A UNIFORM SYSTEM OF TAXATION FOR MINERAL INTERESTS IN KANSAS

*by Hannah L. Brass**

I. INTRODUCTION

From the moment landowners realized the earth beneath their feet was more than just dirt, they have tried to harness that potential revenue source. The states, using their unique powers granted by the Constitution, learned alongside the landowners and set up taxation systems to meet their unique needs and utilize their natural resources. The taxation methods selected by the states have been the subject of controversy ever since, and each cycle of natural resource boom or bust brings new changes to those laws. Kansas settled on a system that brings in revenue from several areas.[1] The State first collects taxes from natural resource producers in the form of a flat-rate excise tax on minerals when they are produced and marketed.[2] The State then has two systems to collect property tax from the mineral estate.[3] First, Kansas levies annual taxes on personal property interest in mineral leases.[4] Second, the State levies annual taxes on the real property itself, and the appropriate tax rate is determined by whether or not the mineral interest is severed[5] from the surface above.

That second piece of Kansas' natural resource tax law has been in place for over a century and has been the subject of litigation since its passage.[6] The

---

* J.D. Candidate 2017, University of Kansas School of Law; B.B.A. (Energy Management), University of Oklahoma. I would like to thank Dean Stephen Mazza for his insightful comments and the Kansas Journal of Law & Public Policy for their editing efforts.

1. KAN. CONST. art. XI, § 1.
2. KAN. STAT. ANN. § 79-4217 (2015).
3. KAN. CONST. art. XI, § 1(a).
4. KAN. CONST. art. XI, § 1(b).
5. The Kansas Constitution uses the word "severed" to describe two different processes: the process of severing sub-surface minerals from the ground through the extraction of natural resources and the process of severing the ownership of the mineral estate from the ownership of the surface estate. *See* KAN. CONST. art. XI. The use of the word "severed" in this paper refers to the process of severing the ownership of the mineral estate from the ownership of the surface estate.
6. *See, e.g.*, Cherokee & Pittsburg Coal & Mining Co. v. Board of Comm'rs, 71 Kan. 276 (1905).

disparate tax treatment of severed and non-severed mineral interests for taxation, which is codified in K.S.A. § 79-420, likely violates the Equal Protection Clause of the Fourteenth Amendment. Even if Kansas determines the current law does not violate Equal Protection, the State should address the disparate tax treatment of mineral interests and adopt a uniform taxation system that appraises those interests on an expected production basis. The State should adopt a uniform system to ensure that equally situated property owners are taxed equally and to provide clarity for mineral owners and assessors.

Many groups involved are dissatisfied with the current system because of its complexity and seemingly arbitrary valuation system. The Kansas County Appraisers Association (KCAA) discussed the statutory tax system, § 79-420, at several annual meetings, specifically the "listing and valuation problems brought forth by application of the statute."[7] The KCAA advised county appraisers to "proceed cautiously" when applying § 79-420 and held meetings to discuss the challenges with assessing mineral interests under current Kansas law.[8] The Southwest Kansas Royalty Owners Association invited two speakers to their annual meeting in 2012 to address this issue and give recommendations to the mineral owners.[9] The mineral owners were briefed on the Constitutional challenges of § 79-420 but were told not to expect any resolution in the near future.[10] One county even refunded taxes on severed mineral interests and later stopped levying any taxes on severed minerals for fear of being burdened with expensive litigation.[11] A uniform valuation system would remove most of these concerns and provide clarity for mineral owners and county employees.

This paper will discuss Kansas' current tax treatment of mineral interests and how the taxation systems can be improved to ensure the constitutionality of the State's laws, meet the stated goals of Kansas tax law, and maintain a revenue stream for the State and local governments that is representative of the actual revenue from the State's mineral properties. Part II will discuss the history of Kansas' current property tax treatment for mineral interests and identify some of the problems with the current system. Part III will analyze the Equal Protection concerns with the current law and isolate the portions that are unconstitutional. Part IV will present a solution to change Kansas' property tax treatment of mineral interests and focus on a State-wide system that removes much of the burden from the individual county assessors and values mineral interests based on their production generating capacity.

7. David Harper, *The Director's Update*, APPRAISING THE PLAINS (Kan. Cty Appraisers Assoc.), Oct. 2012, at 4.

8. David Harper, *The Director's Update*, APPRAISING THE PLAINS (Kan. Cty Appraisers Assoc.), Jan. 2013, at 4.

9. *Southwest Kansas Royalty Owners Association hosts 64th annual meeting*, LEADER & TIMES (May 3, 2012 10:00AM), http://www.leaderandtimes.com/index.php?option=com_content&view=article&id=7759:southwest-kansas-royalty-owners-association-hosts-64th-annual-meeting&catid=12:local-news&Itemid=40.

10. *Id.*

11. *Appraiser Gets Heat for Decisions, Expenses*, THE WESTERN STAR, Apr. 5, 2012, at 17.

II. BACKGROUND

Deeply ingrained in our legal system is the idea that property owners are free to divide their property in almost any way they can imagine. Kansas landowners, like many others, exercised this right to free conveyance by dividing their estates horizontally, retaining ownership to some or all of the earth below.[12] In *Cherokee & Pittsburg Coal & Mining Co. v. Board of Comm'rs*, the Kansas Supreme Court explained that these mineral estates were severed from the surface by mineral deed or mineral reservation in order to capitalize on the marketability of this separate class of real estate.[13] Since Kansas' incorporation, the State and its counties have generated significant revenue from privately owned natural resources, and that revenue represents a large line item in those governments' budgets.[14] These natural resources were, and continue to be, marketable and profitable for their owners.

Just as the landowners adapted to ensure continued profits, the states enacted their own changes.[15] The Kansas legislature responded to the newly discovered natural resources and subsequent horizontal property divisions by enacting Gen. Stat. 1901, § 7583, later K.S.A. § 79-420, which mandates the recording of severed mineral interests and permits their taxation and appraisal separate from the surface above.[16] The purpose of this law was "to meet a newly developed class of property or division of ownership of real estate in Kansas, by which lands came to be divided horizontally."[17] But for this statute, a large and valuable class of real estate might avoid taxation.[18] The Kansas Supreme Court's decision in *Cherokee* marked an almost immediate protection of this statute which continues to this day.[19] The three-page opinion has insulated § 79-420 from anything but the broadest rational basis scrutiny for over 100 years.

