1997-98 SESSION COMMITTEE HEARING RECORDS

Committee Name:

Joint Committee on Finance (JC-Fi)

Sample:

Record of Comm. Proceedings ... RCP
- 05hrAC-EdR_RCP_pt01a
- 05hrAC-EdR_RCP_pt01b
- 05hrAC-EdR_RCP_pt02

- Appointments ... Appt
- **

- Clearinghouse Rules ... CRule
- **

- Committee Hearings ... CH
- **

- Committee Reports ... CR
- **

- Executive Sessions ... ES
- **

- Hearing Records ... HR
- **

- Miscellaneous ... Misc
- 97hrJC-Fi_Misc_pt28a

- Record of Comm. Proceedings ... RCP
- **

General Fund Taxes

(LFB Budget Summary Document: Page 21)

LFB Summary Items for Which Issue Papers Have Been Prepared

Item #	Title
-	Information Technology Funding (Paper #714)
-	Revenue Field Auditors (Paper #100)
-	Integrated Tax System (Paper #101)
3	Sales Tax Agreements with Direct Marketers (Paper #102)
4	Sales Tax on Interstate Telecommunications That Terminate in This State (Paper #103)
5	Sales Tax on Coin-Operated Laundries (Paper #104)
6	Sales Tax on Telephone Answering Services (Paper #105)
7	Sales Tax on Fabricated Building Units and Manufactured Buildings (Paper #106)
-	Sales Tax on University Food Contracts (Paper #107)
10	Reestimate Funding for the Earned Income Tax Credit (Paper #108)
11	Individual Income Tax Treatment of Nonresidents and Part-Year Residents (Paper #109)
-	Internal Revenue Code Update (Paper #110)
20	Minor Policy and Technical Changes -- Tax Appeals Commission Filing Fee (Paper #111)
-	Tax Amnesty Program (Paper #112)
15	Utility Tax on Personal Communications Services (Paper #113)
9	Minor Policy and Technical Changes -- Use Tax on Automobiles Used by Dealers (Paper #114)
2	Increase Cigarette Tax (Paper #115)
-	Individual Income Tax -- One-Time Credit (Paper #116)
-	Individual Income Tax -- Indexing (Paper #117)
13	Development Zones Tax Credits (see Paper #252)
16	Recycling Fund Transfer to General Fund (see Paper #592)

To: Joint Committee on Finance

From: Bob Lang, Director
Legislative Fiscal Bureau

ISSUE

Revenue Field Auditors (General Fund Taxes/Revenue)

[LFB Summary: Page 513, #2]

CURRENT LAW

Base level funding for the Department of Revenue's Audit Bureau is $16,550,000 GPR, $315,000 PR, $988,900 SEG and $51,000 FED for 1997-98. (The FED funding is deleted as a standard budget adjustment for removal of noncontinuing elements.) Base level position authority is 315.10 GPR, 5.75 PR and 17.50 SEG positions.

GOVERNOR

Provide $245,900 GPR in 1997-98 and $274,400 GPR in 1998-99 and 5.0 GPR revenue auditor positions beginning in 1997-98. It is estimated that the increased audit activity that would be associated with the revenue auditor positions and would increase general fund tax revenues by $3,500,000 in 1998-99.

DISCUSSION POINTS

Revenue Field Auditors

1. The Audit Bureau is responsible for auditing individual income, corporation franchise and income, sales and use, withholding, motor vehicle fuel, and excise tax returns. The Bureau also audits homestead, earned income and farmland preservation tax credit returns. Bureau activities include conducting office and field audits and issuing assessments and refunds.

The Audit Bureau, along with the Compliance Bureau, provides direct taxpayer assistance during the tax filing season and conducts informational workshops and meetings for taxpayers. The Audit Bureau's main office is in Madison. District offices are located in Appleton, Eau Claire, Madison and Milwaukee with branch offices in 28 other Wisconsin cities. The Bureau also has four out-of-state offices in New York, Minneapolis, Los Angeles and Chicago.

