Approved On:_____

Minutes of the House Committee on Taxation. The meeting was called to order by E. C. Rolfs, Chairman, at 9:00 a.m. on January 20, 1988 in room 519 South at the Capitol of the State of Kansas.

The following members were absent (excused):

Representatives Crowell

Committee staff present:

Tom Severn, Legislative Research
Chris Courtright, Legislative Research
Don Hayward, Reviser of Statutes
Millie Foose, Committee Secretary

Secretary Harley Duncan, Department of Revenue, spoke in support of HB-2626 - AN ACT amending the Kansas retailers' sales tax act; concerning the definition, taxation and exemption of certain sales of property and services thereunder. He said his department generally supports enactment of the bill, but believes clarification of some terminology would be helpful. (Attachment 1)

T. C. Anderson, representing Kansas Society of Public Accountants, expressed the Society's opposition to certain proposed regulations in HB-2626 relating to sales tax on computer software. (Attachment 2) He then answered questions from committee members.

Hank Booth, representing Kansas Association of Broadcasters, expressed concerns with the Department of Revenue's regulation dealing with advertising agency services and related businesses. (Attachment 3)

Roland Smith, representing the Wichita Independent Business Association (an association of 1400 locally-owned businesses in the Wichita trade area). believes that if broadening of the sales tax base is necessary, it should be done by statute and not by non-elected officials. (Attachment 4)

Ron Hein, legislative counsel for the Kansas Advertising Coalition, outlined their objections to any change in policy by revenue rulings. He said the regulations as promulgated contain inconsistencies and are not equally applicable to all groups. (Attachment 5)

Bob Bloomer, president Kansas Auctioneers Association, believes that the Department of Revenue has exceeded its authority by promulgating a policy that is not authorized by the statute. He asked that the legislature delete the proposed statutory changes set out in HB-2626 and insert within the definition of retailer at K.S.A. 79-3602. (Attach. 6)

Gerhard Metz, representing Kansas Chamber of Commerce and Industry. testified that the KCCI Board of Directors has a policy position which opposes the expansion of state sales and use taxes to more goods and services than are currently taxed. (Attachment 7) He believes that the Department of Revenue's reversal of policy would be bad for business in Kansas and would send a message that the tax law cannot be relied upon in making sound business decisions.

John C. Eisele, Chartered, presented his firm±s opinions on Operating Software, Application Software, Custom Programming, Taxation of Canned Application Software, Maintenance Contracts, and Enforcement. (Attachment 8)

The meeting adjourned at 11:00 a.m. to reconvene in Room 526 after adjournment of the House of Representatives.

The meeting reconvened at 11:30 a.m. in Room 526. Kevin Robertson, representing Kansas Lodging Association, discussed HCR-5036 which concerns retailers' sales tax; requesting modifications as adopted by the Secretary of the Department of Revenue and filed with the Revisor of Statutes. His firm believes that since a hotel guest purchases all facilities along with his guest room, utilities for the common areas should be tax exempt.

Secretary Harley Duncan explained HCR-5036 and some of the modified rules. He also explained how sales tax should be figured on coupon books. He than answered questions from committee members.

The minutes of the January 19 meeting were approved.

There being no further business, the meeting was adjourned.

E. C. Rolfs, Chairman

MEMORANDUM

TO: The Honorable Ed C. Rolfs, Chairman
House Committee on Taxation

FROM: Harley T. Duncan, Secretary
Department of Revenue

DATE: January 20, 1988

RE: House Bill 2626

Thank you for the opportunity to appear before you on House Bill 2626 which was introduced by the Special Committee on Assessment and Taxation and affects various definitions in our sales tax law. The department generally supports enactment of House Bill 2626, but objects to one provision in particular.

This bill updates the definition of "sale" in KSA 3602(c) to include the term "license to use" (line 0040). Many transactions which we generally think of as sales technically involve the grant of such a license. The purchase of "canned" software is a good example. Though we think of the purchase of the software as a sale, it commonly involves the receipt by the consumer of a license to use the particular program. This terminology has been raised as a defense for not collecting the tax on certain software sales, and we believe clarification would be helpful.

This issue should not be confused with the issue of what type of software and related activities are taxable. Even if one disagrees with the Department's position on the extent to which software is taxable, the change in HB 2626 deserves your support. Without it, it is doubtful that any software, even the most common off-the-shelf, canned software would be taxable if a taxpayer were to prevail on the argument that a "license to use" does not constitute a sale under our sales tax statutes.

House Bill 2626 also exempts from tax the nonrecurring sale of tangible personal property by an auctioneer or agent on behalf of a single principal if the sale is at the principal's residence. The bill includes such transactions in the definition of the existing exemption for "isolated or occasional" sales (line 0079-0083, page 2-3). This provision would codify a longstanding departmental policy to exempt such sales as being "isolated and occasional" even though it appears from audits and conversations with auctioneers and their representatives that few auctioneers have complied with they policy. Instead, they have chosen not to collect and remit the sales tax. They have taken this approach even though they were advised by the Department in the 1970s and more recently by the Attorney General (both times in response to a written request of the Auctioneers' Association) that an interpretation of current law holding all sales by an auctioneer to be taxable was appropriate.

attach. 1

For their part, auctioneers argue that the policy contained in this bill is too restrictive and that there are other meritorious similar cases that ought to be exempted. For our part, we are interested in establishing a "bright line" test that is easily understood and administrable, but which does not allow an auctioneer to engage in unfair competition against the "Main Street" retailer because he/she does not collect sales tax. This unfair competition most certainly occurs today.

HB 2626 also clarifies that charges under contracts which provide for the maintenance of computer software are taxable (line 0304, page 8). The statute contains a provision which taxes gross receipts from maintenance contracts generally, and this change would clarify that said provision applies to software maintenance contracts. We would, however, suggest an **amendment** to House Bill 2626 to specify under K.S.A.79-3603(q) that the language which taxes repairing, servicing, altering and maintaining tangible personal property also applies to the repair, service, alteration and maintenance of software, the sale of which is taxable under K.S.A. 79-3603(s). These changes will make the treatment of software identical to that of other taxable property. Again, we believe this change is necessary regardless of the extent to which software and related activities are taxable under KSA 79-3603(s).

The department would also recommend an **amendment** to House Bill 2626 to clarify the taxability of receipts from mobile phone services, cellular phone services, beeper services, and other similar services. The department believes these types of services are currently taxable under K.S.A. 79-3603(b) and K.S.A. 79-3603(k), which tax "intrastate telephone or telegraph services" and "cable, community antennae and other subscriber radio and television services". A specific provision in the statute to recognize this recent technology would be beneficial. We have recently promulgated a rule to accomplish this and believe the language therein is workable and acceptable to the industry involved.

Finally, we must **oppose** the provision of the bill which would alter the current statute of limitations ((lines -335-0337). The proposed amendment to K.S.A 79-3609 would provide that no assessment of sales tax could be made for any period preceding date of registration by more than three years. This change would have the effect of rewarding non-filers, and encourage retailers to play "audit lottery". If a taxpayer's only liability exposure is for three years, whether or not he's registered to collect and remit the tax, there exists less incentive to register. The provision suggested would allow a retailer to collect sales tax from consumers, not remit such collections to the state, and still only be liable for three years from the date caught. There are many situations wherein there's no doubt or confusion as to the applicability of the sales tax, other areas are not so clear. It is the department's policy to only assess taxes for three years in most cases. To codify and broaden that policy will only benefit taxpayers who have made a concious effort not to comply with the law. It will penalize the large majority of taxpayers who take the steps and pains to determine their tax obligations and to collect and remit those taxes in a timely fashion.

For the reasons stated, we support the bill generally, but request your consideration of the issues raised herein.

Kansas Society of
Certified Public Accountants

400 CROIX / P.O. BOX 5654 / TOPEKA, KANSAS 66605-0654 / 913-267-6460

FOUNDED OCTOBER 17, 1932

To The

House Taxation Committee

of the

Kansas Legislature

January 20, 1988

Regarding Proposed K. A. R. 92-19-70
Computer Software

and

HB 2626

Attach 2

Mr. Chairman, members of the Committee. My name is T. C. Anderson, Executive Director, of the Kansas Society of Certified Public Accountants.

The Kansas Society is a professional organization representing over 2,000 certified public accountants.

