

SESSION OF 2003

SUPPLEMENTAL NOTE ON SENATE BILL NO. 192

As Amended by Senate Committee on
Assessment and Taxation

Brief*

SB 192, as amended, would make a number of changes to state and local sales tax laws necessary to bring Kansas into compliance with the uniformity and simplification requirements set forth in the multistate Streamlined Sales and Use Tax Agreement (Agreement) adopted by the Implementing States (including Kansas) on November 12, 2002. The majority of the changes in the bill would become effective July 1, 2004.

Uniform Definitions

The Agreement requires that if a state's sales tax laws use certain terms, or if those terms fall within a state's sales tax impositions or exemptions, then the definitions of those terms contained in the Agreement must be adopted. Senate Bill 192 would add several new definitions to Kansas sales tax law. A number of terms would be added, not because they are required definitions, but because they are terms frequently used within the Agreement, including agent, certified automated system, certified service provider, model 1 seller, model 2 seller, model 3 seller, purchaser, registered under this agreement, seller, sourcing rules, agreement, and member state. Additional terms are in fact uniform definitions required by the Agreement and also would be added to the Kansas law, including delivery charges, direct mail, lease or rental, purchase price, retail sale (differs slightly from current Kansas definition), sales or selling price, computer, computer software (differs from current Kansas definition), delivered electronically, electronic, load and leave, pre-written computer software, tangible personal property (differs slightly from current Kansas definition), alcoholic beverages, food and food ingredients, tobacco, drug (differs from current definition), durable medical equipment (differs from current Kansas definition of "medical equipment"), mobility enhancing

*Supplemental notes are prepared by the Legislative Research Department and do not express legislative intent. The supplemental note and fiscal note for this bill may be accessed on the Internet at <http://www.kslegislature.org/klrd>

equipment, prescription, and prosthetic device (differs from current Kansas definition).

Under current Kansas law, tangible personal property is defined to include computer software (both custom and canned) and prepaid telephone calling cards. The Agreement treats custom software as a service and defines canned software as tangible personal property. The Agreement also defines prepaid calling cards as a service. Changes to Kansas law would be made to conform to the Agreement definitions.

Adoption of the Agreement definition for “drug” further requires some cosmetic changes to the sales tax exemption for prescription drugs, which would be made in KSA 79-3606(p).

Kansas law contains an exemption for “medical equipment,” but excluding items customarily used for human habitation purposes. KSA 79-3606(hh). The Agreement contains a required definition for “durable medical equipment,” and this new term would be inserted in the exemption statute.

Kansas law contains an exemption for prescribed prosthetic and orthopedic appliances in KSA 79-3606(r). The Agreement contains required definitions for “prosthetic devices” and “mobility enhancing equipment” which should not substantively change the exemption.

State Administration of All Local Sales Taxes

The Agreement requires that all local sales taxes be administered at the state level. But Kansas legislation enacted in 2002, the “Transportation District Excise Tax Act,” created a locally administered excise tax (on the same tax base as the local sales tax) to support transportation infrastructure. SB 192 would amend this act and make this tax a transportation district local sales tax, to be administered at the state level, in conformity with the Agreement.

A number of additional amendments to the Transportation District Excise Tax Act are not related directly to the Agreement and were suggested by bond counsel for local units working on transportation development district and tax increment finance projects. Among these amendments is language requiring the Secretary of Revenue – for certain transportation development district or redevelopment project areas – to provide reports on tax liability by retailer to bond trustees, escrow agents, or paying agents. These parties would be required to keep the information confidential.

Uniform State and Local Sales Tax Bases

The Agreement requires that by 2006, except for motor vehicles, aircraft, watercraft, modular homes, manufactured homes or mobile homes, the sales tax base (*i.e.*, the items subject to sales tax) must be identical at the state and local level. If an item is subject to state sales tax, it must also be subject to local sales tax, and vice versa. In Kansas, sales of water, natural gas, electricity and heat delivered through mains, lines or pipes for residential or agricultural use is exempt from state sales tax but subject to local sales tax. However, the Agreement does allow a state to impose a zero state sales tax rate on sales of piped natural or artificial gas, electricity, or other heating fuels delivered by the seller. Thus, the only state vs. local sales tax base issue for Kansas concerns sales of water for residential or agricultural use. SB 192 would amend the local sales tax statutes to exempt on January 1, 2006, such sales. The bill also provides on that date a "zero" percent state sales tax rate on the sales of natural gas, electricity, and heat delivered through pipes, lines or mains for residential or agricultural use, and a "zero" percent state sales tax rate on the sales of propane, LP gas, coal, wood and other fuels for residential use. But no policy change is being made with respect to such sales, which are currently exempt from state (but not local) taxes.

Local Use Tax

Unlike many other states, Kansas does not have a local use tax, except for boats and motor vehicles (when the local use tax is paid upon registration). In order to level the playing field for Kansas retailers relative to out-of-state retailers, and in order to allow local governments to participate in the benefits of the voluntary collection efforts of out-of-state retailers registering under the Agreement, a local use tax would be imposed on all other transactions which are subject to the state use tax.