2. The Audit Bureau has four sections:

Central Audit Section. This section is authorized 111.10 positions, including 97.1 auditor positions. The section is responsible for auditing individual income, corporate franchise and income, partnership, homestead, earned income and farmland preservation returns. Section personnel also provide taxpayer assistance and conduct nonfiler programs.

Field Audit Section. There are 155.75 authorized positions in the section, including 125.85 auditor positions. The section is responsible for conducting field audits of sole proprietorships, partnerships, and corporations for individual income, corporate franchise and income, state and county sales, and withholding taxes. Staff provide technical assistance for office and field auditors, review completed audits, and offer taxpayer assistance.

Excise Tax Section. This section has 23.50 authorized positions, including 15.5 auditor positions. The responsibilities of the section include conducting office and field audits of beverage, cigarette, tobacco products and motor vehicle fuel taxes.

Office Services. The section has position authority for 39.40 positions. Staff primarily perform word processing and clerical functions for the Bureau. In addition, there are 8.6 supervisor and technical specialist positions authorized for the Bureau Director's office.

Although the Bureau is authorized 238 auditor positions, it currently has 115 field auditor and 97 office auditors. The remaining positions provide technical assistance and taxpayer assistance. There were also 10 vacancies in 1995-96. The Department indicates that hiring freezes over the past 10 years have prevented it from bringing the staffing level for auditors up to the number of authorized audit positions.

3. In fiscal year 1995-96, the Bureau conducted 37,717 office audits which resulted in \$60.0 million in assessments and \$17.6 million in additional tax collections. For the same period, a total of 1,419 field audits led to \$78.9 million in assessments which generated \$33.7 million in tax collections. Of the total amount of field audit collections, \$19.5 million was collected through corporate sales and use tax audits and \$12.7 million was collected through corporate income and franchise tax audits.

4. The 5.0 field auditor positions would be hired in the Department's out-of-state offices and would conduct large case franchise and income and sales tax audits of multistate

corporations. The Department generally hires former Internal Revenue Service (IRS) auditors for these offices.

Large case field audits focus on the largest 500+ corporations that have filed Wisconsin returns as identified by staff of the Audit Bureau's Technical Services Unit. The staff are responsible for selecting the cases to be audited. They compile an inventory of the corporations which includes relevant information, such as prior year audit results and, after reviewing the inventory, they identify possible audit cases and check the corporation income and franchise and sales tax returns for each case. The corporations with the largest potential for tax adjustments are selected for audit.

Once a corporation is selected for a large case field audit it is assigned to an audit supervisor who assigns the case to one of his or her auditors based on: (a) the location of the audit; (b) the complexity of the case; and (c) the auditor's experience. Increasingly, Large Case field audits are conducted outside of Wisconsin because many state firms have been acquired by firms that are domiciled outside of the state. Generally, a case is assigned for the most recent four years and often includes both income and franchise and sales and use taxes.

Upon receiving the assigned case, the auditor logs it into his or her inventory control and is responsible for contacting the taxpayer and scheduling an office visit. When notifying the taxpayer the auditor can request information relevant to the audit. The auditor then prepares preliminary workpapers from tax return schedules and identifies potential audit adjustments. The field audit assignment sheet is reviewed for comments regarding potential adjustments or questions.

Field work begins with a conference with the taxpayer so that there is a mutual understanding of what is expected during the course of the audit. The taxpayer is provided with a copy of the Wisconsin Taxpayer Bill of Rights and the list of rights are discussed and explained. The typical large case income and franchise tax audit focuses on (but is not limited to) the following areas of potential adjustments: (a) book to tax income adjustments; (b) intercompany transactions; (c) apportionment computations; (d) manufacturer's sales tax credit; and (e) research facilities and expenses credit. Since the corporate income and franchise tax is federalized, the Department does not focus audits on areas the IRS will review. Instead, the auditor receives audit reports from the IRS. The auditor reviews computations and adjustments made during the audit with the taxpayer.

