties), if the taxes due have not been paid, the certificate holder is required to notify the property owner that the bill must be paid within 90 days. If, after the 90 days, the tax bill has not been paid, a treasurer's deed to the property is issued to the tax certificate holder. (Note: Appendix A provides a detailed comparison between Kansas' and Iowa's processes for dealing with delinquent real property taxes.)

According to a senior legal counsel staff member at the Iowa Legislative Services Agency, Iowa recently increased the interest rate that applies after the sale of the certificate. The interest rate prior to the sale is 1.5 percent per month, or 18 percent per year. After the certificate is sold, the interest rate increases to 2.0 percent per month, or 24 percent per year. The staff member noted reports had been received from counties indicating this increase (a) has decreased the number of tax-delinquent properties, because owners have preferred to pay their tax bills at the lower interest rate, and (b) has decreased the amount of taxes that remain unpaid, because investors have been given greater incentive to buy tax sale certificates.

It should be noted that differences exist in various states' statutes dealing with tax lien (or tax sale) certificates. For example, in Iowa, in the case of competing bidders the tax sale certificate is awarded to the bidder who bids the total amount of taxes due for the smallest percentage of undivided interest in the property. In Arizona, however, the winning bidder is the one who bids the lowest interest rate to be charged to redeem the property.

COMMITTEE ACTIVITIES

At the September meeting, staff summarized the issue of tax lien certificates and

compared them to current Kansas law. Staff also reviewed draft legislation from 1993 that authorized a lien certificate program in Kansas. Technical issues would require a redraft of this proposed legislation if the Committee recommended a bill, but all of the substantive issues remained relevant. Additional information was requested regarding (1) a comparison of tax lien certificate laws in neighboring states and a comparison of current Kansas law, tax lien certificates and 2005 SB 45; and (2) relative priority of mortgage liens versus tax liens.

At the October meeting, staff provided the additional information requested, including summary information on SB 45 and a table comparing neighboring states' tax lien certificate requirements (See Appendix B). At the public hearing, one conferee appeared in support of the implementation of tax lien certificates and one appeared in opposition. Members questioned staff and the conferees regarding lien priority, interest rates, and other issues related to the certificates.

At the November meeting, the Committee reviewed its policy options and made final decisions.

CONCLUSIONS AND RECOMMENDATIONS

After review and discussion, the Committee has determined not to recommend introduction of tax lien certificate legislation at this time. The Committee recommends instead that the standing legislative committees, namely, the Senate Assessment and Taxation Committee and the House Taxation Committee, examine the interest rate applied to delinquent property taxes. The purpose would be to determine whether changing the interest rate would assist in speeding the collection of delinquent property taxes. Currently the interest rate is determined by using the rate prescribed in a specific section of the Internal Revenue Code and adding three percentage points. According to that formula, the interest rate is seven percent for 2005 and nine percent for 2006. Before Kansas law was changed to use the IRS formula, it was as high as 18 percent annually.

DELINQUENT PROPERTY TAXES - COMPARISON OF PROCEDURES FOLLOWED IN KANSAS AND IOWA

Appendix A

IOWA		KANSAS
<p>Tax sale certificate operates as a lien against the parcel (see "Tax sale," below).</p>	<p>Under a more complicated process, delinquent personal property can become a lien on a person's real estate.</p>	Lien attaches automatically to real property on which taxes are owed.
<p>One process, which does <i>not</i> include judicial foreclosure:</p> <ul style="list-style-type: none"> • The sale must be for the total amount of taxes plus interest and charges. • Therefore, the amount bid for at a public tax sale is the <i>percentage amount of undivided interest the tax sale certificate holder will have in the property if the property is not redeemed.</i> • The person bidding the total amount of taxes due for the smallest percentage of undivided interest in the property is issued the <i>tax sale certificate</i>, which operates as a lien against the parcel. • Most parcels may be redeemed at any time within two years of the sale upon payment of the delinquent taxes, interest, penalty, fees and other costs. • Certificate holder must send notification to property owner and specified others 90 days before a deed to the property would be issued to the certificate holder. (One year and nine months from the date of sale for most parcels.) • If delinquent taxes are not redeemed within 90 days of completed service of the notice, a treasurer's deed to the property is issued to the tax certificate holder. 	<p>Two processes, which must follow the order specified:</p> <p><i>Bid-off</i> process - county establishes beginning of "redemption period," i.e., period when property cannot be sold to private parties, giving the taxpayer the opportunity to redeem the delinquent property. Must occur annually. Redemption period differs for property type: 3 years for homestead, 2 years for all other properties except certain abandoned properties.</p> <p><i>Judicial Foreclosure and Sale</i> process -</p> <ul style="list-style-type: none"> • County attorney/counselor files an action in district court against the property owner(s) or other specified parties. • Court determines the amount of taxes and charges. • Once filed, county treasurer cannot accept payments except as provided under the requirements of the judicial foreclosure statutes. • The judicial foreclosure and sale is the sale of the actual property and is by public auction for the highest and best bid, but it can be for less than the amount of taxes due. • County may bid up to the amount of the judgment lien plus interest and charges. 	Tax sale
<ul style="list-style-type: none"> • Before tax sale - 1.5% per month (18% per year) • After tax sale - 2.0% per month (24% per year) 	<p>Amount specified in section of Internal Revenue Code plus 1%</p> <ul style="list-style-type: none"> • 2005 - 7% • 2006 - 9% 	Interest rate

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Appendix B

TAX LIEN CERTIFICATE PROVISIONS: CENTRAL REGION STATES

	Tax Certificate Sale Calendar	Tax Sale Notification	Purchaser Fees	Prohibited Buyers	Sets Detailed Bidding Rules for Local Auctions
Colorado	On or before 2 nd Monday of December	Newspaper general circulation, first notice at least 4 weeks prior to sale	--	County officials and employees	No
Iowa	3 rd Monday in June	Once in the newspaper, 1-3 weeks before sale	\$10 purchase fee	--	No
Missouri	4 th Monday in August	Publish 3 weeks consecutive in a general circulation newspaper and last 15 days before sale	\$0.50 (50 cent) fee to issue, \$0.25 to assign	Treasurer	No
Nebraska	Sales occurs 1 st week of February	Publish 3 weeks consecutive in a general circulation newspaper and at office	\$10 purchase fee	--	No
Oklahoma	1 st Monday in October	2 weeks 2 times before 3 rd Friday in September	\$10 purchase fee	--	No
South Dakota	3 rd Monday in December	Once in newspaper the week before the sale	Purchase fee up to \$50 limit	--	No

Source: National Conference of State Legislatures 2005

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	Other Provisions	Maximum Interest Rate	Assignable; Can Be Resold	Minimum Duration to Deed Transfer	Notice to Acquire Property
Colorado	If Internet auctions are held county not liable for technical problems buyer encounters	9% plus federal discount rate	Yes	3 years	--
Iowa		24% (2% per month)	Yes, \$100 fee	1 year and 9 months	90-day notice certified mail
Missouri	Nonresidents must meet additional requirements	10%	Yes	1 year	--
Nebraska	Procedures and deadlines required to foreclose on lien	14%	Yes, \$10 fee	3 years	--
Oklahoma	Can exempt from sale if owner is 65 or disabled, poverty income and home is under \$125K	8%	Yes	2 years	60-day notice certified mail return receipt
South Dakota		10%	Yes	4 years	--

Source: National Conference of State Legislatures 2005

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