MINUTES

SPECIAL COMMITTEE ON ASSESSMENT AND TAXATION

October 9-10, 2003
Room 519-S—Statehouse

Members Present

Senator David Corbin, Chair
Representative John Edmonds, Vice Chair
Senator Mark A. Buhler
Senator Stan Clark
Senator Les Donovan
Senator Janis Lee
Representative Steve Brunk
Representative Paul Davis
Representative Tom Holland
Representative David Huff
Representative Bruce Larkin
Representative Don Myers
Representative Arlen Siegfreid

Staff Present

Chris Courtwright, Kansas Legislative Research Department
Martha Dorsey, Kansas Legislative Research Department
Gordon Self, Revisor of Statutes Office
Shirley Higgins, Committee Secretary

Conferees

Joe Lawhon, Legislative Division of Post Audit
Mark Beck, Director of Property Valuation
Pete Bodyk, Alcohol Beverage Control Division, Kansas Department of Revenue
Gwendolyn Cargnel, Tobacco Free Kansas Coalition
Derrick Crawford, Altria Corporate Services (Phillip Morris USA)
Kaye Morrison, Altria (Phillip Morris USA) Brand Integrity Division
Tom Whitaker, Kansas Motor Carriers Association
Ron Hein, R. J. Reynolds and Pioneer Natural Resources U.S.A., Inc.
Michael L. Worswick, Wolfe's Camera Shops
Lew Ebert, Kansas Chamber of Commerce and Industry
Kenneth Daniel, Midway Wholesale and National Federation of Independent Businesses
Joan Wagnon, Secretary, Kansas Department of Revenue
Bruce Johnson, Utah Tax Commissioner
Melissa A. Wangemann, Deputy Assistant Secretary of State

Marlee Carpenter, Kansas Chamber of Commerce and Industry
Richard Cram, Kansas Department of Revenue
Philip Knighton, for Cecil O'Brate, American Warrior, Inc., Palmer Manufacturing
Jack Glaves, Duke Energy Field Services
Dave Hughes, Duke Energy Field Services
Edward Cross, Kansas Independent Oil and Gas Association
William B. McKean, Woolsey Petroleum Corporation

Thursday, October 9
Morning Session

The meeting was called to order in Room 519-S, Statehouse, by Senator David Corbin, Chair, at 10:05 a.m. on October 9, 2003, at which time he opened the public hearing on Topic 12, Property Tax Income and Expense Information (SB 99). He called upon Joe Lawhon, Legislative Division of Post Audit, for an overview of the Division's November 2002 performance audit, *Valuing Commercial Buildings for Property Tax Purposes: Determining Whether Current Procedures Ensure Accurate Appraisals at Fair Market Value.* A copy of the report may be obtained at the office of the Legislative Division of Post Audit.

Mr. Lawhon explained the audit evaluated the practices used to appraise a sample of 32 large office buildings located in Johnson, Sedgwick, Shawnee, and Wyandotte Counties. He noted that, if a property is not appraised accurately, a property owner's property tax bill may be significantly more or less than it should be as illustrated in a table on page 3 of the audit report entitled "Estimate of Property Taxes Payable in 4 Kansas Counties." He went on to explain the fair market value of a building can be determined through the income approach, the sales comparison approach, or the cost approach, all of which are described on pages 4 and 5 of the report. He noted the income approach is the preferred approach for valuing commercial buildings and followed with an explanation of the income approach formula, calling attention to a sample calculation on page 5 of the report.

As to the first question addressed in the post audit report, "Are county appraisers accurately valuing commercial office properties in Kansas?" Mr. Lawhon said the short answer is "yes" for Johnson, Wyandotte, and Sedgwick Counties, and "no" for Shawnee County. He explained the intent of the review was to determine whether the appraised value assigned by the county appeared to be reasonable and in-line with the local market. To help make this determination, a panel of three experienced, independent appraisers from Wichita, Manhattan, and Kansas City were hired to help review information about each property. A table on page 8 of the report summarizes the results of the review. Mr. Lawhon pointed out that, out of the 32 properties reviewed, 23 were reasonably valued, 2 were valued too high, and 7 were valued too low. As to the buildings that were valued too low, he explained the added value of attached parking garages did not appear to have been taken into consideration in several buildings in Shawnee County. In addition, the rates used by the counties to calculate the appraised value via the income approach were different from the typical rates contained in the county's market studies. The rates the county used for 4 of the 7 buildings that were undervalued were significantly different from the typical market rates. In this regard, he reviewed a table on page 12 comparing the rates used to value three buildings in Shawnee County.