I appear before you today to express the Society's opposition to proposed regulation K.A.R. 92-19-70 which is designed to interpret K.S.A. 79-3603(s) relating to imposing the Kansas Sales tax on computer software and to discuss several issues raised in HB 2626.

The proposed regulation on software was approved by the Department of Administration on October 28, 1987 and by the Attorney General on November 2, 1987. A public hearing, at which I appeared in opposition to K.A.R. 92-19-70, was held by the Department of Revenue on November 24, 1987.

This Legislature enacted K.S.A. 79-3603(s) in 1981.

Nearly seven years have passed since the Legislative action, but the Department is only now promulgating a regulation.

Audits recently have been completed by the Department of Revenue which have resulted in sales tax being assessed on the design services of creating a custom software package for a particular client. These audits were completed prior to this proposed regulation ever being written.

The Kansas Society has attempted to monitor the implementation of K.S.A. 79-3603(s) by the Kansas Department of Revenue since it was enacted.

In January 1982 the Kansas Society's Federal and State Taxation Committee met with then Secretary of Revenue Michael Lennon and his staff. A question regarding the Department's interpretation of K.S.A. 79-3603(s) was offered by

our Committee for discussion. We were told the statute would apply to "a canned" or multiple sale software as opposed to the custom software prepared by our members for their clients.

Many of you know me well enough to know, if we had been told the Department was going to tax professional services on the design of custom software, I would have brought the issue before the 1982 session of the Legislature.

Thus, Kansas CPAs have operated in good faith since 1982 that the services of designing custom software would not be taxed and we ask for your favorable support of House Concurrent Resolution No. 5036 which requests that the Secretary of Revenue revoke K.A.R. 92-19-70. We would also support any statutory attempt to revoke the regulation. I have attached to my statement the transcript of a hearing before the Board of Tax Appeals on the software issue. Proposed K.A.R. 92-19-70 was introduced into evidence and the transcript contains testimony of a Department of Revenue official who says this regulation is the first to ever mention that professional services in designing software would be taxed. I think you'll find it interesting reading.

With regard to HB 2626, I'd like to express our concern with the new language added in line 40. Traditionally, the terms license to use, trademarks, copyrights, patients, franchise agreements, etc. have not been subject to sales or use tax.

If you vote to tax "license to use" it will be a break from existing policy, and will raise the cost of the preparation of tax returns for the citizens of this state.

Most tax preparation software is issued on a license to use basis. Then

a fee is also paid to the software company for each return processed on the software.

However, the item that concerns me most about this issue is the fact the Kansas Department of Revenue has, for the past two years, been assessing sales and use tax against CPA firms and others on license to use agreements. These assessments obviously have been made without legislative authority nor without notification of taxpayers.

I would ask that you not adopt the new language on line 40, however, if it is your desire to have the sales and use tax apply to license to use agreements then the committee minutes reflect your desire that the tax be collected only for transactions occurring after July 1, 1988.

Our next concern is found on page 8 or HB 2626 at line 304. I have attached for your review the first page of the Kansas Supreme Court opinion in the Tax Protest of Strayer.

This opinion issued in 1986 offers our courts' judicial definition of computer software. It wrote software programs which constitute the operational programs, without which a computer cannot operate, have a value that is to be considered an essential portion of the computer hardware and are therefore taxable as tangible personal property in conjunction with the hardware.

Application programs, those which are particularized instructions adopted for special programs, are intangible property not subject to the personal property tax for tangible property.

Since section (r) refers back to (p) and (q) which deal with the servicing, altering or maintaining of <u>tangible personal property</u> I would ask

the committee to consider the following amendment which would clarify the matter for all taxpayers:

On line 304 insert before computer, the word operational, and after the word software insert programs. This would make it clear that the service or maintenance agreements would apply to operational computer software programs, which to date are the only ones deemed by the Kansas Supreme Court to be tangible.

Finally, since several of our members have been assessed sales tax on their services of designing customer software, prior the promulgation of any rule or regulation or taxpayer informational guide, the Kansas Society would ask that section (s) of K.S.A. 79-3603 be amended by adding the following language at line 312: but does not include the services of creating software on or after July 1, 1981. This language will make it clear that the professional services of designing computer software are not to be taxed.

Thank you for allowing me to appear today and I would be happy to stand for questions. Should questions be technical in nature, Mr. Chairman, I ask that I be permitted to refer them to Mr. Mike Land, a Topeka CPA, who is familiar with the issues.

92-19-70. Computer software. (a) Sales tax shall be imposed on the gross receipts received from the sale of computer software. Computer software includes all software or computer programs, whether contained on tapes, discs, cards or other devices or materials which direct a computer or hardware to perform different functions, and includes customized software, canned software, operational software, application software, systems software and other forms of software or computer programs.

(b) Sales tax shall be imposed on the total cost to the consumer without any deduction or exclusion for the cost of:

(1) The property or service sold;

(2) labor or services used or expended, including:

(A) Program development, problem definition;

(B) analysis, design, coding, testing; and

(C) implementation, evaluation, maintenance and documentation;

(3) materials used;

(4) losses;

(5) overhead or any other costs or expenses; or

(6) profit, regardless of how any contract, invoice or other evidence of the transaction is stated or computed, and whether separately billed or segregated on the same bill.

(c) The principal line of business of the seller is not material when determining the taxability of sales of computer software. Each bank, savings and loan or other thrift institution, accounting firm, computer program developer, dealer and other person is deemed to be a retailer when selling computer software at retail to the final user or consumer. Each retailer shall collect sales tax on the gross receipts received from the retail sale of computer software.

BEFORE THE BOARD OF TAX APPEALS

OF THE STATE OF KANSAS

September 23, 1987

- DIRECTOR OF TAXATION -

DOCKET NO. 2739-87-DT

BOARD OF TAX APPEALS REPRESENTED BY:

MR. KEITH FARRAR,	CHAIRMAN,
MR. ROBERT C. HENRY,	MEMBER,
MR. FRED. L. WEAVER,	MEMBER,
MR. VICTOR ELLIOTT,	MEMBER,
MR. CONRAD MILLER, JR.,	MEMBER,
MS. JOLENE SEYMOUR,	ATTORNEY.

TAXPAYER REPRESENTED BY:

MR. MARK BESHEARS,	ATTORNEY,
MR. JERRY LETOURNEAU,	ATTORNEY,
MR. T. C. ANDERSON,	EXECUTIVE DIRECTOR OF KANSAS CPA'S.

DIRECTOR OF TAXATION REPRESENTED BY:

MR. TOM HATTEN,	ATTORNEY,
MR. MARK BURGHART,	ATTORNEY,
MS. KAREN WARNER,	AUDIT MANAGER,
MS. CLEO MURPHY,	CHIEF OF SALES & EXCISE TAX BUREAU.

know it to be, do you think you would have been notified?

A. Yes.

Q. Ms. Murphy, you indicated that you have written a number of opinions in your capacity as an attorney, and as a tax specialist. What do you require from taxpayers before you issue such written opinions?

A. We require that they write to us, and set out the facts which they want us to respond to.

Q. Why is it so critical you be aware of all of the facts before you issue an opinion?

A. Sales tax, especially the change of one fact can be the whole difference as to whether it is taxable, or exempt. So we do require a factual situation to be laid out in front of us.

MR. BURGHART: No further questions.

MR. BESHEARS: Just a few questions, Mr. Chairman.

CROSS EXAMINATION

QUESTIONS BY MR. BESHEARS:

Q. The Department took the position prior to the enactment of 3603(s) that software, whether canned or custom, was subject to tax?

A. That is right.

Q. However, that opinion was not strong enough to justify the enactment of (s). I mean, if you were consistent in your position that those items were taxable, why did you have to

enact (s)?

A. Due to the other states, and their courts holding that unless you had a specific statute imposing it, you could not get the custom software.

Q. Would you not agree that the Sales Tax Act, in order to specifically tax labor services, has to mention those particular services in the different subsections?

A. That is correct.

Q. And labor services is not mentioned in sub (s), or 3603, is it?

A. Well, the word "services" is not mentioned, right.

Q. And doesn't the Sales Tax Act and Preamble say that only those enumerated items of tangible property and services shall be taxable?