Use Tax on Services

Kansas law currently imposes use tax only on out-of-state purchases of tangible personal property used, consumed or stored in Kansas. There is no use tax on out-of-state purchases of services. SB 192 would extend the use tax to services, both at the state and local level, amending KSA 79-3703 and KSA 12-198. This issue relates to the sale of custom computer software, which is treated as a sale of

service under the Agreement definitions. Without the imposition of use tax on services, there would be no use tax owed on an out-of-state purchase of custom computer software, once the Agreement definitions are adopted.

Seller Registration

The Agreement requires that states develop uniform registration procedures that would apply to out-of-state sellers voluntarily registering under the Agreement to collect sales or use tax. This includes electronic registration and registration through an agent. KSA 79-3608, the sales tax registration statute, would be amended accordingly. Retailers obligated to register in Kansas (because they are located in Kansas or “doing business” in Kansas) would remain subject to the existing registration requirements.

Notices to Retailers of Tax Rate, Effective Date, and Taxing Jurisdiction Boundary Changes

One of the major goals of the Agreement is to give retailers sufficient lead time to implement changes in state and local sales tax rates and taxing jurisdiction boundaries. Current law contains no requirement for any lead time for a change to the state sales tax rate. The Agreement requires that state sales tax rate changes can be effective only on the first day of a quarter and requires revenue departments to make a reasonable effort to provide sellers as much advance notice of changes as is practical. SB 192 would enact these changes and would provide that for certain services covering a period including a rate change, the rate change would go into effect for the first billing period starting on or after the rate change.

The statute governing local sales tax rate and boundary changes, KSA 12-191, was amended in 2001 to accommodate some of the Agreement requirements regarding lead time for local rate and boundary changes. SB 192 amends that statute again to make additional required changes. Local rate changes would not apply to catalog purchases until the first day of the quarter following 150 days after the city or county had provided notice to the department of the change. Once the department had received such notice, the department would be given 30 days to send notice of such change to sellers. Existing law provides that for other than catalog purchases, local rate and boundary changes can become effective on the first day of the quarter following the 90th day after the city has provided the department notice of the

change. SB 192 requires that after receiving such notice, the department would have to give sellers notice of the change within 30 days.

Database for Rate and Boundary Changes

The Agreement requires that, as of the date that a state joins the Agreement, the state must develop and maintain an electronic database (in downloadable format) of all taxing jurisdiction boundaries, rates and the effective dates of any changes, pursuant to certain standards. The state must further develop and maintain a database that assigns each 5 and 9 digit zip code to the proper rates and taxing jurisdictions. The state must also participate with other member states in developing an address-based system for assigning taxing jurisdictions, meeting the requirements of the federal Mobile Telecommunications Sourcing Act. Once these databases are developed, sellers would be relieved from liability for charging the wrong rates if the state's databases contained erroneous rate information, and sellers relied on that information. However, no liability relief is provided if the state develops an address-based system meeting the requirements of the federal Mobile Telecommunications Sourcing Act. SB 192 would enact these provisions.

Sourcing Rules

Current Kansas law generally uses an "origin-based" sourcing rule, applying the local sales tax in effect at the retailer's business location. The Agreement requires a change to a "destination-based" sourcing rule to determine the applicable local sales or use tax. Sales would remain "sourced" to the retailer's location for buyers taking possession of merchandise on site, but sales of shipped merchandise would be sourced to the buyers' location for local sales or use tax purposes.

Exceptions in the Agreement to the "destination-based" sourcing rule would include sales of watercraft, modular homes, manufactured homes or mobile homes, and the sale of certain motor vehicles, trailers, semitrailers or aircraft not used in interstate commerce. Such sales would remain sourced to the retailer's location, as under current law.

Special sourcing rules would be provided for specific categories of sales. For leases of tangible personal property in which periodic payments are made, the first lease payment would be sourced under the general "destination-based" sourcing rules but subsequent payments would be sourced to primary property location. For leases with

only one payment, the sale would be sourced under the general “destination-based” rules. (These provisions are essentially consistent with current Kansas law.) For leases of motor vehicles and aircraft not used in interstate commerce, all periodic lease payments would be sourced to the primary property location. If there is only one lease payment, it would be sourced under the general rules. Retail sale and leases of motor vehicles and aircraft used in interstate commerce would be sourced under the general “destination-based” rules.

When the purchased item can be used in several different locations (such as with computer software purchased by a large company for use in its offices located in several states), the purchaser may give the seller a “multiple points of use” exemption certificate. The seller would then be relieved of the obligation of collecting sales or use tax, and the purchaser would assume the burden to properly apportion the use tax among the jurisdictions in which the item is being used.

Under a similar provision relating to direct mailing to addresses in several states, the purchaser of the mailing may give to the printer a “direct mail form” showing the multiple jurisdictions where the mailing is to be sent. The printer would then be relieved of the obligation to collect sales or use tax, and the purchaser would assume the obligation directly remit the tax to the appropriate taxing jurisdictions, based on the mailing.