When the field work is completed, the auditor completes the detailed audit workpapers and prepares a preliminary audit report documenting proposed audit adjustments. The workpapers and audit report are then submitted to the audit supervisor for review. Revisions are made, if necessary, and the proposed audit report is discussed with the corporation's tax personnel at a final meeting. Further revisions can be made as a result of these discussions. The report is then submitted to the supervisor for final review. After the supervisor completes his or her final review, the final audit report and workpapers are sent to large case reviewers for final review and approval. If approved, the report and assessment notice are issued. The typical large case field audit takes at least four months to complete and process.

The logistics and manner in which a large case sales and use tax audit is conducted are similar to those done in a Large Case income and franchise tax audit. Almost all Large Case sales and use tax audits use sampling due to the large number of invoices that would otherwise have to be reviewed. The majority of the audits, and samples, involve use tax examinations where untaxed purchases are reviewed to determine if tax should have been paid. The majority of samples employed in these audits are computer generated statistical samples set up by Bureau staff. As is the case for income and franchise tax audits, auditors follow sales and use tax policies and procedures to assure consistent auditing and application of the tax laws.

5. It is argued that additional auditors are needed to address the increasing number of tax returns that are filed and the increasing complexity of state tax laws. The number of corporate franchise and income tax returns increased 19.8%, from 89,300 to 107,000, between fiscal years 1989-90 and 1995-96. Corporate franchise and income tax collections increased from $437 million to $636 million during the same period. Similarly, the number of sales and use tax returns increased 16.8%, from 1,052,600 to 1,229,500, between fiscal years 1989-90 and 1995-96. Sales and use tax collections grew from $1,984 million in 1989-90 to $2,704 in 1995-96.

While the number of returns and amounts of corporate income and franchise and sales and use taxes have been increasing, the Department has not been provided with additional audit staff for the past 11 years. The Audit Bureau is authorized 238.45 auditor positions; currently there are 97 central office auditors and 115 field auditors. With this level of audit staffing the Department is able to audit between 1% and 2% of all taxpayers in a year. Some would note that additional auditors would provide DOR with more staff to handle the annual increases in tax filers and tax collections. Moreover, the audits that would be conducted by the five additional field auditors would generate an estimated $3.5 million in tax revenues in 1998-99. The increased audit staff would also strengthen the Department's enforcement of tax laws. Since the tax system relies on voluntary compliance by taxpayers to pay taxes owed the state, the increased enforcement activities (audits) would encourage voluntary compliance with tax laws. Finally, audits promote more accurate future returns.

6. To back their argument for additional field auditors, supporters would point to the audit activities of other states. Many other states have recently increased their field auditor staffing levels and neighboring states and states with similar populations generally have a larger number of field auditors than Wisconsin. According to the annual audit survey published by the State Tax Institute in the September, 1995, Sales and Use Tax Alert, 22 states indicated that they had added auditors during the previous five years and nine states indicated that they intended to add auditors in the future. Tables 1 and 2, which are based on data from the survey, show the number of field auditors for neighboring states and for states with a similar population. The tables show that, even with the additional five positions, the field audit staff for Wisconsin would be relatively small when compared with the other states.

TABLE 1

Field Audit Staffing for Neighboring States

State	Number of Field Auditors (1995)	Population (million)
Iowa	68	2.9
Wisconsin	115	5.2
Indiana	166	5.8
Minnesota	225	4.7
Michigan	229	9.6
Illinois	322	11.8

SOURCE: Sales and Use Tax Alert, Annual Audit Survey, State Taxation Institute, September, 1995.

TABLE 2

Field Audit Staffing for States with Comparable Populations

State	Number of Field Auditors (1995)	Population (million)
Wisconsin	115	5.2
Louisiana	131	4.4
Tennessee	208	5.3
Minnesota	225	4.7
Missouri	232	5.4
Washington	235	5.5

SOURCE: Sales and Use Tax Alert, Annual Audit Survey, State Taxation Institute, September, 1995.