A. That is correct. It says that.

Q. You have reviewed the opinion letters, and you have written several of them yourself. Have any of those letters that have been introduced indicated to a taxpayer that labor services involved in the creating of a software program, or systems design are subject to sales tax, under Provision (s)?

A. There are several which state that the sale of custom software is taxable.

Q. But not the services related to the creation of that software?

A. Well, you have to--the person is going to have to realize

sales tax is a gross receipts tax, and it's based on the amount the customer pays; so if you have to pay for that—in order to get the software, yes, you would have to collect sales tax on it.

Q. But the word "service" is not mentioned, and neither is that referenced in your letters, your opinion letters?

A. It's true, it just says "the sale of custom software is taxable."

MR. BESHEARS: I have nothing further, Mr. Chairman.

MR. WEAVER: Any questions? Let me check my notes.

MR. BESHEARS: Mr. Chairman, I have one other question, if I may--I'm sorry.

MR. WEAVER: Proceed.

Q. (By Mr. Beshears) Ms. Murphy, has the Department of Revenue promulgated any policy concerning the sales tax on services of computer software, other than the opinion letters that we have referenced?

A. No, there has been no revenue ruling.

Q. No informational guide?

A. No.

Q. Is there in the process, an explanation of the policy in the form of a proposed regulation?

A. Yes, there is.

Q. Are you the author of that proposed regulation?

A. I am not. No, I did not write the specific words, no, but

I have reviewed it.

Q. Can you tell the Board what that regulation says?

A. I haven't seen it for awhile, but, basically, if I remember right, it states that the sale of computer software, which is taxable under 79-3603(s), imposes the tax not only on the canned software, but custom software, as well. I do not remember if it goes into detail about the consulting services and training.

Q. Would you like to have your memory refreshed? (Indicating)

MR. BURGHART: Again, I have to object, Mr. Chairman. This copy that she has means absolutely nothing until we get to the final copy that is promulgated. This can change a hundred times between now and then. It's really irrelevant.

MR. WEAVER: I am not aware of what he handed to her.

MR. BESHEARS: It's a copy of a proposed regulation concerning computer software that was written by departmental personnel within the last six months, I assume. And it has been disseminated to various people across the State. And I think it should be important to see what the Department's policy is, regardless of whether it is finalized, or whether it's been through the Attorney General, whatever. This is their own internal feelings on the subject at this point in time.

MR. WEAVER: I'm going to allow it in, but I would quali

my ruling by simply stating that this Board is aware that many times documents are transferred around a Department, or an agency, that don't necessarily reflect the final outcome of a decision.

MR. BESHEARS: I would agree, Mr. Chairman, but it does reflect that departmental policy.

MR. WEAVER: Well, we will make that determination, but I will allow her to proceed.

Q. (By Mr. Beshears) I believe Paragraph 1 is nothing but a recitation of Subsection (s) of 3603, and Paragraph 2, if you would read it to the Board?

A. First, with respect to Paragraph 1, it does go on, it begins with just a recitation of 3603(s), but then at the very tailend, it states that it's not limited to customized software, canned software, operational software, application software, and other forms of software, computer programs.

Q. Would you characterize that last sentence as a broadening of the statutory language?

A. No, I do not think so.

Q. Even though it is not in the statute?

A. Right, even though it is not in the statute. I do think the statute intended to tax all of that.

Q. Paragraph two?

A. Paragraph two states,"Sales tax is imposed on the total cost to the consumer without any deduction or exclusion therefrom

for the cost of: the property or service sold, labor or services used, or expended, including but not limited to program development, problem definition, analysis, design, coding, testing, implementation, evaluation, maintenance and documentation, materials used, losses, overhead, or any other costs or expenses, or profit, regardless of how any contract, invoice or other evidence of the transaction is stated, or computed, and whether separately billed, or segregated on the same bill."

Q. To your knowledge, is that Paragraph 2 the first time that has ever been enunciated in a written position by anybody?

A. That's the first time it has been in a regulation. As to whether that's the first time, I can't answer. There are a lot of people who write letters regarding sales tax, whether I see them, I am sure I do not.

Q. But you have not introduced any letters at this hearing that would contain that particular language?

A. That's true. I think these letters mostly were limited to the time prior to the audit, and during the audit, but I do think--

Q. (Interjecting) Is that Paragraph 2 a direct result of the Mize, Houser sales tax audit?

A. I don't know if it's a direct result. When regulations and revenue rulings get issued around the Department is when, basically, pursuant to audits that have been issued, and

the taxpayers come in and complain that it hasn't been clear to them that that was taxable, and they certainly would appreciate something; so if you want to interpret as a fact we did audit Mize, Houser and found they were not picking up the sales tax, we decided that might be a problem, so we should put it in a regulation so everybody would be aware of it, yes.

Q. Are the services that are enumerated in Paragraph 2 anywhere specifically referenced in Subsection (s) at 3603?

A. As I stated before, Subsection (s) does not have the magic word "service." I do not think that you just look at that particular section. You have to look at the Sales Tax Act in total. When you impose the sales tax on the gross receipt I do think you get the service of developing the software.

Q. Also, within that enactment of gross receipts, it's also enunciated services will be part of those gross receipts?

A. True.

MR. BESHEARS: I have nothing further.

MR. WEAVER: Anything further?

MR. BURGHART: Just a quick follow-up question.

REDIRECT EXAMINATION

QUESTIONS BY MR. BURGHART:

Q. This draft you have before you doesn't really reflect any change in departmental policy, does it?

A. No, it does not.

Session of 1988

HOUSE BILL No. 2626

By Special Committee on Assessment and Taxation

Re Proposal No. 6

12-16

AN ACT amending the Kansas retailers' sales tax act; concerning the definition, taxation and exemption of certain sales of property and services thereunder; amending K.S.A. 79-3609 and K.S.A. 1987 Supp. 79-3602 and 79-3603 and repealing the existing sections.

Be it enacted by the Legislature of the State of Kansas:

Section 1. K.S.A. 1987 Supp. 79-3602 is hereby amended to read as follows: 79-3602. (a) "Persons" means any individual, firm, copartnership, joint adventure, association, corporation, estate or trust, receiver or trustee, or any group or combination acting as a unit, and the plural as well as the singular number; and shall specifically mean any city or other political subdivision of the state of Kansas engaging in a business or providing a service specifically taxable under the provisions of this act.

(b) "Director" means the state director of taxation.

(c) "Sale" or "sales" means the exchange of tangible personal property, as well as the sale thereof for money, and every transaction, conditional or otherwise, for a consideration, constituting a sale, including the sale or furnishing of electrical energy, gas, water, services or entertainment taxable under the terms of this act and including, except as provided in the following provision, the sale of the use of tangible personal property by way of a lease, ~~license to use~~ or the rental thereof. The term "sale" or "sales" shall not mean the sale of the use of any tangible personal property used as a dwelling by way of a lease or rental thereof for a term of more than 28 consecutive days.

strike "license to use"

(d) "Retailer" means a person regularly engaged in the business of selling tangible personal property at retail or furnishing

tion, restoration, replacement or repair of a bridge or highway.

For the purposes of this subsection:

(1) "Original construction" shall mean the first or initial construction of a new building or facility. The term "original construction" shall include the addition of an entire room or floor to any existing building or facility, the completion of any unfinished portion of any existing building or facility and the restoration, reconstruction or replacement of a building or facility damaged or destroyed by fire, flood, windstorm, hailstorm, rainstorm, snowstorm, lightning, explosion or earthquake, but such term shall not include replacement, remodeling, restoration, renovation or reconstruction under any other circumstances;

(2) "building" shall mean only those enclosures within which individuals customarily live or are employed, or which are customarily used to house machinery, equipment or other property, and including the land improvements immediately surrounding such building; and

(3) "facility" shall mean a mill, plant, refinery, oil or gas well, water well, feedlot or any conveyance, transmission or distribution line of any cooperative, nonprofit, membership corporation organized under or subject to the provisions of K.S.A. 17-4601 *et seq.*, and amendments thereto, or of any municipal or quasi-municipal corporation, including the land improvements immediately surrounding such facility;

(q) a tax at the rate of 4% upon the gross receipts received for the service of repairing, servicing, altering or maintaining tangible personal property which when such services are rendered is not being held for sale in the regular course of business, and whether or not any tangible personal property is transferred in connection therewith. The tax imposed by this subsection shall be applicable to the services of repairing, servicing, altering or maintaining an item of tangible personal property which has been and is fastened to, connected with or built into real property;

(r) a tax at the rate of 4% upon the gross receipts from fees or charges made under service or maintenance agreement contracts *for computer software and* for services, charges for the providing

operational programs

of which are, taxable under the provisions of subsection (p) or (q); and

(s) a tax at the rate of 4% upon the gross receipts received from the sale of computer software. As used in this subsection, "computer software" means information and directions loaded into a computer which dictate different functions to be performed by the computer, whether contained on tapes, discs, cards or other devices or materials~~x~~_____, but does not include the services of creating software on or after July 1, 1981.

