

Testimony of Coffeyville Resources Nitrogen Fertilizers, LLC
Submitted by Kevan Vick, Executive Vice President and General Manager
Regarding HB 2501:
Property Taxation of Commercial and Industrial Machinery and Equipment
Before the House Taxation Committee
Wednesday, February 1, 2012

Thank you Chairman Carlson and members of the Committee for this opportunity to share our support for HB 2501, a proposal to clarify the definition of commercial and industrial machinery and equipment for property tax purposes. My name is Kevan Vick and I have been serving as the Executive Vice President and General Manager of Coffeyville Resources Nitrogen Fertilizers, LLC, the owner and operator of the fertilizer plant in Coffeyville, Kansas.

Company Background

Coffeyville Resources Nitrogen Fertilizers, LLC (“CRNF”) operates a nitrogen fertilizer manufacturing facility in Coffeyville, Kansas. CRNF’s affiliated company, Coffeyville Resources Refining & Marketing; LLC (“CRRM”) operates a petroleum refinery adjacent to the CRNF fertilizer plant in Coffeyville, Kansas.

CRNF is the only fertilizer producer in North America that uses petroleum coke as its major feedstock, producing fertilizers through a gasification process. In 2010, we produced 155,600 tons of anhydrous ammonia and 578,300 tons of UAN, all important fertilizers for Midwest agricultural production.

CRRM is one of only three petroleum refineries left in Kansas. Its refinery has 115,000 barrels per day of capacity.

Our company (collectively referred to herein as “Coffeyville Resources”) is a major economic growth engine for this region through job creation and community investment. Together these operations employ 466 employees with good wages and benefits and with forty-two open positions yet to be filled. During the past five years, we have created more than 100 new jobs for this region.

Last year, our company purchased \$35 million worth in goods and services from Montgomery County-based suppliers. We continue to be supportive of community needs by contributing several hundreds of thousands of dollars to education and charitable efforts. In 2011, we contributed more than \$2.4 million in payroll (unemployment and withholding) taxes to the state of Kansas as well as nearly \$2 million in other business-related taxes.

Our concern today is the massive increase in property taxes as a result of the incorrect classification of commercial and industrial machinery and equipment as real property instead of as personal property, the appropriate classification.

The bill being introduced defines commercial and industrial machinery and equipment (CIME) as that term is used in the Kansas Constitution and in the Kansas property tax statutes, clarifying how these assets should be treated for property tax purposes. In the past few years, Montgomery County has reclassified Coffeyville Resource’s commercial and industrial machinery and equipment as real property and taxed it accordingly. This change has resulted in a massive increase in the tax burden on our company. Coffeyville Resources challenged that reclassification, and on Friday, January 13, 2012, COTA issued a decision that Coffeyville

Resource's CIME is real property for property tax purposes. The decision is contrary to Montgomery County's historical treatment of this very machinery and equipment, as well as the historical treatment of CIME by other counties. COTA's decision is also contrary to the treatment of CIME by the Kansas appellate courts and the Property Valuation Division of the Kansas Department of Revenue, which have historically treated manufacturing equipment as personal property. COTA's decision is also contrary to the clear intent of the legislature in passing the 2006 amendments to KSA 79-223, which was to provide economic incentives for business growth and expansion in Kansas through a tax exemption for CIME.

This testimony is being offered in support of the bill, so that Coffeyville Resources is not disadvantaged as compared to its competitors, both within and outside of the state. The testimony establishes both the policy reasons for passage of the bill, as well as the impact that this fundamental change in property tax policy will have on Coffeyville Resources and potentially other manufacturers if the bill is not passed.

The Effect of Reclassification on Coffeyville Resources

If the fertilizer plant's machinery and equipment were treated as personal property, as Montgomery County had historically done, the fertilizer plant's 2008 tax owed would have been approximately \$907,000. Instead, Montgomery County reclassified it as real property causing the tax owed to increase to approximately \$10,947,000 - an increase of over \$10 million dollars for just one year. This fundamental change in treatment is not good for Kansas or its taxpayers. COTA's method of classification makes the fertilizer plant's property tax burden its second

largest expense, even larger than what it pays its 115 employees and Coffeyville Resources is the highest paid employee pool in Montgomery County.