7. Opponents would argue that providing additional field auditors would not necessarily generate additional revenues or improve compliance with the tax system. The opponents note that an audit does not always result in additional assessments; often, audits generate refunds. Moreover, audits usually require the taxpayer to provide supporting documents and to participate in meetings with Department staff. As a result, participation in an audit can disrupt the daily activities of the taxpayer. This can cause the taxpayer to resent the enforcement

activities. Rather than creating support, audits can cause a lessening of public support for the tax system.

Audits can also lead to litigation which can be costly to both the state and taxpayer. A recent example would be the case of NCR v. Wisconsin Department of Revenue. The case originated from audit assessments made by DOR beginning in 1981. In part, the assessments related to the treatment of dividends and other intangible investment income received by NCR from foreign subsidiary corporations. NCR objected to the additional assessments and eventually filed with the Wisconsin Tax Appeals Commission for review. The case went before the Commission, the Circuit Court of Dane County and a settlement was reached in September, 1996, with the case before the District IV Court of Appeals. As a result of the settlement, DOR will refund an estimated $38.4 million in taxes and interest between 1997 and 2000. On the other hand, NCR will not contest the inclusion of certain other intangible investment income in taxable income.

8. The bill includes $3.5 million in general fund tax revenues in 1998-99 to reflect the estimated revenue that would be generated by the 5.0 field auditors. The estimate was determined by multiplying the estimated average annual tax collections generated by a field auditor times the five auditors. The average collections per field auditor was calculated by dividing the total amount of annual field audit assessments by the total amount of field auditors and adjusting to reflect the portion of assessments that are collected.

Assuming that each field auditor position would generate additional revenue raises a significant budget issue. As noted, under the bill, each auditor is estimated to generate $700,000 annually, which is the average amount of revenue currently estimated for each field auditor. However, at some level of staffing, the average amount of revenue that could be raised by each auditor would begin to decline until, eventually, the cost of each auditor would exceed the revenue the auditor could generate. Thus, at a certain number of auditors, each additional auditor would raise less revenues until the amount raised would be less than the cost of the auditor position. The bill provides $45,500 for a full year of salary and fringe benefits for each auditor. Annual support costs of approximately $9,300 are also provided.

In reviewing the estimate of $3.5 million in additional revenue attributed to the five auditor positions a number of factors can be considered:

a. Over the past 10 years the number of auditors has not increased while the amount of corporate income and franchise and sales tax returns have increased substantially. Consequently, the number of potential audits is increasing each year.

b. The Department is only able to audit between 1% and 2% of taxpayers. In addition, about 1/3 of the corporations in the large case inventory are annually audited. At this level, it would seem that additional audits would not quickly reach a plateau and begin to generate diminishing returns.

c. The auditors will focus on out-of-state corporations which pay relatively higher taxes. Consequently, the audits should generate higher than average revenues.

d. Wisconsin generally has fewer auditors than neighboring states and states with comparable populations. In addition, many states have recently increased their audit staffs. The experience of other states could be viewed as indicating that the additional auditors would generate additional revenue.

Given these considerations, supporters would argue that the estimated additional revenue attributed to the auditors appear to be reasonable. No additional revenues are estimated in 1997-98 because the new auditors would be involved in training activities for most of that year.

9. It should be noted, however, that total corporate franchise and income tax audit collections have decreased in each of the last two fiscal years, from $28.7 million in 1993-94, to $28.2 million (-1.7%) in 1994-95 and then to $25.2 million (-10.6%) in 1995-96. Although sales and use tax audit collections increased from $59.6 million in 1994-95 to almost $74 million in 1995-96, the 1994-95 amount represented a decrease of about 5.1% from $62.8 million in collections in 1993-94. The decreases in audit collections occurred during a period in which both corporate income and franchise and sales and use taxes were annually increasing. Opponents would argue that these patterns of audit collections indicate that additional audit activity would not necessarily generate additional revenues.