As background information regarding the introduction of SB 99, Mr. Lawhon called attention to page 16 of the report, which addresses an ongoing problem reported in several audits since 1993 concerning county appraisers' ability to accurately estimate the value of a commercial building. He commented that appraisers need reliable information about income and expenses in order to determine what the typical rates are for their county, and one of the best ways to obtain that information is to ask the building owners to provide it. However, relatively few property owners provide the income and expense data requested in an annual survey conducted by county appraisers to help develop their computer valuation models. For example, the 4 counties in the sample averaged a response rate of only 11 percent. Mr. Lawhon went on to explain that, according to a 1994 informal opinion by the Attorney General's office, the Division of Property Valuation has the power to require property owners to provide income and expense information to county appraisers. But Kansas law does not contain any enforcement provisions. Therefore, Division and county staff have no recourse if owners fail to provide the requested information. He noted the International Association of Assessing Officers recommends that states include statutory penalty provisions for failure to provide the requested information. The November 2002 performance audit report recommended that the Property Valuation Division propose amendments to state law to allow county appraisers to levy penalties against property owners who fail to provide the requested income and expense information. That recommendation led to the introduction of SB 99 during the 2003 Legislative Session. The bill provides for a penalty equal to a 10 percent increase in the assessed value of the property owner's real property.

In conclusion, Mr. Lawhon emphasized the issue boils down to giving county appraisers tools to develop more accurate and meaningful models for valuing commercial property via the income approach. To strengthen its oversight process, the post audit report recommends that the Property Valuation Division periodically spot-check information for a small sample of commercial properties in each county to see whether or not the valuation procedures are being applied correctly and that the Division provide training and guidance where needed.

Senator Corbin called the Committee's attention to written testimony in opposition to SB 99 submitted by Christy Caldwell, Greater Topeka Chamber of Commerce. Ms. Caldwell notes county appraisers have other methods to appraise income-producing property should the property owner choose not to provide income and expense information, and she contends that the penalty is arbitrary and punitive. She also expresses her concern that the bill may cause a backlog of appeals before the Board of Tax Appeals by an increased number of angry taxpayers (Attachment 1).

Senator Corbin called upon Chris Courtwright, Kansas Legislative Research Department, for a review of the 2003 Supplement to the Seventh Edition of *Kansas Tax Facts.* A copy of the Supplement may be obtained at the office of the Kansas Legislative Research Department.

Mr. Courtwright pointed out the following facts concerning state and local revenue:

- The total state and local tax revenue for FY 2003 was $8.774 billion, with state taxes accounting for $5.38 billion of the total.

- Local governments continue to spend most of their state and local tax revenue.

- Although the general property tax is still the most important single revenue producer, its proportion has steadily declined over the decades. But the trend has reversed itself recently.

- Income and privilege taxes accounted for 22 percent of state and local tax revenue in FY 2003, compared with 11 percent in FY 1970 and only 2 percent in FY 1940. But this long-run trend has changed in recent years.

- Sales and use tax revenue over the decades also has been increasing significantly as part of the state-local tax mix. State and local tax revenue in FY 2003 was 11.20 percent of CY 2002 Kansas personal income. Historically, this figure has remained remarkably constant.

- The recent rate of growth in local taxes, especially property taxes, slowed significantly in FY 2003.

- In FY 2003, state tax revenue increased by $237 million, or 4.8 percent above collections in FY 2002. But for the passage of two tax bills in 2002, state taxes would have gone down in 2003.

- Individual income tax receipts have declined for the second consecutive year in FY 2003, and compensating use taxes also declined.

- The relative balance in the big three sources of state and local tax revenue – sales, income, and property – that Kansas had achieved for a number of years after the 1992 school finance law appears to be eroding. Economists generally believe that with a diversified revenue portfolio not relying too heavily on a single source, Kansas state and local governments are better able to withstand economic downturns.

For the Committee's information, Mr. Courtwright called attention to tables on page 5 of the Supplement showing state, local, and combined state and local tax revenues for the last six years and the 50-state tax burden ranking of Kansas and surrounding states. He also called attention to 11 tax policy objectives recommended by the Governor's Tax Equity Task Force in 1995, a summary of 2003 tax legislation, and tables regarding state and local government tax revenue found on pages 28 through 31.