The machinery and equipment that Coffeyville Resources uses in its operations are the tools of its trade, and that equipment is there to benefit its businesses, not the land. The machinery and equipment is not part of the real estate and was never intended to be real property. Like any manufacturer, Coffeyville Resources uses equipment, such as pumps, compressors, tanks, and processing vessels, to take in various feedstocks and turn them into a final, saleable product. Because Coffeyville Resources works with liquid and gaseous feedstocks, its equipment is connected by pipes, whereas a manufacturer of solid products might connect its equipment along an assembly line or conveyor. As in other industries, this equipment is removed and reinstalled regularly for maintenance, upgrades, and production changes. None of the production assets are intended to become a permanent part of the land. Coffeyville Resources uses the equipment for as long as it makes economic sense to do so. When market or production conditions warrant, that equipment is removed and replaced. Coffeyville Resources purchases and sells equipment on the used equipment market frequently.

In fact, a very large portion of Coffeyville Resources' fertilizer plant was originally constructed from used parts. The gasification unit of the fertilizer plant, which we often call the "front end" of the plant, was purchased from an electrical power plant in California, which used the gasification unit to generate electricity. When that facility closed, the 134 components that comprised the gasification unit became available on the used market. The fertilizer plant's predecessor purchased the gasification equipment, removed it from the California site, and

relocated it to Coffeyville. The remainder of the fertilizer plant was constructed with a mixture of new and used equipment.

Coffeyville Resources' production assets are specifically designed to be moved. Coffeyville Resources' plants are not single, huge machines, as argued by Montgomery County and apparently adopted by COTA. Much of the equipment is small and can be moved by hand. Larger assets have built in lifting lugs and/or are skid mounted for ease of removal. The fertilizer plant moves some assets in and out of operation so often that it keeps spares on hand for replacement. Many of these assets are removed and replaced on a "turnaround basis," which is normal, scheduled replacement. Coffeyville Resources moves assets in and out of the fertilizer plant so frequently that it actually owns its own forklifts and cranes to remove and replace assets. The fertilizer plant was also designed with several integrated hoists installed in areas where assets are moved regularly to facilitate equipment replacement. Indeed, in the COTA case, Coffeyville Resources presented evidence that, of the 640 machinery and equipment assets in dispute, 50 of the assets are small enough to be moved by hand, 272 more could be hauled in the bed of a pickup, 275 could be hauled by semi-truck, and 29 would need to be moved by rail. Only 14 assets at the fertilizer plant could not be shipped in a single piece. This equipment was never intended nor designed to be part of the real estate.

COTA's Decision Fundamentally Changes the Way Machinery and Equipment is Classified and Taxed in Kansas.

For as long as heavy equipment and machinery has been used in Kansas, the machinery and equipment that businesses use to operate have been classified as personal property, not real property. The Kansas Supreme Court has held repeatedly that machinery and equipment serves

the business and not the land to which it is attached. Therefore, such machinery is personal property. Ignoring Kansas Supreme Court precedent, COTA has set the standard that machinery and equipment that is integral to a business or production process becomes part of the real property to which it is attached. By finding that such equipment can be constructively, as opposed to actually, attached to the land, COTA has opened the door to claims that any asset that is integral to a business operation, potentially including computers, staplers, and hand tools, is real property. COTA's test for personal property deviates from historical precedent and is unworkable.

County appraisers have already started to re-classify property what has long been considered personal property. These efforts result in more short-term tax revenue at the expense of long-term economic competitiveness. In Montgomery County, the county appraiser has already reclassified formerly personal property assets at the TessengerloKerley sulfur processing plant, Linde Group air separation plant, and Acme Foundry. The County appraiser previously testified that a favorable COTA decision would result in the re-classification of much more. All processing and manufacturing operations in this state are subject to reclassification as a result of this decision. COTA's broad analysis of what constitutes real property is likely to result in aggressive county appraisers pursuing reclassification of virtually all business machinery and equipment assets as real property.

Taxes for Kansas Businesses Will Increase Dramatically.

Once reclassified, due to the differences in how the actual amount of tax is determined in Kansas as between real and personal property, in general the ultimate taxes paid by Kansas businesses will increase significantly under COTA's decision, just as they have for Coffeyville Resources.

COTA's Decision is Bad for Business and Economic Growth in Kansas.

Manufacturing and industrial operations, such as the state's refineries, fertilizer plants, auto and aircraft manufacturing plants, are the state's largest users of expensive machinery and equipment. These industries all provide some of the state's most lucrative job opportunities. COTA's decision massively increases the property tax burden for large manufacturing and industrial operations, which will have a serious and negative impact on the state's competitive business environment.

Such a tax burden may have drastic negative consequences on CRNF and any other manufacturer, and the willingness of manufacturers to expand their operations or come to Kansas. The increase in tax expense, and consequent reduction in operating margins, could have long term impacts on any manufacturer, causing it to pursue a more tax friendly environment.