10. According to the state vacancy report for the pay period ending March 29, 1997, the Audit Bureau had seven GPR revenue auditor positions that were vacant for more than a year. The vacant positions included three revenue auditor 1, two revenue auditor 3 and two revenue auditor 5 positions. Current annual funding for salary and fringe benefits for these positions is $269,300. The Governor's recommendation is to provide five revenue auditor 7 positions. The bill would provide funding of $245,900 in 1997-98 and $274,400 in 1998-99 to fund these positions. As an alternative, the Committee could authorize DOR to reclassify five of the vacant positions as revenue auditor 7 positions and to reallocate funding from other vacant revenue auditor positions to partially cover the cost of the upgrade. In addition, funding could be reduced by $23,500 in 1997-98 and $5,100 GPR could be provided in 1998-99 to fully fund the revenue auditor 7 positions. The Department could fill the reclassified positions and generate the additional tax revenue associated with the increased audit activity.

However, the Department indicates that it conducts an annual recruitment and fills its vacant auditor positions each June. As a result, the Audit Bureau only fills its authorized auditor positions once a year. Department staff note that the currently vacant auditor positions will be filled this June. If the Audit Bureau is required to reclassify and reallocate funding from existing positions it will not have sufficient staff to conduct current audit activities. In effect, it would reallocate auditors from current responsibilities to Large Case audits. As a result, revenues from current audit activities will be decreased and offset the increased revenues from the large case audits. The Department would argue that only with the additional auditor positions would additional revenue be generated.

11. The Governor's recommendation is based on an action plan prepared by DOR in which the Department proposed adding 12 field auditors to concentrate on auditing income and franchise and sales and use taxes paid by large and multistate companies. The Department's plan estimated that 12 field auditors would each generate the $700,000 average collections attributed to each field auditor. The estimate was based on the same factors that were used to develop the estimated $3.5 million for the five auditors included in the bill.

The Committee may wish to modify the bill and provide 12 auditors rather than the five included in the bill. This would require total funding of $590,400 in 1997-98 and $658,800 in 1998-99 to cover the cost of the positions and related expenses. If each additional auditor generated $700,000 in collections annually, general fund tax revenues would increase by $8.4 million in 1998-99 and thereafter.

It should be noted that DOR is confident that the additional 12 auditors would each generate $700,000 in collections. However, it is not clear that beyond the level of 12, each auditor would continue to generate this amount. In order to assess the effectiveness of the new audit staff, the Committee could require DOR to prepare a report for the Committee on the activities of the new auditors, the amount of revenue that was generated by the additional staff and an analysis of the amount that could be generated by further increases to the audit staff. The report could be due on January 1, 2000.

Individual Income Tax Audit Software

12. The Department of Revenue has requested spending authority of $105,000 GPR in 1997-98 and $80,000 GPR in 1998-99 to purchase computer software to be used in auditing individual income tax returns. (The $80,000 would be the ongoing cost of using the software.) Recently, the vendor has allowed the Department to use the software for four months and in that time Department auditors have generated an additional $1.0 million in assessments. Although not all additional assessments result in additional collections, it can be reasonably expected that this enhanced capability will generate considerable collections. Assuming that 70% of the additional annual assessments will result in additional tax collections, it is estimated that use of the software would generate an additional $2.0 million annually in audit collections.

The software allows the Department to put three years of state and federal individual income tax and information returns on a personal computer. Auditors can then use the software to select likely audit candidates. The current system requires the Department to conduct tape matches of tax files through a mainframe computer. Computer programmers are needed to perform audits. As a result the software would allow the Department to increase both the number and efficiency of individual income tax audits.

ALTERNATIVES TO BILL

Revenue Field Auditors

1. Approve the Governor's request to provide $245,900 GPR in 1997-98 and $274,400 GPR in 1998-99 and 5.0 revenue auditor positions beginning in 1997-98.