The effect of § 79-420 is that similarly situated property may be subject to very different tax rates. This results in gross disparities that violate the Equal Protection Clause. In relevant part, K.S.A. § 79-420 states:

> Whenever the fee to the surface of any tract, parcel or lot of land is in any person or persons, natural or artificial, and the right or title to any minerals therein is in another or in others, such mineral interest shall be listed and the market value, if any, determined separately from the fee of such land, in separate entries and descriptions. Such

12. 1 EUGENE KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 3.2(a) (Matthew Bender, rev. ed., 2015).

13. Cherokee & Pittsburg Coal & Mining Co. v. Bd. of Comm'rs, 71 Kan. 276, 277 (1905).

14. *See, e.g.*, SAM BROWNBACK, STATE OF KANSAS COMPARISON REPORT: THE FY 2015 GOVERNOR'S BUDGET REPORT WITH LEGISLATIVE AUTHORIZATION 20 (2014), http://budget.ks.gov/publications/FY2015/FY2015_Comparison_Report--7-10-2014.pdf.

15. JOHN H. TIPPIT, 2 ROCKY MT. MIN. L. INST. 17-1 (1956).

16. *See* KAN. STAT. ANN. § 79-420 (2015).

17. *Cherokee*, 71 Kan. at 278.

18. *Id.*

19. *See, e.g.*, Kan. Att'y Gen. Op. 2012-18 (Aug 8, 2012), http://ksag.washburnlaw.edu/opinions/2012/2012-018.pdf.

> land and such mineral interest shall be separately taxed to the owners thereof respectively. In determining the market value, if any, of any such mineral interest, the appraiser shall consider every proper factor, including but not limited to, the size of the particular mineral interest, the fractional share of such interest and the number of fractional shares in existence for such interest.[20]

The Kansas Constitution establishes seven subclasses of real property for taxation.[21] The majority of Kansas real property, and therefore its mineral interests, falls into the agricultural use subclass.[22] This subclass is assessed based on the agricultural income or productivity of the land and taxed at 30%.[23] If mineral interests have not been severed from the surface, they are generally classified as agricultural use and appraised based on the agricultural income or productivity of the surface above.[24] Under § 79-420, if that same mineral interest is later severed from the surface interest, the mineral interest moves into the "all other urban and rural real property" subclass and is appraised at its fair market value.[25] Consequently, similar mineral interests are subject to vastly different tax assessments depending on whether those interests are severed from the surface.[26]

This leads to the illogical result that the same mineral interest may be subject to significantly varied property valuation and tax assessments from one day to the next if it is severed from the surface, even though the property changes in no other way. It does not objectively generate more revenue or provide greater use, but it is subject to greater property tax. The same illogical result follows from a transaction in the other direction. If the owner of a severed mineral interest, who is taxed based on fair market value, later acquires the surface interest, the mineral interest is then taxed at the lower agricultural income or productivity rate because, as § 79-420 states, the fee to the surface is no longer in another.

This disparity violates the taxation purpose and power given to the legislature in the Kansas Constitution.[27] The Kansas Constitution states that "the legislature shall provide for a uniform and equal basis of valuation and rate of taxation of all property subject to taxation."[28] A mineral estate that remains attached to the surface is no less marketable than a mineral estate that has been severed. The initial conveyance that severs the mineral estate from the surface estate will look identical to all subsequent conveyances of the mineral estate.

As with other real property, valuation of mineral estates is at the

20. KAN. STAT. ANN. § 79-420 (2015).
21. KAN. CONST. art. XI, § 1(a).
22. *See* Kan. Att'y Gen. Op., *supra* note 19, at 2.
23. KAN. CONST. art. XI, § 1(a).
24. *See* KAN. CONST. art. XI, § 1(a); *see also* Kan. Att'y Gen. Op., *supra* note 19, at 2.
25. *See* KAN. CONST. art. XI, § 1(a); *see also* Kan. Att'y Gen. Op., *supra* note 19, at 2.
26. Kan. Att'y Gen. Op., *supra* note 19, at 2.
27. *See* KAN. CONST. art XI, § 1(a).
28. KAN. CONST. art. XI, § 1(a).

discretion of each county's appraiser.[29] Roughly half of Kansas counties track the mineral interests that are titled separately from the surface, however, only 42 out of 105 Kansas counties appraise those mineral rights for annual property taxes.[30] In those counties that appraise severed mineral interests, the fair market values of mineral properties range from $1.00 to $200.00 per acre.[31] "Some have updated values in the past two years but many simply apply a per acre value which has been in place for years."[32] As explained below, this disparity creates serious Constitutional concerns.

III. EQUAL PROTECTION ANALYSIS

The Equal Protection Clause of the Fourteenth Amendment to the U.S. Constitution, § 1 established that no State shall "deny to any person within its jurisdiction the equal protection of the laws." [33] It is important to note that most laws differentiate between classes of persons, and the Equal Protection Clause does not forbid this practice.[34] Rather, the purpose of the Equal Protection Clause is to keep lawmakers from treating people differently when they are alike in all relevant aspects.[35] Legislatures are presumed to have acted within their power even if, in practice, their laws result in inequality.[36] Consequently, unless a classification jeopardizes the exercise of a fundamental right or creates categories on the basis of a protected characteristic, the Equal Protection Clause requires only that the chosen classification rationally further a legitimate state interest.[37] A law rationally furthers a legitimate state interest if there is a plausible policy reason for the classification,[38] the classification is rationally based on facts considered true at the time the law was enacted,[39] and "the relationship of the classification to its goal is not so attenuated as to render the distinction arbitrary or irrational."[40]

A. Economic Equal Protection

When establishing taxation practices, states have broad discretion to make classifications that the state feels will produce reasonable systems of taxation.[41]

---

29. KAN. STAT. ANN. § 79-420 (2015).

30. KAN. DIV. OF PROP. VALUATION, HOUSE BILL NO. 2264-MINERAL RIGHTS (Jan. 18, 2012), http://www.kslegislature.org/li_2012/b2011_12/committees/misc/ctte_h_tax_1_20120118_01_other.pdf.