Sec. 3. K.S.A. 79-3609 is hereby amended to read as follows: 79-3609. Every person engaged in the business of selling tangible personal property at retail or furnishing services taxable ~~hereunder~~ in this state, shall keep records and books of all such sales, together with invoices, bills of lading, sales records, copies of bills of sale and other pertinent papers and documents. Such books and records and other papers and documents shall, at all times during business hours of the day, be available for and subject to inspection by the director, or the director's duly authorized agents and employees, for a period of three ~~(3)~~ years from the last day of the calendar year or of the fiscal year of the retailer, whichever comes later, to which the records pertain. Such records shall be preserved during the entire period during which they are subject to inspection by the director, unless the director in writing previously authorizes their disposal.

The amount of tax imposed by this act is to be assessed within three ~~(3)~~ years after the return is filed, and no proceedings in court for the collection of such taxes shall be begun after the expiration of such period. In the case of a false or fraudulent return with intent to evade tax, the tax may be assessed or a proceeding in court for collection of such tax may be begun at any time, within two ~~(2)~~ years from the discovery of such fraud. *In no event shall an assessment be made for any period preceding the date of registration of the retailer by more than three years.* No refund or credit shall be allowed by the director after three ~~(3)~~ years from the date of payment of the tax as provided in this act unless before the expiration of such period a claim therefor is filed by the taxpayer, and no suit or action to recover on any claim for refund shall be commenced until after the

No. 58,619

In the Matter of the Protest of THOMAS D. STRAYER, CPA, for Taxes Paid in the Year 1982 in Graham County, Kansas.

(716 P.2d 588)

SYLLABUS BY THE COURT

1. WORDS AND PHRASES—*"Computer Programs."* Computer programs are the instructions which make the data processing equipment perform tasks and include "operational programs," which orchestrate the basic functions of the computer, and "application programs," which provide the particularized instructions adapted for specialized programs.

2. STATUTES—*Construction.* Rules of statutory construction are stated.

3. TAXATION—*Personal Property Taxes—Tax Treatment of Computer Software Programs.* Under the tax statutes, software programs which constitute the operational programs, without which a computer cannot operate, have a value that is to be considered an essential portion of the computer hardware and are therefore taxable as tangible personal property in conjunction with the hardware. Application programs, those which are particularized instructions adopted for special programs, are intangible property not subject to the personal property tax for tangible property.

Appeal from Graham district court; CHARLES E. WORDEN, judge. Opinion filed March 28, 1986. Reversed.

Allen Shelton, of Clark & Shelton, P.A., of Hill City, argued the cause and was on the brief for appellant Thomas D. Strayer.

Steven E. Worcester, county attorney, argued the cause and was on the brief for appellee Graham County.

The opinion of the court was delivered by

LOCKETT, J.: Taxpayer appeals the decision of the Graham County District Court upholding a ruling of the Kansas Board of Tax Appeals which determined that computer software was taxable as tangible personal property.

The appellant, Thomas D. Strayer, is a certified public accountant. In November of 1981, Strayer purchased a computer from Computax Systems, Inc. Additionally, Strayer executed a licensing agreement with Computax at a cost of $7,010. The agreement provided for the use of certain computer software programs. Annual renewal of the license agreement cost one-half of the initial fee. The agreement required Computax to update the software as needed during each year and to provide other services. The bulk of the annual fee paid for the use of an income tax preparation software program.

Under the agreement, the software program and later updates

Kansas Association Of Broadcasters

818 Merchants National Bank Bldg., Topeka, Kansas 66612 913/235-1307

TESTIMONY TO THE HOUSE TAXATION COMMITTEE

by Hank Booth, KLWN/KLZR, Lawrence
Past President and Legislative Chairman for the
Kansas Association of Broadcasters

January 20, 1988

Mr. Chairman, and Members of the Committee:

I am Hank Booth, immediate past president and legislative chairman for the Kansas Association of Broadcasters (KAB). The KAB is a state trade association representing over 100 radio stations and 19 television stations in Kansas.

We appreciate the opportunity to express concerns we have with the Department of Revenue's (DOR) regulation dealing with advertising agency services and related businesses, KAR 92-19-80.

The regulation is a departure from past DOR policy and constitutes a substantial change by expanding the tax base. In past letters issued by the DOR, it has been stated that "production revenues are not taxable under the Kansas Sales Tax Act" (see attachment); and that "services rendered by an advertising agency are not subject to sales tax. These services are deemed to be professional in nature and are not within those services taxable pursuant to the Kansas Retailer's Sales Tax Act." Yet KAR 92-19-80 would assess tax on ad agency services and charges on productions not for broadcast, if tangible personal property is 'transferred'.

What constitutes the transfer of tangible property? How does the

Attach 3

service an ad agency or television station provides in the production of a 20-minute quality of life film for Topeka, differ from that of an attorney who does a 20-page legal brief for a client. In both cases, the transfer of tangible property occurs: a video tape in the case of the Topeka film; a stack of paper in the case of the legal brief. However, these are incidental to the buyers interest. The buyer is purchasing the creativity and professional services of the broadcaster or the attorney which has been reduced to film or paper.

Aside from the fact that the regulation is a departure from past DOR policy and expands the tax base, its enforcement would be an administrative nightmare because of the complexity of the advertising process. Advertising is highly fragmented and often includes interstate activities and numerous entities. The most talented of DOR personnel would have a monumental task in determining who pays how much on what transactions, not to mention the burden it would place on small businesses in making the same determinations.

We also have economic concerns. Advertising is a cost of doing business and assessing sales tax on advertising services sends a negative message to businesses that may be considering Kansas as a location. And it would place Kansas businesses which provide advertising services at a disadvantage with their competitors in other states.

A tax on advertising services would place a disproportionate burden on small and emerging businesses because a five percent tax on these services is more likely to be a factor in whether small firms advertise at all.

Tax measures which discourage advertising are bound to hurt the economy. Every dollar spent on advertising generates significantly more

than a dollar in sales. If ad budgets, which are fixed, decrease proportionate to the tax, the end result is less advertising per se, therefore fewer sales. It seems counter-productive to us and has the potential of doing economic harm to the state and its businesses.

We support HCR 5036, introduced by the Joint Committee on Administrative Rules and Regulations, requesting the secretary of revenue to revoke several regulations including KAR 92-19-80. We further urge this committee to introduce a bill which would repeal KAR 92-19-80 on May 1, 1988, when the regulation is scheduled to go into effect.

Further, we offer for your consideration, an amendment to HB 2650, which would specifically exempt services rendered by ad agencies and broadcast stations, by adding a new section as follows: "Notwithstanding any other provision of law to the contrary, no state sales or use tax nor any such tax levied by a political subdivision of the state shall be levied on any service rendered by an advertising agency or broadcast station or any member, agent or employee thereof to any client, including, but not limited to any service rendered in the creation or production of advertising or promotional materials embodied in the form of film, tape, negative, video or other media."

If the Kansas Legislature has on its agenda, the taxing of these professional services, we oppose it. However, this is the proper forum for discussing that issue and making a decision; it's not one that should be left to those in the Department of Revenue.

Thank you for your attention.

Attachment

KANSAS DEPARTMENT OF REVENUE
Office of the Secretary
State Office Building · Topeka, Kansas 66612-1588

November 26, 1985

Mr. Christopher M. Hurst
Foulston, Siefkin, Powers & Eberhardt
700 Fourth Financial Center
Broadway at Douglas
Wichita, Kansas 67202

Dear Mr. Hurst:

I am in receipt of your letter dated November 13, 1985 concerning the two Kansas sales tax audit assessments levied against your clients. Both audit assessments concerned "production revenues" generated by your client. Mr. Roy Haines, Assistant Chief, Sales and Excise Tax Bureau has recently written you notifying you that "production revenues" were not taxable under the Kansas Sales Tax Act.