2. Adopt the Governor's recommendation with a modification to require DOR to prepare a report for the Committee on the activities of the new auditors, the amount of revenue that was generated by the additional staff and an analysis of the amount that could be generated by further increases to the audit staff. Specify that the report would be due on January 1, 2000.

3. Delete the Governor's recommendation. Instead authorize DOR to reclassify 5.0 currently vacant revenue auditor positions as revenue auditor 7 positions. Reallocate funding from other vacant revenue auditor positions to cover the costs of the position upgrade. Finally, decrease funding by $23,500 GPR in 1997-98 and provide $5,100 GPR in 1998-99 to fully fund the revenue auditor positions.

Alternative 3	GPR
1997-99 REVENUE (Change to Bill)	- $3,500,000
1997-99 FUNDING (Change to Bill)	- $538,700
1998-99 POSITIONS (Change to Bill)	- 5.00

4. Modify the Governor's recommendation to provide $590,400 GPR in 1997-98 and $658,800 GPR in 1998-99 and 12.0 revenue auditors beginning in 1997-98. Estimate additional general fund revenues of $8,400,000 in 1998-99 due to the additional audit activities. In addition, require DOR to prepare a report for the Committee on the activities of the new auditors, the amount of revenue that was generated by the additional staff and an analysis of the amount that could be generated by further increases to the audit staff. Specify that the report would be due on January 1, 2000.

Alternative 4	GPR
1997-99 REVENUE (Change to Bill)	$4,900,000
1997-99 FUNDING (Change to Bill)	$728,900
1998-99 POSITIONS (Change to Bill)	7.00

5. Delete the Governor's recommendation.

Alternative 5	GPR
1997-99 REVENUE (Change to Bill)	- $3,500,000
1997-99 FUNDING (Change to Bill)	- $520,300
1998-99 POSITIONS (Change to Bill)	- 5.00

Individual Income Tax Audit Software

1. Provide $105,000 GPR in 1997-98 and $80,000 GPR in 1998-99 to purchase individual income tax software.

Alternative 1	GPR
1997-99 REVENUE (Change to Bill)	$4,000,000
1997-99 FUNDING (Change to Bill)	$185,000

2. Maintain current law.

MO#____________________

BURKE	Y	N	A
DECKER	Y	N	A
GEORGE	Y	N	A
JAUCH	Y	N	A
WINEKE	Y	N	A
SHIBILSKI	Y	N	A
COWLES	Y	N	A
PANZER	Y	N	A
JENSEN	Y	N	A
OURADA	Y	N	A
HARSDORF	Y	N	A
ALBERS	Y	N	A
GARD	Y	N	A
KAUFERT	Y	N	A
LINTON	Y	N	A
COGGS	Y	N	A

Prepared by: Ron Shanovich

AYE _____ NO _____ ABS _____

To: Joint Committee on Finance

From: Bob Lang, Director
Legislative Fiscal Bureau

ISSUE

Integrated Tax System (Revenue -- Tax Administration)

CURRENT LAW

The Department of Revenue (DOR) currently has more than 130 application systems dedicated to tax administration and revenue collection. The Department's major tax systems include: individual income tax; corporate income and franchise tax; sales tax; withholding tax; individual income tax audit; corporate income and franchise tax audit; fuel taxes; beverage taxes; cigarette and tobacco products taxes; stadium tax; exposition center tax; delinquent tax control system; individual income estimated tax; recycling surcharge; partnerships; estate and inheritance; manual refunds; manufacturing assessment; utility taxes; and real estate transfer fee.

GOVERNOR

No provision.

DISCUSSION POINTS

1. Generally, the Department's tax processing systems have been developed to support a specific tax program. Although each of the systems is basically reliable, they are built to stand alone from other tax processing systems. These systems were implemented at various times over the last 30 years using different methods for organizing data and different programming languages and are not designed to be connected in their operations. The systems often have duplicate functions involving registration, tax processing methods and computation,

issuance of refunds and bills, management of estimated payments, audit case activities and appeals.