31. *Id.*

32. *Id.*

33. U.S. CONST. amend. XIV, § 1.

34. Nordlinger v. Hahn, 505 U.S. 1, 10 (1992).

35. Bruce Comly French, *Willowbrook Reclaimed*, 2 CHARLOTTE L. REV. 297, 304 (2010).

36. *See, e.g.*, F.S. Royster Guano Co. v. Virginia, 253 U.S. 412, 415 (1920).

37. *See, e.g.*, City of Cleburne v. Cleburne Living Center, Inc., 473 U.S. 432, 439–41 (1985).

38. *See* U.S. R.R. Retirement Bd. v. Fritz, 449 U.S. 166, 174–75 (1980).

39. Minnesota v. Clover Leaf Creamery Co., 449 U.S. 456, 464 (1981).

40. *Nordlinger*, 505 U.S. at 1, 11 (citing *Cleburne*, 473 U.S. at 446).

41. Gerald L. Neuman, *Constitutional Equality: Equal Protection, "General Equality" and Economic Discrimination From a U.S. Perspective*, 5 COLUM. J. EUR. L. 281, 302 (1999).

This is not to say, however, that there can be no judicial restraint on state taxation laws and practices.[42] The level of judicial restraint has fluctuated over time and reached a high point during the first half of the twentieth century, marked by the Lochner era of judicial interpretation.[43] As states increased regulation, the Supreme Court faced the issue of defining the police power of the states.[44] Jurists worried that unless the Court identified the limits of the state, "either the regulatory state would strip the right of property of any meaning, or the right of property would triumph over the just claims of society."[45] Beginning with the 1905 decision in *Lochner v. New York,* the Supreme Court established clear limits on the regulatory powers of the states, invoking the Equal Protection Clause in several instances.[46] After this era ended in the late 1930s, there was a marked shift in the tone of economic Equal Protection interpretation within the Supreme Court.[47] The Court became much more reluctant to invalidate state laws concerning economic regulation, and instead applied "an insurmountable standard of Rational Basis Review."[48]

In *Williamson v. Lee Optical*, the Court noted this shift toward more state discretion, stating "the day is gone when this Court uses . . . the Fourteenth Amendment to strike down state laws, regulatory of business and industrial conditions, because they may be unwise, improvident, or out of harmony with a particular school of thought."[49] The holding in *Williamson* presents a seemingly impossible standard of rational basis review, and gives the impression that the Court will no longer use the Fourteenth Amendment to rule on state economic regulations, marking a 180-degree difference from the *Lochner* era. *Williamson* marks a "recoil from the excesses of the activist conservative court of the early 20th Century. Both in what it says and what it does, the Court has come back to equilibrium since."[50] The Court has shown that it is still willing to strike down state law using the Fourteenth Amendment, even when those laws relate to regulation of business and industrial conditions, softening the holding in *Williamson*.[51]

Even though states have broad discretion to establish tax classifications

42. William D. Araiza, *The Trouble With Robertson: Equal Protection, the Separation of Powers, and the Line Between Statutory Amendment and Statutory Interpretation*, 48 CATH. U.L. REV. 1055, 1117 (1999).

43. *See* Stephen A. Siegel, *Lochner Era Jurisprudent and the American Constitutional Tradition*, 70 N.C.L. REV. 1, 7 (1991).

44. *Id.* at 7–8.

45. *Id.* at 8.

46. *See* David E. Bernstein, *Lochner Era Revisionaism, Revised: Lochner and the Origins of Fundamental Rights Constitutionalism*, 92 GEO. L.J. 1, 13 (2003); Lochner v. New York, 198 U.S. 45 (1905).

47. Kirk Berger, Note, *Foul Play: Tennessee's Unequal Application of Its Jock Tax Against Professional Athletes*, 13 CARDOZO PUB. L. POL'Y & ETHICS J. 333, 345 (2013).

48. *Id.*

49. Williamson v. Lee Optical of Oklahoma, Inc., 348 U.S. 483, 488 (1955).

50. Matt Coles, *Reinhardt is Right: Perry is a Case About California*, 37 N.Y.U REV. L. SOC. CHANGE 131, 135 (2013).

51. *See, e.g.*, Allegheny Pittsburgh Coal Co. v. County Comm'n, 488 U.S. 336 (1989); *see also* Coles, *supra* note 50, at 135.

and assign each class a different burden, those divisions and burdens must be reasonable if they are to survive an Equal Protection Claim.[52] Lawmakers are restricted from treating differently persons who are alike in all relevant respects.[53] If the classifications are neither capricious nor arbitrary and are based on some consideration that is substantially related to the object of the tax, there is no Equal Protection violation.[54]

In *Allegheny Pittsburgh Coal Co. v. County Comm'rs*, the Court made it clear that state taxation laws are not beyond the reach of the Fourteenth Amendment.[55] Following a fairly narrow rational basis analysis, the Court clarified that when two methods are used to assess property in the same class, the resulting tax determination is, without more, "of no constitutional moment."[56] The Equal Protection Clause "applies only to taxation which in fact bears unequally on persons or property of the same class."[57] The Equal Protection Clause allows for occasional errors of state law or lapses in judgment when valuing property for tax purposes.[58] A law does not need to be applied evenly at its first implementation if it is accurate enough to equalize the differences between property owners in a short period of time.[59] In each case concerning taxation, the Equal Protection Clause requires "the seasonable attainment of a rough equality in tax treatment of similarly situation property owners."[60] This overarching fairness concern requires a property owner's allocable share of the total property tax burden be relative to the share of other property owners who are similarly situated.[61]

The Supreme Court again revisited the Equal Protection consideration of tax laws in *Armour v. City of Indianapolis*.[62] Even though the tax provision at issue in *Armour* did not violate the Equal Protection Clause, the Court did not use *Armour* to weaken the position taken in *Allegheny*. The Court clarified that the burden remains on the party opposing the legislation to negate "every conceivable basis which might support it."[63] Then, the Court stated that in a case where a state law is clearly and dramatically violated, like in *Allegheny*, the facts preclude any alternative reading of the law and in turn, any alternative

52. Allied Stores of Ohio v. Bowers, 358 U.S. 522, 526–27 (1959); *see also* Roger V. Abbott, *Is Economic Protectionism a Legitimate Governmental Interest Under Rational Basis Review?*, 62 CATH. U.L. REV. 475, 493–94 (2013).

53. Nordlinger v. Hahn, 505 U.S. 1, 10 (1992) (citing F.S. Royster Guano Co. v. Virginia, 253 U.S. 412, 415 (1920)).

54. *Id.* at 32 (citing Brown-Forman Co. v. Kentucky, 217 U.S. 563, 573 (1910)).