Senator Corbin called upon Mark Beck, Director of Property Valuation, for a report on the status of the aircraft property tax exemption law. Mr. Beck said a recent Supreme Court ruling has the potential to remove a property tax exemption for almost all small aircraft in the state. He went on to explain that the Legislature passed a law in 1982 exempting aircraft used in the conduct of the owner's business or industry. In 1988, the Kansas Court of Appeals declared owners of businesses who collect a rental fee for airplanes used for the renter's personal use do not qualify for a tax exemption because the airplanes are not exclusively used in the conduct of the owner's business. Subsequently, the 1988 Legislature inserted language exempting " all aircraft actually and regularly used exclusively to earn income for the owner in the conduct of the owner's business or industry." It was assumed that the legislation solved the problem until a recent court case was filed after the Board of Tax Appeals denied an exemption for two aircraft, finding that both of the taxpayer's aircraft were not regularly used to earn income but were used 16.7 percent and 19.2 percent for personal use. The Kansas Supreme Court concluded all uses of aircraft must be considered in determining eligibility of exemption, and any personal use of the airplane, even by a lessee, is a disqualifying use that defeats the exemption (Attachment 2). Mr. Beck noted that, if the Legislature chooses to remedy the situation, the Court has suggested striking the word "exclusively."

Senator Corbin opened the public hearing on Topic 10, Job Retention Policy. He noted the topic was brought by Senator Dave Jackson, who was unable to attend the meeting. Mr. Courtwright clarified the topic deals specifically with small businesses that would continue to retain low to moderate income employees who would otherwise lose their jobs. He went on to summarize Senator Jackson's prepared testimony, which states Senator Jackson and other legislators attended a NCSL sponsored conference entitled "Helping Working Families in Tight Budget Times," and the Kansas delegation subsequently determined that a business tax credit policy which encouraged retention of employees might be a cost effective means to encourage businesses to retain employees during recessionary times. Other states' programs are listed in an attachment to Senator Jackson's written testimony. Senator Jackson asks the Committee to consider a state program which would dovetail with the federal work opportunity tax credit (WOTC) and pick up the benefits once the federal program has concluded. In addition, he requests the Committee consider recommending the introduction of legislation allowing state child care assistance credits and employer health insurance contribution credits to be transferrable or saleable by the small businesses using the credits (Attachment 3).

The meeting was recessed for lunch at 11:30 a.m.

Afternoon Session

Senator Corbin called the meeting to order at 1:35 p.m., at which time he opened the public hearing on Topic 5, Transportation of Cigarettes, and on HB 2422 relating to the shipment of cigarettes into Kansas. He called upon Pete Bodyk, Alcohol Beverage Control Division, Kansas Department of Revenue, to present an overview of Kansas law regarding the transportation, taxation, and sale of cigarettes.

At the outset, Mr. Bodyk called attention to a list of cigarette tax rates by states from lowest to highest and a map showing the tax rate in surrounding states (Attachment 4). He went on to say the direct sale of cigarettes over the Internet violates current Kansas law, and both the retailer and purchasers are subject to punishment. He noted the Department can seize cigarettes as contraband in Kansas if the possessor has 20 or more packages without Kansas tax stamps affixed to them. He explained a federal law, the Jenkins Act, requires any person, other than a licensed distributor, who sells and ships cigarettes across state lines to report the sale to the buyer's state tobacco tax administrator, who can then send a tax assessment to the buyer. However, states have difficulty enforcing the law. Other than referrals or complaints, the Department does not have an effective method to determine who illegally ships cigarettes into Kansas. He pointed out direct shipments through the Internet make sales of cigarettes to minors much easier. Mr. Bodyk noted that HB 2422, which is aimed at the purchase of cigarettes directly over the Internet, was modeled after a New York statute recently upheld in the federal appellate courts. The Department suggests the bill be amended by striking lines 34 through 37 on page 2, because a similar provision already exists, and by striking Subsection (f), because the Director of Taxation has no authority over common contract carriers. In addition, Mr. Bodyk noted New York state negotiated an agreement with 40 shippers that they stop handling cigarette shipments from a certain Native American reservation retailer. He suggested that Kansas could similarly provide a list of known companies that sell cigarettes over the Internet in Kansas so that shippers would not accept packages from those companies (Attachment 5).