2. DOR indicates that many of the existing tax processing systems are difficult and expensive to maintain and modify. A number of administrative problems have been identified:

a. DOR staff perform many tasks manually that could be automated. Standard letters frequently must be obtained by a typed request. Adjustments are often made on handwritten worksheets and keyed into the processing system. Thirty different accounting transfers are manually recorded to generate a monthly report. In some cases, staff must retrieve previously filed returns to verify amended returns.

b. The existing systems contain redundant information that is difficult to maintain and update. Under the current systems, it is possible that the Department would maintain a separate record of the name and address of a business owner in the sales tax system, withholding tax system, individual income tax system and the individual income estimated tax system. A separate system was established to process stadium sales tax returns because the state sales tax system could not be modified in time to process stadium tax returns.

c. The same level of taxpayer service cannot be provided from every tax processing system. Some tax returns, such as the individual income tax, allow electronic filing of returns while other systems, such as the sales tax system, require paper returns. Each system independently issues bills and refunds. Response time for taxpayer inquiries varies from system to system.

d. The Department cannot always ensure that all taxes that are due will be paid and deposited in a timely manner. Some current refund processes do not check current refunds against refunds previously issued to detect duplication. Employer withholding deposits are not reconciled to the amount of state withholding shown on employer copies of W-2 forms filed with the state. Sales tax payments not deposited with a return may not be deposited until a bill is generated. Some delinquent tax bills must be manually entered into the delinquent tax system, delaying the commencement of collection activity.

e. DOR staff cannot electronically access all information that is collected by the Department. W-2 information is not available to staff on-line. Certain Department actions are not shown on computer screens that are accessible to all Department staff. In order to determine if audits have occurred that modify a taxpayer's income tax history, an employe must refer to the taxpayer's paper file.

f. Some processing systems are written in out-of-date, unsupported software and use antiquated processes. The sales tax processing system is written in a language that is relatively inflexible and difficult to modify to reflect law changes. Statistical requests from the individual income tax system must be generated by a programmer. The Department has difficulty hiring programmers that are knowledgeable in the language used for the income and sales tax systems. Most systems use batch processing.

g. Applications development staff devote most of their resources to working on existing applications. Staff activities include making modifications to reflect law changes, monitoring systems for accuracy and performance, correcting problems and incorporating enhancements. The Department reallocated staff from the sales tax team and the audit automation project to implement the stadium tax. Modifying the recycling surcharge system caused the Department to delay redesign of the corporate income and franchise tax system for approximately one year.

3. DOR has proposed developing an integrated tax processing system, beginning in fiscal year 1997-98. The integrated tax system would be a tax administration system that would use technology whenever possible to:

a. Assist taxpayers by providing information and returns to voluntarily comply with tax laws.

b. Register taxpayers by establishing a single registration system that would create a taxpayer profile in a departmentwide database. The current business tax registration system would be the foundation for this system.

c. Process returns through an automated system.

d. Manage accounts receivable through a central system that promptly and accurately records payments and outcomes of balance due notices.

e. Process refunds by creating a single automated system that processes overpayments for all tax types in a timely and accurate manner.

f. Audit and investigate taxpayers by creating a single automated system for all tax types, including utility and special taxes, that targets most productive areas for revenue production and compliance.

g. Manage collection cases by developing a single automated system that permits the prompt collection of all delinquent taxes using the lowest level of enforcement necessary. The current delinquent tax system would essentially perform this function.

h. Develop a single automated system that provides statistics and disbursements to internal and external customers for all documents, revenues and refunds.

4. DOR contracted with Grant Thornton to develop an action plan for developing and implementing an integrated tax processing system in the state. The report was completed in October, 1996, and listed a number of alternative actions the Department could take.