55. *Id.*

56. Allegheny Pittsburgh Coal Co. v. County Comm'n, 488 U.S. 336, 343 (1989).

57. *Id.* (citing Charleston Fed. Savings & Loan Assn. v. Alderson, 324 U.S. 182, 190 (1945)).

58. *Id.*

59. *Id.*

60. *Id.* (citing Allied Stores of Ohio v. Bowers, 358 U.S. 522, 526–27 (1959)).

61. *Id.* at 346.

62. *See* Armour v. City of Indianapolis, 132 S. Ct. 2073 (2012).

63. *Id.* at 2080–81 (citing Lehnhausen v. Lake Shore Auto Parts Co., 410 U.S. 356, 364 (1973)).

rational basis.[64] Further, the Court reiterated that when considering the "state constitution and related laws requiring equal valuation, there could be no other rational basis for the practice."[65]

B. The Equal Protection Violations of K.S.A. § 79-420

While Kansas has broad powers to establish and impose taxes, § 79-420 likely violates the Equal Protection Clause because through its application, comparable mineral interests are subject to significantly different tax burdens. Like in *Allegheny*, Kansas law creates opportunities for similar interests to be assessed at very different property values. These opportunities come from both the application of the law and from the law itself. When applying § 79-420, individual counties are given complete discretion as to how they value severed mineral interests for property taxation, if they tax those interests at all.[66] Creating a uniform valuation system would fix some discrepancies across the State, but it would not address the deeper Equal Protection violations. The State must also reclassify mineral interests for taxation to ensure that similarly situated property owners are treated equally.

Current practice and law in Kansas are not rationally related to the purpose of providing a uniform and equal basis of valuation, which is evidenced by the fact that they create intentional systematic discrepancies. The State of Kansas actually recognized these gross disparities and their apparent irrationality.[67] In 2012, the Secretary of the Kansas Department of Revenue requested that the Kansas Attorney General address the Equal Protection implications of § 79-420.[68] In a short opinion, the Attorney General opined that the "state may separately classify severed and non-severed mineral interests for taxation purposes without violating the Equal Protection guarantee of the Kansas and United States Constitutions."[69] The Attorney General first noted that mineral ownership—specifically, the condition of a mineral estate in relation to the surface estate—is neither a fundamental right nor a protected class.[70] While this first step of the analysis is correct, the Attorney General's remaining application of the rational basis test is less persuasive.

A thorough rational basis analysis of § 79-420 requires identification of a plausible policy reason for the law.[71] The Attorney General's opinion notes that there is no legislative history available to explain the motivation for the original law, which was later codified as K.S.A. § 79-420.[72] Instead, the Attorney General cites several Kansas Supreme Court cases that have long been understood to articulate the purpose of § 79-420, concluding that the

64. *Id.* at 2084.
65. *Id.*
66. Kan. Att'y Gen. Op., *supra* note 19.
67. *See, e.g.*, *id.*
68. *Id.*
69. *Id.*
70. *Id.*
71. *See, e.g.*, City of Cleburne v. Cleburne Living Center, Inc., 473 U.S. 432, 446 (1985).
72. Kan. Att'y Gen. Op., *supra* note 19.

purpose of the law is to ensure that severed mineral interests are placed on the tax rolls.[73] In 1905, the Kansas Supreme Court interpreted the precursor to § 79-420 and considered this exact Equal Protection issue.[74] In *Cherokee*, the Court stated that this tax measure was "passed to meet a newly developed class of property or division of ownership of real estate in Kansas, by which lands came to be divided horizontally, as it were. But for this provision, it would be possible for a very large and highly valuable class of real estate to escape taxation."[75] Over thirty years later, the Kansas Supreme Court addressed this issue again in *Hunshaw v. Kansas Farmers' Union Royalty Co.* and stated that the purpose of the law was to place oil and gas properties on the tax rolls.[76] The Kansas legislature chose to accomplish this by compelling disclosure of the "true ownership of such minerals as they are from time to time transferred."[77]

The policy justifications articulated in both *Cherokee* and *Hunshaw* are logical. Kansas contains many valuable resources, and it is reasonable for the State to ensure those resources are taxed in relation to their value. These policy reasons, however, do not justify § 79-420 because distinguishing between severed mineral interests and non-severed mineral interests does not accomplish either of these policy goals. By allowing the mineral interests in non-severed estates to remain untaxed, Kansas is permitting a very large and highly valuable class of real estate to escape taxation. This directly contradicts the long-understood goal of § 79-420 as expressed in *Cherokee*. Allowing for different treatment of minerals that are "from time to time transferred," depending on whether they are also transferred with the surface interest, contradicts the goals expressed by *Hunshaw*. Minerals that remain attached to the surface are no less transferrable or valuable than those that are severed. If the goal of § 79-420 is to ensure taxation of Kansas' vast reservoirs of oil and gas, then no distinction should be made between severed and non-severed mineral interests because there is no distinction in their values or abilities to produce revenue.

Further Equal Protection analysis requires that the classifications chosen by the legislature be rationally based on facts considered true.[78] As discussed previously, the decision to classify severed and non-severed mineral interests separately is not rational. It is difficult to conceive of a set of facts that could rationally lead the legislature to determine that severed mineral interests are different from non-severed mineral interests and should be afforded their own class for property taxation. As evidenced by the preceding discussion, the relationship of Kansas' selected classifications to the goals of § 79-420 is so attenuated that it is arbitrary and irrational, and therefore fails the rational basis

73. *Id.*
74. *See* Cherokee & Pittsburg Coal & Mining Co. v. Bd. of Comm'rs, 71 Kan. 276 (1905).
75. *Id.* at 278.
76. Hushaw v. Kansas Farmers' Union Royalty Co., 149 Kan. 64, 74 (1939).
77. *Id.*
78. Nordlinger v. Hahn, 505 U.S. 1, 11 (1992).

test.[79] The differences between the classes do not represent characteristics that are relevant to the stated policy justifications for § 79-420. Together, the severed and non-severed mineral properties make up that large and highly valuable class of real estate which the Kansas legislature aims to place on the tax rolls. Both types of interests may produce identical amounts of natural resources and may be sold or leased for identical sums. Nothing about the physical condition or revenue-generating capacity of the mineral estate may change, but it may freely move between the severed and non-severed classes. This illustrates the irrationality of § 79-420 and the inexplicable distinction between severed and non-severed mineral estates.