Gwendolyn Cargnel, Tobacco Free Kansas Coalition (TFKC), testified in support of HB 2422. She emphasized that limiting youth access to tobacco products and ensuring better compliance with the state's taxation requirements on tobacco products is a priority for TFKC members. She noted that it is becoming easier and cheaper for kids to buy cigarettes over the Internet. She pointed out that, according to a study by a private research firm, three-quarters of all Internet tobacco sellers explicitly say that they will not report cigarette sales to tax collection officials. As a result, states lose as much as $200 million annually in uncollected tobacco taxes. In conclusion, she called the Committee's attention to model legislation provided by the Campaign for Tobacco-Free Kids (Attachment 6).

Derrick Crawford with Altria Corporate Services, the parent company for Phillip Morris USA, stated HB 2422 presents a good starting point in an opportunity to shore up the distribution system in Kansas to prevent the shipment of contraband cigarettes. He introduced Kaye Morrison with the Brand Integrity Division of Phillip Morris USA, to present further information on the shipment of contraband cigarettes.

As background information, Ms. Morrison said that, prior to employment at Phillip Morris USA in December 2002, she was an ATF agent assigned as the Deputy Chief of the Intelligence Division with the Bureau of Alcohol, Tobacco, and Firearms. Her last duty before retiring from ATF was to evaluate the intelligence of the bureau, to listen to the different disciplines working on intelligence, and to determine how she could help them communicate with each other. Her job with Phillip Morris is similar in that it includes listening to persons throughout the corporation who provide her with information on counterfeit product and illegal import nationwide. When Brand Integrity receives information on illegal sales through Phillip Morris's complaint line, the information is passed on to a network of peers. On every occasion, a considerable amount of product has been found. An illegal sale reported to her by the Phillip Morris's sales force is currently under investigation by a federal agency.

Ms. Morrison went on to discuss illegal Internet sales of cigarettes. She noted her corporation does not believe in a ban on Internet sales but does believe in understanding the volume of Internet sales that may be affecting a particular state, and Phillip Morris has a unit that tracks those sales. Whenever someone sends information on a site, a program is initiated whereby a product can be ordered from that site. The unit then evaluates it, and in a majority of times, it is either illegal import product or it is counterfeit with a mixture of multi-state tax stamps. Although she supports HB 2422, she suggested other provisions within Phillip Morris's model bill be amended into it to further enhance the effectiveness of Kansas' efforts to fight the sale of contraband cigarettes (Attachment 7).

Tom Whitaker, Kansas Motor Carriers Association, testified in opposition to the provisions in HB 2422 relating to transportation by common or contract carrier. He informed the Committee that the bill was based on a New York public health law, which took effect in March 2003 after being challenged in 2000 by tobacco companies in the U.S. District Court of the Southern District of New York on the grounds that the statute violated the Constitution's commerce clause by improperly discriminating against interstate commerce. On June 27, 2003, a lawsuit based on the provisions of the Federal Aviation Administration Authorization Act was filed against the State of New York, challenging the transportation provision of the New York law. To date, the court has not handed down a ruling. Mr. Whitaker contended that HB 2422 is not about cigarettes but about the shipping business. He emphasized compliance with the provisions would affect the timeliness of the carrier's service, and it would create a substantial burden on the carrier in the form of labor, costs, and delay. In addition, he noted that the bill does not apply to one of the industry's major competitors, the United States Postal Service (Attachment 8).

Ron Hein, representing the R.J. Reynolds Tobacco Company, expressed support for legislation that would ensure that Internet and other interstate sales of cigarettes are handled in a manner that only persons of lawful age are able to obtain cigarettes and would also ensure applicable taxes are collected from entities shipping cigarettes. However, he could not support HB 2422 due to the wording. He proposed that model legislation attached to his written testimony be adopted in lieu of the language in the current bill. He noted the model was slightly amended to meet concerns raised by shippers (Attachment 9).

Senator Corbin opened the continued hearing on Topic 3, Monitor Streamlined Sales Tax Implementation (destination sourcing).

Mike Worswick, Wolfe's Camera Shop, commented that, as a Kansas storefront and Internet retailer, he supports the collection of appropriate sales taxes in interstate commerce transactions. However, he believes that HB 2005 places onerous and ongoing cost burdens on small businesses. He contended the implementation of HB 2005 will not result in any revenue growth for the state because the administrative costs will reduce the net profit of Kansas retailers, thereby reducing income tax revenue to the state. He pointed out that, technologically, the smallest Kansas businesses will be the most burdened because they have no way to automate the tax lookup, calculation, and reporting requirements. Furthermore, all Kansas retailers do not have Internet access at their place of business. He noted that, in order for Wolfe's to continue to provide service to rural customers, he will be forced to increase the shipping and delivery charges due to the ongoing time spent in properly collecting the sales tax. In conclusion, he suggested the bill be amended to provide compensation to businesses for the cost of administering the law or that the bill be amended to allow businesses with sales volumes less than a threshold level to collect and remit taxes based on the location of their place of business (Attachment 10).

