

Secretary of Revenue
109 SW 9th Street
PO Box 3506
Topeka, KS 66601-3506
Mark A. Burghart, Secretary



Phone: 785-296-3042
Fax: 785-368-8392
www.ksrevenue.org
Laura Kelly, Governor

MEMORANDUM

TO: Adam Smith, Chairman
House Committee on Taxation

FROM: Michael Hale, Deputy General Counsel
Kansas Department of Revenue

RE: Digital Products Proposal

DATE: February 18, 2021

Thank you for the opportunity to appear before the Committee in support of H.B. 2230 a recommendation of the Governor's Council on Tax Reform that would include the sale of digital goods in the state sales and use tax base. Council efforts to broaden the sales tax base have been endorsed by the Tax Foundation, the Kansas Chamber and Urban Institute.

I. SUMMARY OF COUNCIL FINDINGS

Thirty of the forty-five states that have a retailer's sales tax (plus the District of Columbia), include the sale of digital products in their tax bases. Reasons include:

1. Changes in technology have allowed what were once taxable sales of tangible personal property to now avoid tax merely because the property is delivered in digital format.
2. The technological advances in the delivery of property were never contemplated by the Legislature in 1937 when the sales tax act was enacted, and effectively result in unintended exclusions from the state tax base.
3. The state and local sales tax base continues to shrink in light of these unintended exclusions; the reliability of the sales tax as a stable revenue source has declined.
4. The current statutory scheme is not fair and equitable. The inclusion of digital products in the tax base would be a step toward leveling the playing field between brick and mortar stores and retailers selling digital products. A book delivered in digital format should, for tax purposes, be treated in the same manner as a book purchased from a brick and mortar store.

II. SUMMARY OF LEGISLATION

H.B. 2230 would tax all sales of digital products and subscription services, including digital audio-visual works, digital audio works, digital books, artwork, digital photographs and pictures, periodicals, newspapers, magazines, video, audio and other greeting cards, graphics, templates, patterns, desktop applications, mobile applications, web applications, cloud-based applications, native applications, online games, video games, electronic games, any digital code related to any of the above items and any streaming services related to the above items.

Since the 1930s, Kansas has imposed sales tax on items such as books, albums, magazines, movie tickets, etc. These types of commodities have been a part of the Kansas sales tax base for decades.

The body of sales tax law we live and work with today is based on those original statutes whose logic and drafting style adhered to the predominant business models of their time, and focused exclusively on sales of tangible goods, and some services. At the time, no one envisioned a society where services were equally valued as products, let alone products and services delivered in cyberspace.

As technologies changed, the Kansas Legislature insured that the sales tax base was kept, more or less, whole. So, in the 1970s, as subscriber cable and satellite began to enter the market, and people stayed home instead of purchasing theater tickets, the Legislature enacted K.S.A. 79-3603(k) in 1970 to include subscriber cable and satellite services.

Digital products first started attracting consumers' interest just prior to the tech boom in the late 1990s. At that time, existing laws and regulations imposing sales taxes focused on tangible property and specific services only. Since a sale of digital products involved no tangible property and no specific service was delivered, the sale was a non-event according to sales tax laws on the books.

Since that time, the sales tax base has eroded. As more and more things we used to purchase and consume (and pay sales tax on) were now available on-line, or downloadable to our PDA devices.

By 2013, many states routinely apply sales taxes to these types of transactions, yet the shift in consumer spending leaves us a body of sales tax laws originally drafted with tangible goods in mind that are now regularly, if not uniformly, applied to intangible services.

That is why HB 2230 is needed. To once again update the Kansas tax code, just as the Legislature has always done, to re-constitute its tax base.

What Are Digital products?

Digital products are broadly construed in many formats, but they generally fall into the following categories: digital audio files — music and podcasts, digital video files — television shows or movies, digital books, delivered electronically without physical media, computer software, on-line services, streaming services, and ringtones, games and apps.

Nationwide, on-line sales of books, recordings, movies, and games are well over \$50 billion dollars a year and growing.

How Much Sales Are Occurring (as of 2018)?

Music - The Recording Industry Association of America (RIAA) reported US Recorded Music Revenues for 2019 via digital format (including streaming) to be \$9.7 billion.