Based upon Mr. Haines' letter to you and in the endeavor to maintain consistency in this Department's position, the Director of Taxation, Carol B. Bonebrake, has decided to abate the two Kansas sales tax audits in their entirety. The Kansas Compensating Use Tax audit remains due and owing.

Should you have any questions, please contact me.

Sincerely,

William L. Edds
General Counsel

Nancy E. Freund

BY: Nancy E. Freund
Attorney

WLE:NEF:glb

cc: Carol B. Bonebrake
William Grier

WICHITA INDEPENDENT BUSINESS ASSOCIATION
Riverview Plaza • Bldg. 200 • Suite 5 • 2604 W. 9th St. at McLean Blvd. • Wichita, Kansas 67203
(316) 943-2565

January 20, 1988

STATEMENT TO: THE HOUSE COMMITTEE ON TAXATION

FROM: The Wichita Independent Business Association

SUBJECT: House Bill 2626 and action proposed by the Rules and Regulations Committee regarding certain Department of Revenue rulings on sales tax.

Chairman Rolfs, members of the committee and Staff members, I am Roland Smith, Executive Director of the Wichita Independent Business Association. We are an association of 1400 locally-owned businesses in the Wichta trade area which now encompasses Sedgwick County and into the five surrounding counties. Most of our members are businesses with five or less employees, however, the total employees represented exceed 12,000.

It has been the practice of many states to expand their sales tax base into service businesses giving the least resistance. This was very clear in the testimony before the Special Assessment and Taxation Committee on September 18th last year given by Steven Gold, NCSL Staff from Denver, Colorado. The systematic expansion of the sales and use tax base into the service businesses has been taking place at an ever-increasing rate in Kansas. We recognize that some broadening of the sales tax base may be necessary as the service areas are expanding more than the retail (over the counter sales). It is our contention that this should be done by statute and not by regulations from the Revenue Department who are non-elected officials. The problem was brought to the forefront in November 1986.

The Special Committee on Assessment and Taxation, of which some of you were a part, met in Wichita in July of last year to hear tesitmony on the problems that had surfaced. We have worked very hard with the Revenue Department to work out many of the problems administratively. They have been very cooperative and we appreciate this. Much progress has been made in trying to reach mutual understanding of these problems. The implementation of many of the Revenue Department's public commitments on policy changes have yet to be realized for a variety of reasons. There appears to be a concerted effort on the Tax Department's part not to go back at all on a business when they apply for sales tax registration, unless there is fraud involved, a position we appreciate very much. There is, however, still a considerable lack of confidence by many businesses in trusting the Revenue Department because of the inconsistent practices and policies of the past. However, how many have slipped through the cracks and been assessed back taxes and penalties, without us knowing about it, is unknown. We are trying to assure businesses they will be treated fairly by the Revenue Department, but actions speak lounder than words

Attach 4

The House Bill 2626, which requests that a statute of limitations of three years be made when a business registers for the sales tax, is still very damaging and could be disastrous to a business and should be as the Revenue Department agreed to do and that was not to go back at all unless fraud is proven.

This concept should also be applied to those businesses audited that didn't have a tax number because of the lack of information or unintentional non-compliance. The Tax Department, in all fairness to any business, should be required to issue an individual letter ruling for that business before the business starts collecting the tax, especially when there are questionable grey areas and when there has been an audit. One of the most serious problems is that the Tax Department personnel can not agree on many situations in question. To this date, we are not aware of any private letter rulings issued as agreed to publically by the Tax Department last summmer and as stated in one of the proposed regulations. We know that letters have been requested some time ago and have not been received. This has gone well past the ten days or two week commitment made by the Tax Department before the Special Committee. These letters should be as accessible, as court rulings are, to insure fair and equal enforcement. Technology is moving forward so fast that the Tax Department personnal are not informed adequately on many of the service businesses in order to make consistent rulings. We would also like to see the statute of limitations on the collection of Use Tax set at the three years and not for an indefinite time as it is now. Most businesses are not even aware of their obligations in the use tax areas and there has been little effort to accomplish this. Budget restraints and the lack of this having any type of priority is part of the problem.

The position of WIBA has been not to get involved in determining where the line is to be drawn in taxing service business. Due to the events of the past few months and the lack of initiative by the special committee, from our perspective, WIBA is now taking a strong position to hold the line on broadening the sales tax base which increases the cost of services to the consuming public, which is everyone, unless it is voted on by our elected officials. Many other organizations, including state-wide organizations, are interested and concerned about the sales tax problems on services and will continue working with WIBA for reform until there has been some substantial progress. These sales tax problems are not limited to just the Wichita area, but all sections of the State of Kansas.

The Governor's office has assured us he is not in favor of broadening the sales tax base. A request was made to the Secretary of Revenue for a list of all the services currently being taxed and he supplied the same list that was provided to the special committee. This list is only a small part of where the sales tax is currently being applied under the current definition of a "retailer" and the transfer or alteration of "tangible personal property" not for resale. Under the present rationale of the Tax Department, products and/or service that may be included in the price on the final billing, will cause the amount paid by the final consumer to include compounded sales tax many times over. With this reasoning,

there is almost unlimited possibilities in applying the sales tax unless specific exemptions are called out. We also believe the inclusion of "custom software" and "license to use" in this bill is another way of broadening the tax base and WIBA opposes those changes. There has to be a way found to draw the line and have it implemented in a fair and equitable manner. It would cost less in staff expenses within the Tax Department and make their job much easier. It would also make it more understandable for businesses to comply which is their desire as long as it is fair and equitable.

The Tax Department believes they are only enforcing the statutes as they understand them. That may be correct, but the result we feel is wrong and the statutes need more clarification.

WIBA believes the proposed regulations that the Rules and Regulations Committee requested be revoked or reverted to previous ruling, are regulations that are actually expansions of the sales tax base without proper legislation, therefore, WIBA supports the Committee's recommended action. WIBA has worked with the Tax Department on the contents of 92-19-80 before it was issued in the form of an information guide last July and feel there is much more work to be done with it so the involved businesses can understand where they are to collect the sales tax. There is no doubt in the minds of many businesses and members of WIBA that this ruling is a broadening of the tax base when implemented. Since the distribution of the information guide, many businesses are outraged at its content and are getting very impatient with me for not being more outspoken, to you the lawmakers, on the progress made so far in this area. We are continually encougaging those businesses to be patient as the legislative process takes time and patience as Senator Fred Kerr, Chairman of the Senate Tax Committee, has politely reminded me.

WIBA is trusting that this committee and the Senate Tax Committee will give the Sales Tax on Services issue ample consideration this session and help bring to the legislature fair and equitable solutions in the statutes that will not leave the decisions up to the non-elected officials. WIBA intends to have legislation introduced, not covered in Bill 2626, before the deadline and urges this committee to give it a fair hearing when it is presented. Mr. Chairman, we hope you will see fit not to limit the discussion by this committee on the sales tax issues to this week as stated in the published agenda.

Attached is a letter that one of our members sent to Governor Hayden regarding sales tax on services covered in 92-19-80 which constitutes sales tax on professional services that could result in considerable loss of business to out- of- state firms not charging tax on these services

Thank You! I'll be glad to answer any questions.

Patric Rowley & Partners
ADVERTISING/GRAPHIC ARTS

January 10, 1988

Governor Mike Hayden
State Capitol Bldg.
Topeka, KS 66612

Dear Governor:

We have corresponded with you in the past regarding sales tax liabilities on professional services provided by graphic arts and advertising agencies in Kansas.

After an exhaustive study of all the available information, we are persuaded that the rulings on what to pay and what not to pay on are still ambiguous--and impossible to follow at this time.

When we discussed this tax matter with our largest client, the leading general aviation manufacturer in America, they said that if we were to begin collecting taxes for professional services provided, that they would be inclined to purchase these services out of state where they would not be subject to Kansas Sales Tax.

I am certain that you would not favor any punitive taxes which would create a substantial loss of business revenue for Kansas firms and even possibly contribute to the failure of some.