Lew Ebert, Kansas Chamber of Commerce and Industry (KCCI), noted KCCI supported the enactment of Streamlined Sales Tax Project (SSTP) during the 2003 Legislative Session. However, he is concerned that the destination sourcing requirement has had unintended consequences for retailers. He pointed out a survey of KCCI members showed that a change to destination sourcing is an expensive proposition, and additional expenses will be incurred for the extra manpower hours needed to collect and remit the tax to the state. Mr. Ebert reported KCCI members have complained that, without a guarantee that Congress will act quickly to enact the SSTP, changing to destination sourcing does not make sense at this time. In conclusion, Mr. Ebert noted KCCI is willing to work with the Legislature to find solutions for the destination sourcing issue (Attachment 11).

Ken Daniel, Midway Wholesale, testified on behalf of National Federation of Independent Businesses (NFIB). He reported that 84 percent of NFIB members requested the destination sourcing provisions of the SSTP be changed. He contended destination sourcing will harm 30,000 small businesses, will cause $25 million of local sales tax revenues to disappear, will decrease state income tax revenues significantly as businesses deduct high compliance costs, will give a major competitive advantage to large retailers, and will cause a significant entry barrier to new small business startups. He suggested Kansas should change its tax laws to reduce its 751 destination jurisdictions to one. Under that scenario, a retailer could collect local sales taxes for all sales and deliveries in his jurisdiction and collect sales taxes using a second rate for all deliveries outside his local area. He went on to discuss the problems Midway Wholesale has experienced in implementing destination sourcing (Attachment 12).

With regard to Mr. Daniel's suggestion that the state's taxing jurisdictions be reduced to one, Senator Corbin recalled previous testimony indicated that this action would violate the commerce clause. In response, Mr. Daniel said, "As long as you treat Kansas retailers the same way you treat out-of-state retailers, I don't believe it does violate the commerce clause." Senator Corbin noted the problem with this approach is Kansas would not be in compliance with the SSTP Agreement.

Joan Wagnon, Secretary, Kansas Department of Revenue, reported that as of July 31, which was the close of the first month in which destination sourcing was in place, the number of businesses filing ST-36 returns (used to report sales to multiple jurisdictions) increased by almost 900, compared to the number that filed ST-36 returns for the May filing period before destination-based sourcing became effective. With regard to the status of Streamlined Sales Tax legislation at the federal level, she noted a measure has been introduced which would authorize states that are members of the Interstate Sales and Use Tax Agreement to require remote sellers to collect tax on goods and services sold into the state. For the Committee's information, she called attention to a copy of a letter from the president of a pest control business concerning the costs to modify his business software system to implement destination-based sourcing. She also called attention to a map of Kansas county and city sales tax jurisdictions. She noted the Department is developing instructions to advise businesses located in or making sales in counties which have a county sales tax but no city sales tax. In addition, the Department is attempting to determine if there are options available to help simplify sales tax collections in populous counties which have massive jurisdictions. The final attachment to her testimony is a copy of an update on destination sourcing implementation issues in Kansas which she presented at the SSTP meeting held in Chicago on September 25, 2003 (Attachment 13).

Secretary Wagnon introduced Bruce Johnson, one of four Utah Tax Commissioners who also co-chairs the SSTP implementing states group and chairs the multi-state tax commission. Noting the main purpose for coming to the meeting was to answer Committee questions regarding destination sourcing, he commented that although the destination sourcing rule is one small part of a very large SSTP Agreement, the Agreement is not possible without it. He said that the intent of the Agreement was to balance state sovereignty against simplicity for businesses. The implementing group also attempted to balance local sovereignty. He noted that every decision made to preserve a little more state sovereignty meant a little more complexity for businesses. Mr. Johnson went on to say that destination sourcing allows tax money collected from taxpayers in the state to remain in the state. By the same analysis, tax money collected from taxpayers who are citizens of a city should stay within the city. He noted that one-half of the states already have destination sourcing in place, but some states, such as Utah and Kansas, must change because there is zero flexibility. He explained that destination sourcing is necessary to avoid the violation of a clause in the *U.S. Constitution* concerning discrimination against interstate commerce. He explained that an out-of-state merchant cannot be required to collect a higher tax on a delivery into Kansas than a local Kansas merchant must collect on a delivery to the same location. He observed that destination sourcing levels the playing field for national retailers and local retailers. In his opinion, the SSTP will not work without destination sourcing.

