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Division of Property Valuation

DIRECTIVE #99-037

TO: County Appraisers

SUBJECT: Merchant's and Manufacturer's Inventory Exemption
This Directive Supersedes Directive No. 92-026

This directive is adopted pursuant to the provisions of K.S.A. 79-505, and reflects the law of Kansas due to a published Kansas Supreme Court decision issued on December 11, 1998.

Directive No. 92-026 entitled "Rent to Own" Property is hereby rescinded.

Summary

Article 11, Section 1 (b) of the Kansas Constitution and K.S.A. 79-201m provide a property tax exemption for merchant's and manufacturer's inventory. The terms "merchant," "manufacturer," and "inventory" are defined in K.S.A. 79-201m. The Kansas Supreme Court issued a decision that helps define merchant's inventory. (*Board of Sedgwick County Comm'rs v. Action Rent to Own, Inc.*, 266 Kan. 293 (1998)(hereinafter *Rent to Own, Inc.*)) The court held that leased property subject to depreciation for federal income tax purposes may still qualify for exemption if it is primarily held for sale in the ordinary course of business.

Kansas Supreme Court: leased and depreciated property may be inventory

In *Rent to Own, Inc.*, the Kansas Supreme Court held that for purposes of K.S.A. 79-201m, a capital asset subject to depreciation for federal income tax purposes may still be considered inventory. (*Rent to Own, Inc.* at 303-4). However, the property tax exemption extends only to capital assets that are primarily held for *sale* in the ordinary course of business. Assets that are primarily *rented* in the ordinary course of business are not exempt. (*Rent to Own, Inc.*, at 304).

In *Rent to Own, Inc.*, the property at issue was furniture. Some of the furniture was sold outright for cash, but the vast majority of it was leased. These lease agreements allowed the lessee to acquire the furniture by renewing the lease for a specified number of consecutive periods. No additional payment was required at the end of the lease for title to transfer. The Board of Tax Appeals determined that these lease agreements were in substance finance agreements. (*Rent to Own, Inc.*, at 300; Board of Tax Appeals Original Order No. 93-4695-TG, paragraph 49).

From a legal perspective, the court focused on K.S.A. 79-201m (a) and (c) as these paragraphs were amended in 1989. The relevant provisions follow:

- (a) “Merchant” means and includes every person, company or corporation who shall own or hold, subject to their control, any tangible personal property within this state which shall have been purchased *primarily* for resale ~~without modification or change in form or substance, and without any intervening use in the ordinary course of business without modification or change in form or substance and without any intervening use, except that, an incidental use, including but not limited to the rental or lease of any such property, shall not be deemed to be an intervening use.~~
- ...
- (b) “inventory” means and includes those items of tangible personal property that: (1) Are primarily held for sale in the ordinary course of business (finished goods); (2) are in process of production for such sale (work in process); or (3) are to be consumed either directly or indirectly in the production of finished goods (raw materials and supplies). ~~Assets—A capital asset subject to depreciation or cost recovery accounting for federal income tax purposes shall not be classified as inventory. A depreciable asset that is retired from regular use by its owner and held for sale as standby or as surplus equipment by such owner shall not be classified as inventory.~~ L. 1989, ch. 289 Sec. 1, *Rent-to-Own, Inc.* at 302.

Legislative History

Finding this language somewhat ambiguous, the Kansas Supreme Court turned to documented legislative history. The court found that the legislature intended to exempt large equipment that is occasionally leased for demonstration purposes before it is sold. However, the legislature expressly stated that it did not intend to go so far as to exempt the inventory of *a regular rental business*, such as a video or car rental business.

Kansas Supreme Court: a “rent to own” business differs from a “regular rental business”

The court viewed “*rent-to-own*” business inventory as *something other than* the inventory of a *regular rental business*. (*Rent to Own, Inc.*, at 303). Therefore, the court held that “rent-to-own” business inventory can qualify for exemption if the inventory is primarily held for sale in the ordinary course of business. Whether or not inventory is primarily held for sale is a question of fact generally determined by the county appraiser or the Kansas Board of Tax Appeals.

Factors used to determine whether “rent to own” property is held primarily for sale

In *Rent to Own, Inc.*, the Board of Tax Appeals considered the following factors when it determined that the property was *primarily held for sale* rather than rent:

1. The rent agreements were in substance sales finance agreements given their relatively short length (typically 12 months) and nominal purchase price (\$0) at the end of the agreement. (Docket No. 93-4695-TG, Original Order, paragraphs 49, 50).

2. The assets that were held for sale or under contract for sale were fairly new; typically just twelve months old or less. (*Id.*, paragraph 50). Virtually all the assets were eventually sold without modification or intervening use other than the incidental lease use. (Order on Remand, paragraph 9).
3. On average, the assets were rented slightly more than two times and less than two years before being acquired by the customer. (Original Order, paragraphs 50, 51). There was also evidence of some direct sales. (Order on Remand, paragraph 5).

Property held for sale *in the ordinary course of business*

Depreciable property that is held for sale by its owner but not in the ordinary course of the owner's business does not qualify for the inventory exemption. The last sentence in K.S.A. 79-201(m)(c) states:

“ . . . A capital asset subject to depreciation or cost recovery accounting for federal income tax purposes that is retired from regular use by its owner and held for sale or as standby or surplus equipment by such owner shall not be classified as inventory.”

Conclusion

If a county appraiser is in doubt as to whether rent-to-own property is held primarily for *sale* or for *rent* in the ordinary course of business, he or she should construe in favor of taxation and assist the taxpayer in filing an application for exemption (Directive 92-025). All relevant facts should be presented to the Board to allow them to make a proper determination.

Approved: February 24, 2000

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