Further, § 79-420 does not meet the purpose of property taxation generally, nor the purpose of Kansas property taxation, specifically. The overarching goal of property tax legislation is to ensure that a property owner's share of the tax burden is relative to the share of similarly situated property owners.[80] The Kansas Constitution states that the purpose of property taxation is to ensure a "uniform and equal basis of valuation."[81] The current application of § 79-420 clearly does not meet this purpose, and therefore under the standard set forth in *Allegheny* and later supported by *Armour*, there can be no other rational basis for Kansas' current practice.[82] Since property values continually fluctuate, it is understandable that there may be an occasional error in valuation or a period of time in which similarly situated property owners are treated inequitably. This does not violate the Equal Protection Clause—the Constitution allows for these nuances if the end goal or application of tax legislation is an equal distribution of the tax burden among similarly situated individuals.[83] This is not the case in Kansas, however. The disparate impact created by the severed mineral classification in § 79-420 does not represent an occasional error or a lapse in rough equality. It does not create a situation in which the tax burden is equally distributed among similarly situated mineral owners. It is clear that this is not a momentary inequality among similarly situated property owners. In fact, those inequalities were identified in *Cherokee* over 100 years ago, and have continued to be protected by that ruling ever since. The arbitrary classifications established by § 79-420 represent systematic inequities between similarly situated property owners, consequently creating a violation of the Equal Protection Clause. This problem will not be completely solved by imposing a uniform system of valuation for mineral properties. Instead, the State must also reclassify mineral properties for purposes of property taxation.

79. *See* City of Cleburne v. Cleburne Living Center, Inc., 473 U.S. 432, 446 (1985).
80. Allegheny Pittsburgh Coal Co. v. County Comm'n, 488 U.S. 336, 346 (1989).
81. KAN. CONST. art. XI, § 1.
82. Armour v. City of Indianapolis, 132 S. Ct. 2073, 2084 (2012).
83. Michael D. Rawlins, *Taxation, Equal Protection, and Inquiry into the Purpose of a Law: Nordliger v. Hahn and Allegheny Pittsburg Coal Co. v. County Commission*, 1993 BYU. L. REV. 1001, 1004 (1993).

IV. REVISING CLASSIFICATIONS FOR MINERAL TAXATION

As evidenced by the repeated judicial protection of § 79-420 and the recent Attorney General Opinion, it seems that Kansas may be unlikely to change the property tax classifications based on Equal Protection motivations. Even if the State disagrees that § 79-420 violates the Equal Protection clause, the state should change the tax classes and adopt a uniform method as a matter of public policy.[84] The public policy rationales expressed by *Cherokee* and *Hunshaw* are compelling and persuasive, especially considering the value that Kansas has realized from oil and gas interests in recent years. *Cherokee* stated that Kansas needed this law to account for certain divisions of property ownership, specifically horizontal property division.[85] Without § 79-420, a large and valuable class of property would escape taxation.[86] *Hunshaw* restated this idea by holding that the State was justified in using this law to place mineral properties on the tax rolls.[87] It is reasonable and rational that valuable mineral interests should be subject to property taxes, and the State should extend this reason and logic to encompass all valuable mineral interests—not just those that are severed from the surface above. A more effective method is for the State to move away from mineral classes distinguished by whether or not the mineral estate is severed from the surface, and instead create classes distinguished by whether or not the mineral estate is currently producing natural resources. This method ensures that the State promotes the policy reasons stated in *Cherokee* and *Hunshaw*, meets the overarching Kansas Constitutional goal of uniform and equal valuation, and minimizes the risk of Equal Protection violations. After classifying mineral interests as either producing or non-producing, Kansas should then apply a statewide and consistent taxation method instead of placing the burden on individual county appraisers. The best taxation method for the State is an annual tax levy that is not based strictly on fair market value, but instead on expected production from the mineral interest.

A. Classifying Mineral Interests Based On Producing or Non-Producing Characteristics

By creating tax classifications based on producing and non-producing mineral interests, Kansas will create a stronger relationship between the stated goals of equal taxation and revenue collection and the classifications chosen to achieve those goals. Kansas has long recognized that it may be appropriate to value property based on its production capabilities, as reflected by the creation of the agricultural use classification. Agricultural land is taxed at 30% of its value, which is calculated on the basis of its agricultural income or

---

84. *See* WALTER HELLERSTEIN, *§ 191.02 Treating Mineral Resources Like Other Property for Ad Valorem Tax Purposes: The Search for Value*, 5 AMERICAN LAW OF MINING § 191(2d ed. 2015).

85. Cherokee & Pittsburg Coal & Mining Co. v. Bd. of Comm'rs, 71 Kan. 276, 278 (1905).

86. *Id.*

87. Hushaw v. Kansas Farmers' Union Royalty Co., 149 Kan. 64, 74 (1939).

productivity, not fair market value.[88] The justification for deviating from a fair market value assessment for agricultural properties applies to the class of mineral properties as well.[89] Early advocates for a use-value or production based taxation system argued that the revenue from agricultural property was often insufficient to cover the taxes on the market value of the land.[90] Additionally, many felt that farmers paid for a larger portion of public programs than they actually used.[91]

Both of these justifications apply to mineral interests. If a property owner is not realizing any revenue from the mineral estate, meaning that it is not producing, then theoretically the owner is less able to pay taxes on the fair market value of his estate. There are probably few landowners with the capabilities to produce and market the natural resources on their property without intervention from a third party, such as an oil and gas company. Therefore, the landowner's inability to use his land to pay taxes on the fair market value of that land arises through no fault of his own. Furthermore, like agricultural land, mineral interests may be owned in large sub-surface tracts and may not use public programs at the same consumption per acre rate as the surface above or as neighboring land in urban areas.