Committee questions and discussion followed regarding the effect of destination sourcing on Kansas' numerous taxing jurisdictions. A question was raised as to if it would be possible for Kansas to treat small service companies differently and still remain in compliance with the Agreement. In response, Mr. Johnson noted that the Agreement currently provides authorization for each state to designate which taxes are subject to the Agreement. Utah has designated its general sales tax, its local sales tax, its resort community local tax, and its rural hospital tax as part of the Agreement because those taxes apply to the general body of retail goods. Utah did not include specific taxes such as the transient room tax or tax on car rentals in the interest of maintaining the local jurisdiction's ability to impose a higher rate on those types of non-general taxes. He said, if some of Kansas's service providers fall into the non-general classification, they could be placed outside the Agreement by removing them from the Kansas sales tax act.

As to when Congress will act on the SSTP, Mr. Johnson said it does not appear that the Streamlined Sales Tax bill will pass anytime in the immediate future. A Committee member suggested perhaps legislation could be passed providing that the destination sourcing will become effective when Congress approves the SSTP Agreement. In response to the suggestion, Mr. Johnson noted the Agreement provides that states cannot certify providers, conduct audits, or put together a uniform registration system until the Agreement becomes effective. The Agreement becomes effective when at least ten states with 20 percent of the total U.S. population are in substantial compliance. Under the Agreement, Kansas could amend its law as suggested, but it would no longer be one of the ten states in compliance. In his opinion, Kansas is a leader in the SSTP, and the business community is watching what Kansas does. Therefore, he feels it will be a serious national setback for the Agreement if Kansas retreats at this point.

The meeting was adjourned at 4:45 p.m.

Friday, October 10

Senator Corbin called the meeting to order at 9:05 a.m. and opened the public hearing on Topic 9, Corporation Franchise Taxes. He called upon Mr. Courtwright for background information on corporation franchise taxes.

Mr. Courtwright informed the Committee that an omnibus bill enacted late in 2002 sought to effectively double the amount of revenues received under the corporation franchise taxes. He noted that the FY 2003 revenue estimate for franchise taxes was increased by $18 million based upon the new law. The estimate was subsequently reduced by the Consensus group in November and increased in April. The current estimate of $35 million for FY 2004 is likely to be revised in November. During the 2003 Legislative Session, SB 38, which would have returned the rate to the original level, was approved by the Senate, but it was withdrawn and sent to the House Taxation Committee, where it remains. A 2003 conference committee report on HB 2287, which contained a number of taxation provisions, including a proposal to restore the corporation franchise rate to $1 in combination with increasing the maximum amount of liability to $8,000, was defeated on the House floor in the waning hours of the session. Another concept discussed involved a proposal that would move the responsibility for collection of the current franchise tax liability from the Secretary of State's office to the Department of Revenue, where confidentiality restrictions on audit capabilities exist. Subsequently, HB 2454 was introduced and remains in the House Taxation Committee. Mr. Courtwright noted the corporation franchise tax has been housed in the Secretary of State's office since 1866, when there was no Department of Revenue (Attachment 14).

Melissa Wangemann, legal counsel to the Secretary of State, testified in support of the concept of HB 2454, which would replace the franchise tax with a flat filing fee for the annual report submitted to the Secretary of State and would require the payment of an occupation tax to the Department of Revenue. She noted this bifurcated system would make Kansas more uniform with other states. For the Committee's information, she explained that, following the creation of a business entity, the business entity must file an annual report with the Secretary of State to update information. A franchise tax is paid at the time of filing the annual report. The revenue received from the franchise tax is deposited to the State General Fund and does not support the operation of the Office of the Secretary of State. Ms. Wangemann called the Committee's attention to a table in her written testimony comparing quarterly data on franchise taxes received in FY 2002 and FY 2003 (Attachment 15).

Marlee Carpenter, Kansas Chamber of Commerce and Industry (KCCI), noted KCCI supported the provision in HB 2025 which rolled back the increase in the franchise fee rate from $2 to $1 for every $1,000 of net worth. As to the controversy over the amount the state will lose if the rate is rolled back, she noted KCCI believes that the rate should be rolled back, but the cap should remain the same. In addition, she noted that KCCI opposes the concept of an occupations tax on net worth to be paid to the Department of Revenue in addition to the franchise filing fee paid to the Secretary of State's office (Attachment 16).