With this in mind, please take whatever measures that are possible to expedite legislation that will free our Kansas advertising and communications industry from the anxiety of losing our livelihood and removing from the tax rolls a number of small businesses such as our own.

If you or anyone in your office can provide us with some clear and unequivacol instructions as to how to proceed in the meantime, we would be most grateful to have this information and to share it with others in our profession.

Thank you very much for your consideration.

Patric Rowley

PR/br
cc: Tim Witsman/Wichita Chamber
Roland Smith/WIBA

Brooker Plaza/Suite 2B • 807 North Waco • Wichita, KS 67203-3971 • 316/263-9110

TESTIMONY TO THE
HOUSE ASSESSMENT AND TAXATION COMMITTEE
BY RONALD R. HEIN
ON BEHALF OF THE KANSAS ADVERTISING COALITION
January 20, 1988

Mr. Chairman, and members of the committee:

My name is Ron Hein. I'm legislative counsel for the Kansas Advertising Coalition, representing ad agencies and other groups interested in and affected by legislation impacting on advertising agencies and related businesses.

Since the Sales Tax Act was enacted, professional services have been exempt from taxation under this Act, and the legislature has reaffirmed its consistent policy of not taxing professional services, at numerous times, including when I personally was in the legislature.

The Department of Revenue has now decided to change the legislative policy by rule and regulation (KAR 92-19-80, inter alia) and by revenue rulings.

Our objections to the regulations as promulgated are essentially as follows:

1. There has been very little or no opportunity for advertising agencies to provide meaningful input into the promulgation of the rules and regulations.

2. The regulations contain inconsistencies which will further result in lack of uniformity of sales tax collection.

3. The regulations are not equally applicable to all groups, nor are they enforceable in an equal and fair manner.

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state shall be levied on any service rendered by an advertising agency, or a licensed broadcaster, or any member, agent or employee thereof to any client, including but not limited to any service rendered in the creation or production of advertising or promotional materials embodied in the form of film, tape, negative, video, or other media.

3. In the event that any of the provisions of HB 2626 are amended into HB 2650, we would urge the deletion of the words, "license to use" on page 1, line 40 of HB 2626.

I hope that the Kansas Legislature will not permit the Department of Revenue to do to Kansas what happened to Florida last year. There are major Kansas industries which do a significant amount of business with Kansas advertising agencies. However, if they can save 5% of their annual budget for expense of advertising agencies by having the work done by an out of state agency, they will do so because all it requires is picking up the phone. At a time when Kansas is attempting to promote economic development, imposition of a sales tax on ad agency services seems absolutely ludicrous.

We urge you to reject any proposed regulations along that line, and to affirmatively set out in statute a statement of non-taxability on professional services rendered by advertising agencies in Kansas.

Thank you very much for hearing our testimony today.

Above all else, the Department of Revenue is grossly exceeding its authority by attempting to tax professional services when the statute is clear on its face that such professional services are not to be taxed. They are doing so under the guise that if there is a transfer of personal property (not the sale of personal property, just the transfer) in conjunction with the rendering of professional services, that that transfer "taints" the entire transaction, and renders the professional services taxable as well. If the legislature wants to tax professional services, we would, of course, oppose such legislation. However, we would abide by the legislature's final decision if they changed the statute. However, to have the Department of Revenue and non-elected persons not accountable to the public change the policy that has been established for years by you, the elected policymakers of the state, is unconscionable.

Therefore, we urge the following action:

1. The Joint Committee on Administrative Rules and Regulations has introduced a concurrent resolution to reject the Department of Revenue's proposed regulation KAR 92-19-80. We urge the passage of that resolution, or, would urge you to introduce a bill to reject and revoke that regulation by statute as not being in compliance with the legislature's stated policy not to tax professional services.

2. We urge the legislature to amend HB 2650 by inserting a new section to read as follows:

> Notwithstanding any other provision of law to the contrary, no state sales or use tax nor any such tax levied by a political subdivision of the

4. The regulations are cumbersome, complex, complicated and next to impossible to interpret by those being asked by the State to collect the tax.

5. The regulations have been written in such a manner that the tax can be easily evaded by those so desiring.

6. The regulations will result in adversely affecting Kansas advertising agencies which are forced to compete with out of state ad agencies which are not subject to the tax.

7. The regulations will result in entities which, heretofore have been tax exempt, such as the United States government, the State of Kansas, hospitals, and other entities, having to pay sales tax for the first time in the history of the Retail Sales Tax Act.

8. The regulations make taxable, contrary to legislative intent and legislative action over the years, professional services.

9. The regulations result in double taxation.

In order to keep my testimony short, it is impossible for me to recite in great detail all of the rationale and details that support the objections. Advertising agencies operate, at all levels, in a complex manner. A single advertising transaction can involve the agency, a survey researcher, a video production house, a media representative, a newspaper, a local television station, and a national broadcast station. These entities can be located in a variety of states. The administrative aspect of collecting the sales tax will be a nightmare.

TESTIMONY TO THE
HOUSE ASSESSMENT AND TAXATION COMMITTEE
BY BOB BLOOMER, PRESIDENT,
KANSAS AUCTIONEERS ASSOCIATION
January 20, 1988

Mr. Chairman, and members of the committee:

My name is Bob Bloomer, and I am President of the Kansas Auctioneers Association, an association of professional auctioneers doing business in Kansas.

This last summer, an auctioneer was audited and told to pay $12,000 worth of back sales tax based upon sales that he had auctioned for. During the course of discussions with the agency, he received conflicting responses, and the interpretation of the agency was contrary to the rules and regulations which were on the books at that time.

As a result, the back taxes for that particular auctioneer were abated in whole, but the Department issued a revenue ruling (most recently 19-87-5) and has promulgated a regulation (KAR 92-19-8) which changes the manner by which sales tax is collected when auctioneers are involved.

The current proposal in the regulations is that all sales of personal property by one person for the benefit of another, whether the commission is on a commission or a flat fee basis, are deemed to be sales at retail, and sales tax must be collected. The only exemption currently provided is if the sale was conducted on the property of the owner of the personal property, and is not co-mingled with property of another principal.

Attach 6

On its face, that might seem acceptable, but in practice, it presents quite a dilemma. In order to understand the problem, you need to look to the history of the act and to the exemptions already on the books. The reason why estate and auction sales have not been taxed in the past is primarily due to the occasional sale exemption. If I understand the legislative intent correctly, this was designed to permit one to sell their own property on an occasional and non-recurring basis without having to go through the formality of collecting sales tax. If it was your property, and it was not a recurring sale, it was exempt.

However, that is fine for people who are able to conduct their own garage sale, or their own farm sale, or whatever else within this state. But some people, due to physical infirmity, old age, incapacity, being out of state, or for whatever other reason, cannot conduct the sale for themselves. Those people are willing to pay somebody else to do the sale for them.

Now the department is suggesting that those sales of personal property, which would otherwise be exempt if conducted by the individual themselves, must be taxed if they have somebody else conduct the sale for them.

For example, one of the inconsistencies that results from the proposed regulation and the provisions of HB 2626 would be the following:

1. A person died, and the estate wants to conduct a sale, but it's dead of winter in Kansas, and the sale cannot be held outside, and there is not sufficient room in the house. The

property must be moved to a warehouse to be sold. Sales tax will have to be paid.

2. A blind person living in her own home wants to sell an old refrigerator. She's concerned about conducting the sale herself. Her neighbor is having an auction at her house. The neighbor invites the blind lady to bring her refrigerator over to sell at the same time while there is a crowd. That act "taints" the auction, makes all proceeds taxable, and the lady must pay sales tax, even if it isn't charged to the purchasers.

3. A man who is renting an apartment is in an auto accident and will require extensive hospitalization, and the possibility of extended nursing home care. His family and friends cancel the lease on his apartment, and move his property from his apartment. He subsequently determines that he will be confined to a nursing home for the rest of his life due to his injuries and decides to liquidate his household furnishings. He asks his relatives to sell off his assets. They do so without hiring an auctioneer, and conduct the sale at his brother's garage. Sales tax must be paid.

4. Two sisters living together die in a joint auto accident. Household furniture and other assets have been housed together, but were not jointly owned. The family decides to sell all the assets at the house where the two sisters lived. Sales tax must be collected and paid because there is more than a single principal.