These broader liquidity and benefits concerns play an important role when establishing property taxes. Economists argue that modern property taxes should be responsive to the taxpayer's ability to pay and his relative liquidity from the property.[92] A property tax only retains its integrity if it reconciles the value a taxpayer is charged with the actual value of the property.[93] This reconciliation happens by utilizing realization events,[94] such as mineral production, to accurately assess real property. These assessments are also based on the benefits principle of taxation.[95] Under that theory, property tax is tied to the benefits a landowner receives from his local government, since those local benefits are directly funded by property taxes.[96] Several states use these justifications to establish a producing or non-producing classification system for mineral property taxes and choose not to differentiate between severed and non-severed mineral interests.[97] This ensures that similarly

88. KAN. CONST. art. XI, § 1.

89. *See* Todd Kuethe & Bruce Sherrick, *The Taxation of Agricultural Land in the United States*, UNIVERSITY OF ILLINOIS (Oct. 15, 2014), http://policymatters.illinois.edu/the-taxation-of-agricultural-land-in-the-united-states/; *see also* Carolyn Orr, *The Hows and Whys of Taxing Farmland: Varying State Systems in the Midwest Continue to Evolve*, CSG MIDWEST (Oct. 2012), http://www.csgmidwest.org/policyresearch/1012aglandtaxes.aspx.

90. Kuethe & Sherrick, *supra* note 89.

91. *Id.*

92. Darien Shanske, *Revitalizing Local Political Economy Through Modernizing the Property Tax*, 68 TAX L. REV. 143, 146 (2014).

93. *Id.*

94. *Id.*

95. INST. ON TAXATION AND ECON. POL'Y, HOW PROPERTY TAXES WORK 1 (2011), http://www.itepnet.org/pdf/pb46proptax.pdf.

96. *Id.*

97. *See generally* WALTER HELLERSTEIN, STATE AND LOCAL TAXATION OF NATURAL RESOURCES IN THE FEDERAL SYSTEM: LEGAL, ECONOMIC, AND POLITICAL PERSPECTIVES

situated property (i.e., all revenue-generating mineral interests) is treated similarly.

B. Assessing Mineral Interests Using an Expected Production Basis

After selecting tax classes, a state must then determine the valuation method. The challenge with selecting a taxation and assessment system for mineral interests generally boils down to choosing either an ad valorem tax or a production tax.[98] States have been struggling with this issue for over 150 years, and many have continually revised or completely changed their taxation systems.[99] Michigan led the movement with a 4% tax on all resources mined in the state, to be levied in lieu of all other state taxes.[100] Since then, states have grappled with the issue of what type of tax is appropriate for these minerals and natural resources.

1. Ad Valorem Tax or Production Tax

The ultimate goal for each state is to select a taxation system or combination of systems that allows for equal treatment of all property.[101] The most obvious choice is ad valorem taxation because of its simplicity and perceived equality. Ad valorem literally means "at value" and is defined as "proportional to the value of the thing being taxed."[102] A strict proportional tax, such as ad valorem property tax, provides state and local governments with a fairly uniform and consistent tax levy. Theoretically, ad valorem taxation should work for natural resources as well. This system works for personal and real property of all kinds and allows for an annual tax at a uniform rate, and therefore may be a reasonable choice for natural resources.[103]

The problem with at-value taxation of natural resources stems from the difficulty of assessing the value of exhaustible property. "The heart of the matter was the allegedly unique characteristics of the resources themselves that made them peculiarly ill-suited to ad valorem property taxation."[104] Ad valorem systems of taxation for natural resources present three main challenges. First, and likely the most obvious, is the difficulty with assessing something that is unseen.[105] This problem was succinctly described in a speech to the National Tax Association in 1908.[106] Although it relates specifically to mining, the speech reflects the challenges of valuing all natural

(1986) (providing a general overview of natural resource taxation in the United States, as well as a discussion of each state's natural resource taxation).

98. *Id.* at 7.

99. *See*, *e.g.*, AMERICAN LAW OF MINING, (2d ed. 2015).

100. *See* HELLERSTEIN, *supra* note 98, at 6 (noting that the tax on production from iron mines was limited to 2%).

101. HELLERSTEIN, *supra* note 98, at 7.

102. *Ad Valorem*, BLACK'S LAW DICTIONARY (10th ed. 2014).

103. HELLERSTEIN *supra* note 98, at 7.

104. *Id.* at 8.

105. *Id.*

106. *Id.* (quoting Thomas, *Taxation of Mines in Utah and Nevada*, PROC. OF THE SECOND ANN. CONF. OF THE NAT'L TAX ASSOC'N 431, 431–32 (1909)).

resources even with today's technology:

> The value of real estate could be ascertained with reasonable accuracy, according to its location, desirability and earning power. The value of improvements is, generally speaking, always in evidence, as also that of personal property where it can be found; but to determine the value of mineral-bearing land, with its ores buried in the earth, was something beyond human power. There were so many chances for uncertainties about a vein or deposit of ore, in mountainous countries especially, that the only way to determine its value was to dig it out, sell it, and figure up what you had left; until that was done, no man could tell what a mine was worth.[107]

The second valuation hurdle is the exhaustibility of natural resources.[108] Early lawmakers raised concerns that if the taxation system were solely tied to the annually-assessed value of the natural resource, with no consideration of production, taxpayers and producers would find an incentive to exhaust natural resources at the fastest rate possible, thereby decreasing their aggregate ad valorem tax over the life of the resource.[109] This result could have greater economic impacts and depress the value of the natural resources in question.

The third valuation challenge, closely tied to the second, is the inverse relationship between the value of the resource and the owner's ability to pay taxes on that value.[110] Theoretically, the mineral estate is at its most valuable before any production has occurred. Under a fair market value tax system, the tax bill will be highest at this point. If there has been no production, however, the taxpayer has realized no income from the mineral estate and is less likely to be in a position to pay these property taxes.

These three problems with strict, fair market value based ad valorem taxation led lawmakers and lobbyists to consider production tax instead of property tax. The production tax, like Michigan's 4% rate discussed previously, generally applies a flat tax on the value or quantity of production.[111] This system remedies some of the larger concerns with ad valorem taxation. It allows for more accurate valuation, does not provide incentives for the rate of depletion, and creates a tax burden that parallels the taxpayer's revenues. Production taxes, however, have downsides of their own. A production tax based on gross proceeds does not take into account the margins associated with specific production costs.[112] For example, a low-value, high production cost resource will have a much lower profit margin than a high value, low production cost resource even though their gross proceeds may be the same. A production tax represented by a flat tax on produced quantities is undesirable because it also violates the principles of value-based uniformity and equality.[113] Implementing a production tax based on net

107. *Id.*
108. *Id.*
109. HELLERSTEIN, *supra* note 98, at 8.
110. *Id.* at 9.
111. *Id.*
112. *Id.* at 10.
113. *Id.*

proceeds in an attempt to fix the equity problems in a flat tax or a gross proceeds tax might also create undesirable results.[114] A net proceeds tax is more vulnerable to taxpayer manipulation of "costs" associated with production.[115] Neither ad valorem nor production taxes create a perfect, or even acceptable, model. Many states, including Kansas, turned to a combination of the two.