Telecommunications service has its own sourcing rules consistent with the federal Mobile Telecommunications Sourcing Act, the provisions of which have already been adopted by Kansas.

Administration of Exemptions

A purchaser claiming an exemption for sales tax must give to the seller a properly completed exemption certificate at the time of purchase, documenting the reason for the exemption and providing information concerning the sale and the identity of the purchaser. (The seller then need not charge sales tax on the transaction, but would be required to retain the exemption certificate and make it available upon audit.) The Agreement removes the “good faith” burden on sellers established by current Kansas law for the acceptance of an exemption certificate. Under the new provisions, the seller would need not make any independent judgment (absent fraud) as to whether the exemption claim is valid, so long as the seller obtained a properly completed exemption certificate. Additional language provides that exemption certificates may be filed electronically.

Uniform Returns

The Agreement authorizes sellers who are not obligated to register in a state to voluntarily register and collect and remit sales and use tax. The state may require electronic filing by these sellers and can approve a simplified format for the return, which must be filed at least annually, unless collections exceed \$1600 in a month, in which case, returns must be filed monthly thereafter.

Electronic Remittances

Under the Agreement, a state may require model 1, 2, or 3 sellers to make sales or use tax remittances electronically.

Uniform Bad Debt Recovery Rules

When a seller sells merchandise, receives only partial payment, but has remitted the full amount of sales tax owed on the transaction (as required), the seller may incur a “bad debt” if the buyer later defaults on the transaction. Typically, the seller can take a “bad debt deduction” for sales tax previously remitted on defaulted sales transactions. Some states allow the party providing financing for the defaulted sales transaction to take the “bad debt deduction.” Kansas currently allows only sellers the bad debt deduction. (Third-party financiers are not eligible.) Under the Agreement, a state retains the option whether to allow only sellers to receive the bad debt deduction. However, member states use uniform rules governing how sellers are permitted to deduct bad debts. The bad debt deduction rules in the Agreement are essentially in line with current Kansas policy.

Confidentiality and Privacy Protections

Confidentiality and privacy protection already exists under current law with respect to taxpayer information from sellers required to register. (KSA 79-3614) The Agreement focuses on ensuring that states have in place confidentiality and privacy protections with respect to “personally identifiable information” that certified service providers must collect concerning consumers when handling the sales and use tax collection, reporting and remitting responsibilities for model 1 sellers. New language would provide these provisions.

Uniform Rounding Rules

Rounding rules apply to determine when a sales tax amount calculation should be “rounded up” to the nearest whole cent. The Agreement requires that member states use a uniform rounding rule, and that the tax computation should be carried to the third decimal place, and rounded up to the next cent whenever the third decimal place is greater than four. (This is consistent with current policy, which would be codified statutorily for the first time).

Customer Refund Procedures

The Agreement requires that member states include in their refund procedures a provision that requires a purchaser, before suing a seller for over-collected sales tax, to give the seller 60 days written notice and an opportunity to respond. New language would enact this requirement in KSA 79-3650(b).

Taxability Matrix

The Agreement requires that a member state must maintain a “taxability matrix” in a database in downloadable format that will list the products and services taxable in the state. Sellers and certified service providers would be relieved from liability to the state or local jurisdiction for having charged or collected incorrect amounts in reliance on erroneous data contained in the taxability matrix.

Seller Participation

The Agreement requires that member states develop an online central registration system for out-of-state sellers volunteering to register under the Agreement. Sellers already obligated to register (because they have nexus with the state) must comply with the existing state registration rules. The fact that a seller voluntarily registers under the Agreement cannot be used as a factor in determining whether that seller has nexus with the state.

Amnesty for Registration

Amnesty for past sales or use tax collections is available to a seller registering under the Agreement, provided the seller was not

registered with the state within the 12-month period preceding the effective date of the state's joining the Agreement, and the seller registers within the 12-month period following that effective date. Amnesty is not available to sellers under audit. The seller must continue to remain registered and collect taxes for at least 36 months for the amnesty to be effective.

Method of Remittance

Sellers registering under the Agreement may select 1 of 3 models to operate under: model 1 (seller relies on a certified service provider to perform all tax functions on its sales), model 2 (seller relies on a certified automated system to calculate the tax on each transaction, but the seller performs all other tax functions), or model 3 (seller utilizes a certified proprietary automated sales tax system).

Registration By An Agent

The Agreement requires that member states permit sellers to register through a duly appointed agent. That requirement would be added to KSA 79-3608.

Background

The bill was introduced at the request of and supported by the Department of Revenue.

Kansas could not become a Member State of the Agreement any sooner than July 1, 2004, when a number of the changes in law take effect. Proponents noted that the Legislature therefore would have the opportunity to observe whether Congress acts later in 2003 to authorize the states to require remote retailers to collect use tax on Internet and catalog sales, before the uniformity and simplicity provisions of SB 192 would become effective.

A recent study has suggested that Kansas by 2006 may be losing as much as \$246 million in state and local sales and use taxes from Internet transactions.