Kenneth Daniel, testifying on behalf of Midway Wholesale and NFIB, contended that the franchise tax is the most aggressively anti-small business of all business taxes in Kansas, that it is extremely regressive, and that it is highly unfair. He noted that in FY 2002, the 400 richest corporations in Kansas paid only $2 million of the $31.1 million of franchise taxes collected. He called attention to an attachment to his testimony listing states with corporation franchise fees, states with a net worth alternative calculation in their income tax, and states with no net worth taxes. He pointed out Kansas's franchise tax is the highest in the five-state region, and it is the seventh highest in the 19 states with franchise fees (Attachment 17). When asked by a Committee member what franchise fee NFIB could support, Mr. Daniel said NFIB prefers that the fee be rolled back to $1 per $1,000 with a $5,000 cap if a cap is considered necessary.

Senator Corbin opened the public hearing on Topic 4, Severance Tax Administration (SB 267). He called upon Richard Cram, Kansas Department of Revenue, for an overview of the possible impact of "percent of proceeds" (POP) natural gas purchase contracts on severance tax receipts and for comments on SB 267 which concerns POP contracts.

Mr. Cram presented background information on the severance tax and on natural gas purchase contracts, calling attention to a chart attached to his written testimony illustrating the natural gas pipeline gathering system. He noted most of the natural gas in Kansas is sold at or near the wellhead, and the first purchaser of the gas is required to remit the severance tax to the Department. Although the severance tax is based on the wellhead value of natural gas, the current price indexes are based on the value of the natural gas at the point that it enters the main interstate pipeline. He compared the typical natural gas purchase contract between a natural gas purchaser and the producer prior to the POP contracts purchasers began offering to producers within the past year or so. He noted that the POP contract terms contain more variables than the traditional purchase contract terms, and called attention to a study attached to his written testimony indicating that the upward movement of the natural gas index price works in the favor of the purchaser of the POP contract, and downward movement of that price works in favor of the producer of the POP contract, assuming constant index prices for the extracted components. He also had attached samples of a POP and traditional contract and a graph tracking various natural gas price indexes since the 1990s. As to SB 267, Mr. Cram stated it will not resolve any concern that natural gas utilities and pipeline companies may have monopolistic or unfair bargaining power over producers, resulting in below market value prices being paid for their natural gas and causing decreased severance tax revenues. He outlined the provisions of SB 267 and discussed the unintended consequences for the producer, purchaser, and the Department (Attachment 18).

Philip Knighton testified on behalf of Cecil O'Brate of American Warrior, Inc., Palmer Manufacturing, who operates 900 wells in Kansas. He discussed the losses POP contracts cause for the oil and gas operator which, in turn, affect severance and ad valorem tax revenues and drilling budgets. He said POP contracts are being demanded by large "foreign" corporations in Kansas that almost always have the only pipeline into wells in an area which used to transport oil or gas for much lower rates. To remedy the situation, he offered amendments to SB 267, which would include clarifying and regulatory language regarding POP contracts (Attachment 19).

Following Committee questions concerning Mr. Knighton's suggested amendments, Senator Corbin agreed with other Committee members that SB 267 should be referred to the Utilities Committee because it concerns a regulatory issue rather than a tax issue.

Jack Glaves, representing Duke Energy Field Services (DEFS), testified in opposition to SB 267. He noted the severance tax is calculated on the basis of net proceeds received by the royalty owner. Thus, if the deductible charges are increased under any type of gas purchase contract, the resulting revenue to the producer/royalty owner will be less as will be severance tax revenue. He further noted that, essentially, proponents are suggesting charges for gathering services should be frozen in order to prevent a reduction in severance tax revenues. However, this suggestion ignores the decline in gas production and the volatility of natural gas prices, which will continue in the future. He contended SB 267 would restrict the right to contract freely between producers and gathering and processing companies. In addition, he noted the bill has no provision to address the bad times when volumes are slack and the prices low, and producers and gatherers are unable to cover their costs. In his opinion, the bill could further discourage drilling and investment in Kansas and contribute to premature abandonment of wells and loss of recoverable reserves. Furthermore, it would outlaw a type of contract that best aligns the interest of producers and gathering and processing companies. For the Committee's information, Mr. Glaves called attention to comments related to SB 267 prepared by Dennis Stell, DEFS, attached to his written testimony (Attachment 20). Mr. Glaves added that POP contracts fall under the jurisdiction of the Kansas Corporation Commission (KCC), and the POP contract is currently the subject of a KCC proceeding. Therefore, at this point in time, he sees no reason for the Legislature to be involved in the issue.