2. Proposed Assessment System for Kansas Mineral Property

Kansas should follow the leads of Texas and Arkansas, both states with long histories of mineral production and valuation. In those states, property tax classifications are less concerned with differences between severed and non-severed interests.[116] Instead, mineral estates are taxed on their production capabilities, similar to Kansas agricultural property.[117] Texas and Arkansas, along with many other states, combine the two taxation methodologies and levy annual ad valorem taxes based on the expected production capabilities of the mineral interests, instead of fair market value.[118] Each state has differences in how they calculate the value of this production-dependent property, and the best option for Kansas is a mixture of the two.

The Arkansas Constitution provides for ad valorem taxes in Article 16 § 5 by stating that "all real and tangible property subject to taxation shall be taxed according to its value, that value to be ascertained in such manner as the General Assembly shall direct, making the same equal and uniform throughout the State."[119] This language is nearly identical to the ad valorem taxation provision found in the Kansas Constitution,[120] but it is implemented very differently when applied to mineral interests. In Arkansas, all real property interests related to producing minerals are subject to ad valorem taxation regardless of their status as severed or non-severed.[121] Non-producing minerals are deemed to have zero value for ad valorem tax purposes because of the difficulty in appraisal.[122] This includes non-producing mineral interests even when those interests are owned separately from the surface estate.[123] When a non-producing mineral interest begins producing minerals, it is

114. HELLERSTEIN *supra* note 98, at 10.

115. *Id.* at 10–11.

116. *See, e.g.*, MARK ROBINETTE, ARKANSAS AD VALOREM MINERAL TAXES: AN OVERVIEW WITH RELATED TITLE PROBLEMS 17–22, http://robinettefirm.com/ArkansasTaxTitles Robinette.pdf; *see also* Tex. Att'y Gen. Op. MW-402 (Dec. 3, 1981), https://www.texasattorney general.gov/opinions/opinions/46white/op/1981/htm/mw0402.htm.

117. TEX. TAX CODE ANN. § 23.17 (West 2015); ARK. CODE ANN. § 26-26-1308(a)(2) (2015).

118. TEX. TAX CODE ANN. § 23.175 (West 2015); ARK. CODE ANN. § 26-26-1308(a)(2) (2015); *see* BEAR CHANEY & ROBERT MCGEE, ARKANSAS ASSESSMENT COORDINATION DEP'T, OIL, GAS & MINERALS ASSESSMENT SCHEDULES 245, 249 (2015), http://www.arkansas.gov/acd/pdfs/Minerals2015Web.pdf.

119. ARK. CONST. art. XVI § 5.

120. *See* KAN. CONST. art. XI, § 1.

121. ROBINETTE, *supra* note 117, at 1.

122. ARK. CODE ANN. § 26-26-1110(c)(1) (2015).

123. ARK. CODE ANN. § 26-26-1110(c)(2) (2015).

assessed as directed by the Assessment Coordination Department.[124]

Arkansas creates a duty for county assessors to inventory all lands in the county, ensuring that "every acre of land . . . be accounted for on the assessment roll."[125] The assessor is required to value producing severed mineral interests when he is "advised of the separate holdings by the recording of a deed in the county recorder's office."[126] Generally, property is reappraised for ad valorem taxation once every five years.[127] However, producing mineral interests are reappraised annually.[128] The State of Arkansas, through the Assessment Coordination Department, provides annual Oil, Gas, and Mineral Assessment Schedules to guide the counties in valuing producing mineral interests.[129] These interests are assessed at their present value, which includes the gross value of future production, less all production expenses and allowances for depletion.[130]

The Texas Constitution provides for ad valorem taxation in article 8 section 1 stating that "[a]ll real property . . . shall be taxed in proportion to its value, which shall be ascertained as may be provided by law."[131] This language, like that of Arkansas, is nearly identical to the Kansas Constitution. The Texas Constitution goes on to specify that a mineral interest may be exempt from ad valorem taxation if it has a taxable value less than the minimum amount sufficient to recover the costs of imposing the tax.[132] Mineral interests are classified as real property and assessed ad valorem taxes based on fair market value.[133] Fair market value is calculated using a State mandated discounted cash flow analysis, which has been used annually since 1926.[134] The analysis calculates the economic recoverable reserves and the resulting future income based on four parameters: production profile, monthly average oil and gas price, lease operating expenses, and a discount rate.[135] The production profile consists of the start rate of production and the projected production decline.[136] The price used is the monthly average price for the preceding calendar year multiplied by a Market Condition Factor for the first year's price.[137] The figure for lease operating expenses is provided by the lease operator.[138] If no figure is provided, then a default average is used.[139]

---

124. ARK. CODE ANN. § 26-26-1110(c)(4) (2015).

125. ARK. CODE ANN. § 26-26-718 (2015).

126. ARK. CODE ANN. § 26-26-1110(a)(2)(A)(ii) (2015).

127. ARK. CODE ANN. § 26-26-1308(a)(1).

128. ARK. CODE ANN. § 26-26-1308(a)(2) (2015).

129. CHANEY & MCGEE, *supra* note 118.

130. *Id.* at 245.

131. TEX. CONST. art. VIII, § 1(b).

132. TEX. CONST. art. VIII, § 1(h).

133. GORDON G. PEPPARD, TARRANT APPRAISAL DISTRICT, THE APPRAISAL OF MINERAL INTERESTS (COMPLETED OR PRODUCING) FOR AD-VALOREM TAX PURPOSES IN TEXAS 1 (2009).

134. *Id.*

135. *Id.*

136. *Id.*

137. *Id.* at 2.

138. PEPPARD, *supra* note 133, at 2.

139. *Id.*

The discount rate considers the cost of money as of January 1 and the risk of the mineral property itself.[140] Although the language in the Constitution is discretionary for mineral interests of nominal value, the selected valuation method is based on production, effectively excluding non-producing mineral interests from ad valorem taxation.