Books – The Association of American Publishers (AAP) reported US Sales of eBooks and Audiobooks for 2019 to be \$3.25 billion.

Video Games – The NPD Group and Sensor Tower reported that US Video Game Sales for 2019 of Software, including in-game purchases and subscriptions was \$35.4 billion. The quarterly reports from NPD show record breaking sales in 2020 in the video game industry, with the first 3 quarter sales of software content up over 20% to last year. Continuing that growth would result in annual sales of \$42.745 billion.

For Video Games, using the same population adjustment and the assumption that 20% of Video Game revenue was for the purchase of a tangible version of video games, which is already taxable in Kansas, the remaining \$342 million in sales would result in an increase in annual Sales Tax Revenue of \$22.23 million.

Applications (Apps) – In addition to music, books and video games, other digital products purchased online include Applications (Apps) purchased through iOS App Store or Google Play Store. App revenue, not including advertising, gaming or other digital products already accounted for, we would see an additional \$2.6 million in sales tax revenue from approximately \$40 million in App revenue (mostly generated via iOS App Store and Google Play Store).

Online Media – including newspaper and magazine subscriptions would also account for an increase in sales and use tax on digital products, an estimate of an additional \$1 million in Sales Tax Revenue.

Streaming Services – including Netflix, Amazon Prime, Hulu, HBO Now, etc. and e-Book Subscription services like Kindle Unlimited, would account for an estimate of an additional \$21.95 million in Sales Tax Revenue.

That translates, roughly, to over \$556 million dollars in sales Kansas. 76% of that is games. The tax effect for Kansas on these sales would be approximately \$50-60 million annually over the next three years.

What are other states doing?

I know that the Committee is keenly interested in Kansas being consistent with what other states are doing.

Thirty of the forty-five states (plus the District of Columbia) that have a retailer's sales tax, include the sale of digital products in their tax bases.

It would seem only logical that Kansas join the over 67% of other states in restoring its eroded tax base in this area.

As our society’s consumption has moved away from tangible property and more and more toward services provided through digital means, the tax base has shrunk dramatically. The Tax Foundation, Kansas Chamber and Urban Institute have pointed out that including digital products in the tax base is critical to staunching the base erosion that has been going on over the past decade. By broadening the base, these receipts can be used for tax relief in other areas.

Finally, the current statutory scheme is not fair and equitable. The inclusion of digital products in the tax base would be a step toward leveling the playing field between Kansas brick and mortar stores and those retailers selling digital products. A book delivered in digital format should, for tax purposes, be treated in the same manner as a book purchased from a brick and mortar store. This is a matter of fairness.

It should be noted that HB 2230 is compliant with the Streamlined Sales Tax Agreement.

In Conclusion

- ▶ The Legislature has a history of adopting bills that fit with the times and technologies, HB 2230 brings the Kansas sales tax code into the 21st century;
- ▶ The Kansas Sales tax base has been eroding since the 1990s, HB 2230 stops the erosion and reforms the sales tax base;
- ▶ The current statutory scheme is not fair or equitable, and HB 2230 levels the playing field for in-state stores that are in competition with on-line sellers;
- ▶ 67% of other states, and counting, have restored their tax bases by including digital goods in their base, HB 2230 does the same for Kansas, catching up with the majority of states; and,
- ▶ Mainstream tax organizations, such as the Tax Foundation and Kansas Chamber, encourage the broadening of an eroded sales tax base by including digital goods. HB 2230 would seem to meet their recommendation.

III. FISCAL NOTE

Assuming an effective date of July 1, 2021 and an annual growth rate of 5%, here is the estimated fiscal impact for the next three years:

| | FY 2022 | FY 2023 | FY 2024 |
|--------------|----------------|----------------|----------------|
| SGF | \$ 42.7 | \$ 48.9 | \$ 51.4 |
| SHF | \$ 8.2 | \$ 9.4 | \$ 9.9 |
| Total | \$ 50.9 | \$ 58.3 | \$ 61.3 |

I urge the Committee’s support for this effort to reconstitute the Kansas sales tax base. I would be happy to answer any questions you might have.