Dave Hughes, DEFS, discussed POP contracts. At the outset, he noted the written testimony by Dennis Stell attached to Mr. Glave's testimony summarizes the various types of contracts. He noted less than 10 percent of the gas gathered by DEFS is under POP contracts, and POP contracts are frequently preferred by smaller producers. Although DEFS often prefers POP contracts, if a customer prefers a free based agreement, DEFS will provide the necessary services for a fee. He pointed out the impact on severance taxes can be either positive or negative, depending on gas prices. For the Committee's information, he called attention to three graphs attached to his written testimony, which highlight the decline in natural gas production in Kansas. He emphasized the gas volume decline has caused increasingly difficult problems for gathering and processing companies (Attachment 21).

Edward Cross, Kansas Independent Oil and Gas Association, testified in opposition to SB 267, emphasizing it does not address the more complex issues caused by a variety of forms of gas gathering contracts. He noted that, although natural gas producers share the concerns associated with POP contracts, it is not the POP contracts themselves that cause the erosion of wellhead gas prices. Rather, it is the ineffectiveness of gas gathering regulations to prevent the dramatic escalation of gas gathering rates, whether in the form of POP contracts or other forms of gas purchase contracts. He contended the gas gatherer, which usually holds monopoly over the producer, is exercising monopoly abuse to increase profits at the expense of the producers, royalty owners, and the State of Kansas (Attachment 22).

Senator Corbin called the Committee's attention to written testimony in opposition to SB 267 submitted by David Bleakley, on behalf of Colt Pipeline, LLC and Colt Natural Gas, LLC. Mr. Bleakley concludes, "Let the free market work to set contracts between two independent parties, not the state" (Attachment 23).

Ron Hein, legislative counsel for Pioneer Natural Resources U.S.A., Inc., testified in strong opposition to SB 267, contending it would ultimately result in reduced revenue to both royalty owners and the state. He discussed the methods of processing gas used by Pioneer and other producers and noted producers often enter into POP processing contracts with the expectancy that the reduced percentages of liquids and residue gas available to the producer after processing will produce more net revenue than a sale of gas at the wellhead would have. He noted that, currently, the royalty owners and the state generally share in the increased value of the bi-products of processing and, concomitantly, share in the risk that the net value obtained from processing will not exceed the net value of the wellhead sale. However, SB 267 attempts to ensure the royalty owner incurs no risk with such contracts. He argued it is not appropriate for government to substitute its business judgment on how best to market gas for the business judgment of those in the gas marketing business. He commented that, ultimately, the bill would place all the risk of POP contracts upon the producer (Attachment 24).

William McKean, testified in opposition to SB 267 on behalf of Woolsey Petroleum Corporation, which operates both a gathering system and a processing plant. He argued the bill's underlying assumptions are illogical and do not reflect the economic realities of the gas gathering and processing industry in Kansas. He discussed the "Keep Whole Contract" used by the midstream operator prior to 1996 when natural gas prices become much more volatile. Since 1996, midstream operators have switched to some type of POP contract. He went on to describe POP contracts without sharing and POP contracts with sharing. Based on experience as both an operator and a producer, Woolsey Petroleum believes the ideal gathering-processing contract is a POP agreement with 10 percent to 20 percent sharing (<u>Attachment 25</u>).

Senator Corbin called the Committee's attention to written testimony in opposition to SB 267 submitted by Jon R. Viets and Dana L. Gorman, attorneys at law, who emphasize that "the legislature should not attempt to implement policy by the indirect means of tinkering with the useful and reasonable commercial tool of percentage of proceeds agreements" (<u>Attachment 26</u>).

Senator Corbin called the Committee's attention to the minutes of the September meeting. *Senator Buhler moved the minutes of the September 4-5, 2003, meeting of the Special Committee on Assessment and Taxation Committee be approved, seconded by Senator Donovan. <u>The motion carried</u>.*

The meeting was adjourned at 12:05 p.m.

Prepared by Shirley Higgins
Edited by Martha Dorsey

Approved by the Committee on:

<u>November 12, 2003</u>
(Date)

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