The examples are endless, and represent real life situations to auctioneers, lawyers, executors, and others who have to sell property on behalf of others.

The Department of Revenue has grossly exceeded its authority by promulgating a policy that is not authorized by the statute by simply stating that auctioneers are retailers and that any sales conducted by them are subject to the sales tax. This flies in the face of the isolated and occasional exemption.

We would ask that the legislature delete the proposed statutory changes set out in HB 2626 on pages 2-3, at lines 79-83, inclusive. In lieu thereof, we would ask the legislature to insert within the definition of retailer at K.S.A. 79-3602, the following:

> Retailer shall not include any person holding themselves out as an auctioneer who sells property of another when the sale of such property, if conducted by the person themselves, would constitute an isolated or occasional sale pursuant to the provisions of this act. For the purposes of this section and provisions of this act, auctioneers shall be defined to mean any person who for commission, fee or other remuneration, conducts a sale of property of another and such person (1) holds himself or herself out as an auctioneer; (2) is not engaged in the business of selling property at his business location on a daily basis with normal business hours as one would reasonably determine a retail business to be open to the public; (3) the person conducting the sale does not assume, obtain, or possess any ownership rights to the property being sold; and (4) the proceeds or the remainder of any property not sold belongs to and continues to remain the property of the original owner of the property for whom the sale was conducted, except for any proceeds applied as the commission or fee to the person conducting the sale.

With these changes, we believe that any problems which have existed in the past will be sufficiently clarified so that all persons will know when sales tax should be collected, and that

all persons shall be entitled to the isolated and/or occasional sale exemption without regard to physical handicap or other arbitrary distinction.

In light of this, we would strongly urge the legislature to reject the promulgation of KAR 92-19-8, to support the resolution rejecting that regulation, or to introduce legislation revoking and rejecting that regulation, and further amending the statute as we have requested above to insure that there is no future misinterpretation by the Department of Revenue as to the legislature's intent on this matter.

Thank you for permitting me to express our opinions on this issue.

LEGISLATIVE TESTIMONY

Kansas Chamber of Commerce and Industry

500 First National Tower One Townsite Plaza Topeka, KS 66603-3460 (913) 357-6321

A consolidation of the Kansas State Chamber of Commerce, Associated Industries of Kansas, Kansas Retail Council

January 20, 1988

KANSAS CHAMBER OF COMMERCE AND INDUSTRY

Testimony Before the

House Taxation Committee

by

Gerhard Metz
Director of Taxation

Mr. Chairman and members of the committee. I am Gerhard Metz, representing the Kansas Chamber of Commerce and Industry. Thank you for the opportunity to testify today concerning some proposed changes in the Kansas Administrative Regulations as they apply to assessment of sales and use tax.

The Kansas Chamber of Commerce and Industry (KCCI) is a statewide organization dedicated to the promotion of economic growth and job creation within Kansas, and to the protection and support of the private competitive enterprise system.

KCCI is comprised of more than 3,000 businesses which includes 200 local and regional chambers of commerce and trade organizations which represent over 161,000 business men and women. The organization represents both large and small employers in Kansas, with 55% of KCCI's members having less than 25 employees, and 86% having less than 100 employees. KCCI receives no government funding.

The KCCI Board of Directors establishes policies through the work of hundreds of the organization's members who make up its various committees. These policies are the guiding principles of the organization and translate into views such as those expressed here.

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The KCCI Board of Directors has a policy position which opposes the expansion of state sales and use taxes to more goods and services than are currently taxed under our existing statutory scheme. We believe that the additional cost that would result from bringing non-sale transactions within the statute by arbitrarily defining them as sales is only the most obvious objection to the action proposed by the Department of Revenue.

The sweep of the changes suggested ranges from taxation of telephone services of to sales between related entities to the services of advertising agencies and related businesses. All of these regulatory decisions represent expansion of the state sales tax, and result in a serious, negative impact upon the business climate in Kansas. For instance, consider the revisions to K.A.R. 92-19-30 and 92-19-72, which when construed together amount to removing the exemption for transfer of motor vehicles in return for stock or securities, particularly as applied to mergers.

Kansas law historically has reflected the basic concept of taxation that a transfer to a corporation of property solely in exchange for stock or securities is not a taxable event. The related instance of property which changes title as a consequence of a merger is also the subject of an exemption under current law. We can see no reason to depart from this sound policy.

The effect of language at 92-19-72(b), mandating a tax despite commonality of ownership and location, and the filing of consolidated returns - even where there would be no profit or loss from the transaction - is to negate the exemption heretofore accorded exchanges of property for stock. The result in instances of liquidation is equally ludicrous.

Pertinent language drafted when the sales tax increase was passed in 1986 states that the sales tax does not include"...the transfer of motor vehicles or trailers by a person to a corporation solely in exchange for stock or securities in such corporation, or the transfer of motor vehicles or trailers by one corporation to another when all of the assets of such corporation are transferred to such other corporation."

In the face of such clear language expressing an intention to exempt transfers of motor vehicles and trailers solely in exchange for stock or securities, particularly in the instance of mergers, KCCI finds the Department of Revenue's attempt to effect a 180-degree reversal of policy to be unacceptable. Not only is the immediate effect bad for business in Kansas, but the precedent established by such a decision sends a message that the tax law cannot be relied upon in making sound business decisions.

Thank you once again for your interest and attention. I would be glad to answer any questions you may have on this or other sales tax questions today.

(913) 831-1333

LAW OFFICE
JOHN C. EISELE, CHARTERED
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6405 METCALF
OVERLAND PARK, KANSAS 66202

January 19, 1988

Edward C. Rolfs, Chairperson
House of Representatives
Standing Committee on Taxation

Re: Sales and Use Tax - Computer Software, services, etc.

Dear Mr. Rolfs:

The following is submitted for your consideration as you deliberate about revisions to Sales and Use Tax Statutes.

1. "Operating Software". Historically, and uniformly, the "operating" or "system" software has been construed to be tangible personal property because without it the computer hardware can not function. Even though the operating software delivered with the computer hardware is delivered pursuant to a license agreement it has, as before stated, been treated as part of the computer and a "sale" of a computer included and includes the operating software, and as such has been taxed pursuant to K.S.A. 79-3603(s).

2. "Application Software". A few observations relative to the nature of "application software" are perhaps in order.

A. What is application software? It is the result of the translation of sets of instructions to accomplish certain desired tasks from the English language to a "foreign" or computer language. The computer software programmer is the professional translator proficient in one or more of the computer languages. The translated instructions written by the programmer are called source code. The source code is compiled in the computer which in turn generates object code (the machine readable code which allows the computer to execute the instructions written by the programmer). The object code is the digital binary mathematics translation. Computer programming is the practice of a professional art, just as the practice of law or medicine, and in some areas, accounting is the practice of an art.

Attach 8

B. What is the nature of the property interest in application software? It is the compilation of ideas. Computer application software is an intellectual property which is intangible personal property. "Computer software" is defined as intangible in K.S.A. 84-9-106. Tangible personal property is defined in K.S.A. 79-3602(f) as corporeal personal property.

C. Is a "license to use" application software a transfer of a property interest of any kind? No. It is the grant of a mere permissive and usually highly restricted use. No property interest of any kind, tangible or intangible is conveyed. On the other hand, a sale, lease, or rental agreement does convey a property interest, whether the property be tangible or intangible.

The granting of a license to use application software likewise is not a service. There is no service involved.

The Kansas Supreme Court has defined all application software as intangible personal property in the Strayer case, about which you have heard. You have heard or will hear, that the Strayer case is clearly distinguishable because it deals with a property tax issue and not a sales or compensating use tax issue. Clearly the Supreme Court in the Strayer case defined what application software is - that being "intangible personal property" - and in a very well reasoned and considered opinion. That definition will not change. Some would have you believe that you can call a "cow" a "horse" and make it so. None of the proposed legislation or regulations address that legal need.