Kansas should first follow Arkansas' lead and exempt non-producing mineral estates from ad valorem property tax.[141] Arkansas' blanket exemption[142] ensures equal and uniform taxation and minimizes the difficulty of appraisal. Kansas and its counties will lose some currently realized revenue under this exemption because severed mineral interests currently being taxed, although not producing minerals, would be removed from the tax rolls. This revenue loss will be recovered many times over by the inclusion of all producing mineral interests for ad valorem tax purposes.

Kansas should then follow Texas and Arkansas in establishing a uniform method of taxation for mineral interests, replacing the current system that places all the burden and discretion with individual county appraisers.[143] A per-acre rate, currently used by several counties in Kansas, is not appropriate as a uniform method because it is not reflective of the actual value of the mineral interest. The method chosen should be representative of the finite nature of the natural resources being taxed and should present a discounted cash flow that will accurately value the vast reservoirs of oil and gas that Kansas seeks to tax. By levying an ad valorem tax on all producing mineral interests, Kansas will likely realize much more revenue because the State will be collecting property taxes on non-severed mineral interests that have historically been exempt from taxation.

One of the main concerns with changing tax classifications is the administrative burden that the change might present. By changing the classification from severed and non-severed to producing and non-producing and by using a production-based assessment, the county appraisers will not realize much of a burden beyond what would be expected with any transition to a new system. The administrative burden will be minimal because the county assessors already use this system when assessing taxes on personal property interests in mineral leases.[144] All the information necessary to appraise the mineral estates is already in the county appraiser's possession or can be provided by the State. If the mineral estate is producing, the ownership of the interests is known because the leases and operating agreements listing such ownership will be recorded in each courthouse. Additionally, the individual county appraisers already access and use that information to levy

140. *Id.*

141. ARK. CODE ANN. § 26-26-1110(c)(1) (2015).

142. *Id.* Arkansas requires a nominal property tax for severed, non-producing mineral interests. It may be prudent for Kansas to consider this as a method of ensuring revenue from an exhaustible source, especially in smaller or less populous counties where even a nominal property tax may represent a significant budget item.

143. *See* KAN. STAT. ANN. § 79-420 (2015).

144. *See, e.g.*, KAN. CONST. art. XI, § 1(b).

personal property tax on mineral leases.[145]

After determining ownership, the larger obstacle for county appraisers is actually valuing mineral property, which has been a concern of many appraisers in the State for some time.[146] As stated previously, the Kansas County Appraisers Association discussed those valuation challenges at several annual meetings and ultimately recommended that the State's appraisers "proceed cautiously" when valuing mineral interests.[147] Kansas has already solved this valuation problem through the personal property tax levies, and the solution transfers well to real property tax levies on minerals. Oil and gas leases in Kansas are considered personal property and taxed at 30% of their value, which diminishes over time due to the exhaustibility of the property.[148] The Director of the Division of Property Valuation, a division of the Kansas Department of Revenue, provides annual guides to assist county appraisers in the valuation of mineral estates for personal property taxes,[149] and these guides should also be used in the valuation of real property. The assessment system considers the age of the wells, the quality of oil or gas being produced, the nearness of the wells to market, the cost of operation, the character and permanency of the market, the probable life of the wells, the quantity of minerals being produced, the number of wells operated, and any other facts the appraisers considers to affect the value of the property.[150] The gross oil and gas reserves are calculated by multiplying the gross income stream from the taxable year by a present worth factor based on the decline rate of the wells.[151] The Division of Property Valuation provides many tables and schedules to assist the county appraisers in valuing these interests, and the annual appraisal guide is incredibly thorough. It accounts for different situations that may arise when valuing natural resources,[152] and the county appraisers are familiar with the system and its implementation. The specificity of this system ensures that property taxes are representative of the property they are assessing, and therefore treat similarly situated people in a like manner. Perhaps more importantly, Kansas mineral owners are familiar with this system and

145. *Id.*

146. *See, e.g.*, Harper, *supra* note 7, at 4.

147. Harper, *supra* note 8, at 4.

148. KAN. CONST. art. XI, § 1(a)(7)(b).

149. *See* KAN. STAT. ANN. § 75-5105(a) (2015); *see also* DAVID N. HARPER, DIV. OF PROP. VALUATION, KAN. DEP'T OF REVENUE, 2013 YEAR OIL AND GAS APPRAISAL GUIDE (2013), http://www.ksrevenue.org/pdf/13oilgasguide.pdf.

150. KAN. STAT. ANN. § 79-331(a) (2015).

151. Gross reserve is calculated by multiplying annual production by the net price per barrel (on a price schedule distributed by the Division of Property Valuation), then multiplying that gross income by a present worth factor to arrive at an estimated gross reserve. The present worth factor varies for each mineral interest and is dependent on the discount rate and life expectancy of the well, based on both the cost of production and expected performance. *See* HARPER, *supra* note 149, at 4.

152. The Oil and Gas Appraisal Guide provides for oil and gas appraisal in nearly every conceivable scenario, including wells of different depths and ages, wells producing nominal quantities, wells that have been completed but not produced, wells plugged in the prior year, and wells with an abnormal decline. *See* HARPER, *supra* note 149, at 9–20.

understand a tax system that is relative to the production and lifespan of their mineral interest.

V. CONCLUSION

The disparate tax treatment of severed and non-severed mineral interests for taxation under K.S.A. § 79-420 likely violates the Equal Protection Clause of the Fourteenth Amendment because it treats like property differently for taxation purposes. Even if the State determines the current law does not violate Equal Protection, the State should address the disparate treatment of mineral interests and adopt a uniform taxation system that classifies mineral interests based on production capabilities and appraises those interests on a production basis. A uniform system will create a revenue stream that is representative of the properties being assessed and will eliminate much of the burden currently placed on individual county appraisers. Kansas should no longer differentiate between severed and non-severed mineral interests because that classification is not rationally related to the goals of property taxation and leads to inequalities among similarly situated property owners. Instead, Kansas should levy property taxes based on a classification system of producing or non-producing mineral interests. The State should not leave the method of real property valuation at the sole discretion of the county appraisers, but instead should use the current personal property appraisal guides to value mineral interests for real property taxation. This will remove much of the burden from the individual county appraisers, create a consistent valuation process across the state, and ensure that Kansas property is assessed in a verifiable manner.