New businesses considering relocating or opening new facilities in Kansas will be deterred from doing so. The Kansas legislature enacted K.S.A. 79-223 to exempt newly acquired business machinery and equipment from property taxation and encourage businesses to expand or locate new facilities in Kansas. Counties are trying to avoid the application of this statute by calling this machinery and equipment real property. If the legislature does not act to correct COTA's decision, businesses will not only lose the benefit of the exemption, but they will have their property taxes raised by many multiples of the previous levels.

COTA's Decision Circumvents the Clear Goals and Intent of the Kansas Legislature.

The motivation behind Montgomery County's reclassification of the Coffeyville Resources fertilizer plant assets from personal to real property is transparent: The County is seeking to

avoid the application of the K.S.A. 79-223 exemption for commercial and industrial machinery and equipment purchased new or moved into the state after 6/30/2006. This has been an ongoing problem since the enactment of that exemption statute in 2006. A flurry of reclassification activity prompted the legislature to amend 79-223 in 2008 to add a provision prohibiting reclassification of property that was properly classified as commercial and industrial machinery and equipment. See K.S.A. 79-223(c).

The legislature has already rejected attempts by county appraisers to reclassify personal property to real property for the purpose of avoiding the K.S.A. 79-223 exemption and the economic development that it promotes. The legislature should again revise the Kansas statutes to stop county appraisers' latest attempts to undo legislature's long-term economic stimulus efforts in favor of short-term revenue gains.

COTA's Decision Will Cause Increased Complexity and Uncertainty for Kansas Taxpayers and Taxing Jurisdictions.

Business personal property (commercial and industrial machinery and equipment) is valued in Kansas using a straight line depreciation formula based upon the retail cost new of the asset. The calculation is objective, and values for business personal property are rarely appealed or challenged. Real property, on the other hand, is valued at fair market value. Fair market value is highly subjective and is almost certainly the most litigated issue at COTA.

COTA's decision muddies the classification waters such that counties could make the argument that most, if not all, business personal property should be classified as real property because it is an integral part of the operation of the business being operated on the land. Thus, one would

expect to see more litigation over the classification issue because the test for real versus personal property is now less clear. Then, to the extent that more property is classified as real property, one would expect to see more litigation of the value of that property due to the subjective nature of valuing property at fair market value rather than on a formulaic depreciated cost basis.

Furthermore, the increase in litigation (and particularly in high dollar value litigation) creates complexity for taxing jurisdictions because taxing jurisdictions will be exposed to more situations where they receive tax money that they may have to pay back if the taxpayer successfully appeals the classification or valuation of its property. Large manufacturing operations that use expensive machinery and equipment for their operations represent some of the most expensive properties in the state. COTA's failure to provide a clear test that is consistent with past Kansas law and appraisal practice will exacerbate the revenue uncertainty for all taxing jurisdictions, including cities, counties, libraries, and school districts.

COTA's Decision will Overload its Dockets.

COTA's dockets are incredibly overloaded. The decision in the Coffeyville Resources fertilizer plant appeal took nearly 8 months to issue after the case was submitted to COTA. Other decisions at COTA have been pending for well over a year. COTA has a caseload that is already too heavy. If COTA's decision is allowed to stand, then the problem will only become worse. The increased complexity of COTA's interpretation of the Kansas fixtures test and financial motivation to appeal large swings in property tax value will result in even more litigation at COTA and, ultimately, for the Kansas Court of Appeals. With COTA's current backlog, COTA will surely demand more funding to accommodate increased property tax litigation.

Furthermore, distressed taxpayers whose cases have been pending before COTA for years will also call for some resolution to the backlog.

COTA's Decision Will Cause Increased Costs to Value Properties and Collect Property Taxes.

Most county appraisers are ill-equipped to value large machinery and equipment and sophisticated manufacturing operations on a fair market value basis. The state's mass appraisal system will not typically, if ever, have enough data to provide a reliable value conclusion. Thus, counties would be forced to hire more outside appraisers to provide valuation services, increasing the cost and reducing the efficiency of the tax collection process to the detriment of all Kansas taxpayers. The additional litigation resulting from COTA's decision will add even more costs to the process in the form of attorney fees, expert fees, and lost work time for county appraisers, county attorneys, and other county staff. Ultimately, these costs are borne by Kansas taxpayers.

In Conclusion

We appreciate the opportunity we have had to present these issues to the committee about HB 2501/SB 317 (substitute language.) As you know, passage of this legislation is critical to achieving the very goals set forth by this legislature to enhance the state's economic development and to achieve job growth.

We urge you to seriously consider voting in support of this legislation.

Thank you.

If you should have questions please do not hesitate to contact us by contacting Gina Bowman, Vice President of Government Relations, CVR Energy, Inc. gmbowman@cvrenergy.com or 816/769-7125.