3. Categories of application software. Generally speaking application software can be broken down into two categories:

(A) "Canned", or "off the shelf", software, is that to which most of us are most often exposed. That is the application software which, together with the user documentation, is ready to use without any further modification or enhancement so long as the user does not need it to be modified to fit a particular and specific user need. Canned software is usually developed for mass marketing pursuant to "shrink wrap" software license agreements (by mail order or through retail computer stores). These packages are usually licensed for "low dollar" license fees ranging from $25.00 to $5,000.00, depending on whether the use if for entertainment, home, or business purpose. They derive the name "shrink wrap packages" from the nature of the

license agreement. They are wrapped in cellophane or other clear material with the license agreement visible, and one of the terms of the license agreement is that by destroying the wrapping the end user has agreed to the terms of the license agreement. This software is of the nature you would find in Computer Land or any other computer store.

Canned software also includes more sophisticated application software, license fees for which are substantial. This area of application software is licensed pursuant to very strict use limitations and security requirements. Software license agreements in this category usually are non-negotiable but are bilateral - that is both the licensor and the licensee execute the license agreement prior to the transmission of the application software to the licensee. The transmission of the software often occurs via fiber optic phone lines. Prior to the introduction of fiber optic phone lines there were often electrical interferences which made telephone transmission more difficult and expensive. Such transmission also, obviously can occur and does occur via disk or tape. The means of transmission is <u>never</u> an essential element of the transaction. When my clients transmit application software to a licensee via disk or tape, the ownership of the medium is retained by the licensor, <u>always</u>. If the license is terminated and when it is terminated the medium is returned. If the original medium (other than by phone line) is retained during the license term by the licensee it is stored in a secure place and rarely if ever used again.

(B) <u>Custom programming.</u> One of my clients is one of the largest custom programming groups in the mid-west with its principal office presently in Overland Park, Kansas.

Custom programming can take many forms, but generally it can be defined as the creation of application software for a particular client for very specific and specialized purposes. Often the ownership of the proprietary right in the intellectual property is that of the client and not the programmer. It is done on a "work made for hire" basis as that phrase is contemplated by the Copyright Act. The service performed is not too dissimilar from that of any speech writer for a candidate for political office or any lawyer in the preparation of an estate plan or any accountant in

the preparation of a tax return. It is the expression of specific ideas and requests of the client in computer language form.

i. Custom programming can be the development of "a package" to be licensed through mass marketing techniques - obviously at that stage not developed for an "end user".

ii. It often can extend to programming that modifies or enhances existing licensed or owned application software.

iii. I discussed above the "work made for hire" concept.

4. Taxation of canned application software. Obviously, many would object to any additional or new taxation. It is my belief, and certainly as relates to my clientele, that the imposition of sales or compensating use tax on license fees is not in and of itself objectionable. With carefully drafted legislation (not the current band-aid effort) most would readily support the tax, but only if an effective and practical means is established statutorily to insure the uniform application of the tax to intrastate (sales tax) and interstate (compensating use tax) transactions, which does not exist and is not proposed in effective form. The recent rather long list of new regulations do not help in the problem. The legislation, as proposed, and the regulations recently considered at public hearing guarantee significant litigation, even as to canned software license fees.

5. Maintenance contracts. When most of us think of "maintenance" we think of preventive maintenance or repair to our automobiles, homes, etc. "Maintenance contract" as contemplated by use as to application software is a term of art of the computer software industry. It does not carry the usual connotation. There is nothing to "maintain" in our normal context. Some, in the computer industry, include "support" in the agreement which merely means that if you have trouble using the software you can call somebody and they will answer questions. Beyond that it is normally confined to an agreement that if the software is improved the licensee may, for an additional fee or on a formula set, acquire the improvements when such are offered. If there is a properly imposed tax upon the license agreement itself then the same tax should apply to any subsequent license fees for the acquisition of use of improvements and enhancements, when and if acquired by the end user.

6. Enforcement - canned software. The imposition, collection, payment, and enforcement thereof as to canned software is relatively simple. A properly created statute

with appropriate rules and regulations should not be that complicated. But the presently existing and proposed legislation and regulations improperly and inadequately relate to tangible personal property.

7. Enforcement - custom programming and services. It is impossible to uniformly enforce the interpretation of the proposed legislation and of the proposed regulations. Where is the point of "sale"? Is it at the place that the programmer first conceives the idea of the translation? Is it at the place the last of the source code is written? Is it at the place the source code is compiled into object code? Is it at the place that the object code is down-loaded into the computer?

Even if you could attempt to enforce it against clearly visible custom software firms or practitioners, there are literally hundreds of sole practitioners who do not maintain any business identity. You may rest assured that with the transmission via telephone lines, or for that matter other media via any common carrier, no out of state programmer is going to report to you and consider that he is been subjected to a taxable transaction in Kansas. How are you going to find them? There is no data base to which the state can turn to locate such information or source.

You have heard the song before that all they do is leave the state of Kansas. Doctors and other interests have said "we will relocate if you impose this legislation", but obviously doctors are dependent upon patients for a living and some doctor will serve the patient if another moves. The moving of an industry is more tangible and difficult. The moving of ideas, thought processes, and personnel (many of whom already live in Missouri) across the state line is the simplest of tasks, and of my five principal clients, two of the three who are Kansas entities are now in the process of forecasting the budgetary requirements of the move in the event that you attempt to implement the tax on their ideas and services. Some large firms have already commenced the process to move to Missouri as a result of the property tax modifications. The service rendered in custom programming, the professional practice, is so intangible that it makes no difference where the mind is "housed". Geographical location is not a factor in success. They do not depend on masses of people for the use of their skills. And only a small portion of the client base are Kansans.

I know one "cottage industry" programmer who services one of eastern Kansas most visible and prominent companies, and I can assure you that neither he nor his client would ever reveal to you his work, and you will have no way of locating him.

The imposition of the sales and use tax on custom software and services imposes a significant economic disadvantage to Kansas firms. You have heard that story before. BUT, THIS INDUSTRY IS MOBILE.

8. New regulations. Attached is a copy of an article from the Kansas City Times - Saturday, January 16, 1988. I have had the opportunity to see the proposed legislative changes and I have had the opportunity to see the proposed regulatory changes. The regulations have legislated substantially beyond their power. They had no right to do that. Legislating is your business.

If anyone would have you believe that nothing is new by the proposed regulations and statutory changes and that it is merely clarification of the "long standing policy". Such is not the case. 1987 is the first time the announced policy and the effort to implement it and enforce it has occurred. Following the enactment of 79-3603(s) I was concerned as to the department's intention, I conferred with Cleo Murphy at length. That was precipitated by virtue of a "package" being developed that was to be an off the shelf or canned licensed package with no modifications needed for the end user. The result of about an hour or an hour and a half conference was the clear understanding that custom coding, servicing, support, and the like were not considered taxable by the state of Kansas and that the licensed fee for the canned software would be considered taxable. Further, as to any custom software which had an underlying basic license agreement for the generic software, such would be, if distributed in Kansas, taxed as to the license fee for the generic work but not taxed as to any custom work performed. When the clients canned package was ready for licensing, one such license was marketed in Kansas; my client at that time obtained its sales tax number, and paid to the state of Kansas the tax on the license fee therefor.

Mr. Duncan's memo of October 29, 1987, which I first viewed in early November, was the first time I had any knowledge of any "change" in that policy.

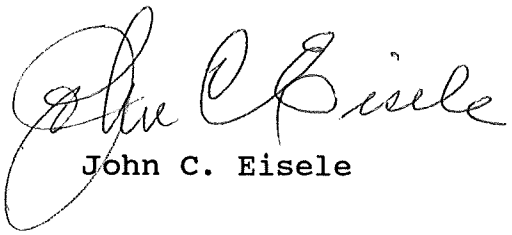
9. Summation. There are too many holes in the effort to merely modify a word here and word there in the existing statutes on sales and use tax. As indicated, to the extent of the imposition of the taxes on license fees of canned software, properly done most would not object. I offered this committee my time in assisting in properly codifying that which must be done to have an effective statute which will not generate voluminous litigation. The offer still stands.

Legislation to eliminate poorly conceived regulations would seem to me to be imperative.

The efforts in modification of regulations and statutory amendments which you are considering are much like application software that is coded simultaneously as the system is designed. There are lots of programming bugs which have to be worked out later. The legislative programming bugs resulting from this approach to legislative and regulatory change are called "lawsuits" and "appeals". None of us want them. My clients prefer to cooperate with the process in achieving well drafted, considered, and fair legislation than litigation.

Thank you very much for spending your time and energy to consider our position.

Respectfully submitted,



John C. Eisele