5. One alternative would be to continue the current method of developing systems. The Income, Sales and Excise Tax Division is generally organized by function and is gradually moving toward integration. The Department's Strategic Business and Information Technology plan recommends several integration initiatives over a five-year period. In addition, the Department's IT migration plan includes a number of projects, such as providing auditors access to local area networks, that would be part of an integrated tax processing system. The delinquent tax and business tax registration systems provide integrated systems for registering taxpayers and managing collection cases. It could be argued that providing DOR with funding for IT hardware and software would allow the Department to gradually achieve tax processing integration, maintain internal control over the project and limit the cost.

However, the action plan indicates that gradual integration that extends beyond five years is at serious risk of being unsuccessful. Projects with long timelines frequently create situations where current and future development teams cannot wait for an integrated solution. The primary goal becomes project completion or implementation of law changes, not addressing future agency needs. Under the current method of system development, high priority law changes will continue to drive applications development. System improvements will only occur when resources are provided for a specific tax. Current systems will continue to be modified until the complexity makes integration efforts more difficult. Even if the Department does not develop an integrated processing system, it will still need to rewrite the individual income tax system and the sales tax system to eliminate dependence on out-of-date computer languages.

6. A second alternative would be to develop a tax integration system using internal resources. The Delinquent Tax System (DTS) will be fully implemented by June, 1998, while the business tax registration system (BTR) will complete the first phase by January, 1998. Both project teams are aware of the tax integration initiative and have included tax integration as a goal for their projects. These initiatives cover two major functions of a Tax Integration System. The remaining functions could be addressed by dedicated project teams internally, as resources allow. Internal reorganization of the IS&E Division would be required with the specific organizational structure developed as a component of a tax integration plan.

The development of DTS and BTR could continue with some level of oversight to insure conformity with overall integration by function. The audit automation project could be expanded to consider audits for all tax programs. Project teams are already working on a revenue accounting action plan and an action plan for processing refunds. Upon completion of DTS, the existing development ream could be assigned to develop the system to manage accounts receivable. Case management functionality developed for DTS could be used as a basis for developing the audit system. The BTR team, upon completion of their work for permit taxes, would also complete the registration of taxpayers by adding individuals, corporations and partnerships to their business name and address tables. The development of a Sales Tax Processing System could serve as a prototype for processing all other tax types. Eventually an "expert" system could be built to assist taxpayers. Internal development would retain the completed work from BTR and DTS and DOR would have compete control over subsequent development efforts apart from resource levels and other externally driven conflicting priorities. The cost would be funded from existing resources.

Experience has shown that a development project of this scope cannot be completed within five years relaying on internal resources. The Corporation and Withholding System projects each took six years even without law changes or court cases during this period. Moreover, the Department indicates that an integrated tax system could not be developed internally. In addition, the Department needs outside expertise in order to develop and program a system using the best technologies.

7. A third alternative for developing an integrated tax system would be to use a combination of internal and external resources. Under this alternative method, the Department would combine its current integrated systems, such as DTS and business tax registration, with systems development of the remaining functions provided by a private vendor. Applications development staff would work with the vendor to plan, design, develop and implement the integrated processing systems. This would allow the development team to take advantage of the experience of Department staff and would result in a system that would meet the Department's needs. Use of a private vendor would provide the Department with additional staff to develop new applications and expertise in systems development. According to the action plan, this alternative method of implementing integration would most likely lead to a fully operational integrated tax processing system for the sales and individual income taxes within five years, with integration of the other taxes shortly thereafter.

8. The Department has requested $1,257,100 GPR in 1997-98 and $203,500 GPR in 1998-99 to contract with a vendor through a RFP process for assistance in developing a staged implementation of an integrated tax processing system. The funding would be placed in unallotted reserve in the Joint Committee on Finance's supplemental GPR appropriation. The Department would be required to submit a plan for implementation of an integrated tax system to the Committee for its approval before the funding could be released. The Department indicates that it would work with the vendor to develop the following:

a. Requirements definition. The first phase of the project is the definition of system requirements. This involves an analysis and determination of all the functions and features that the system must have.

b. High level systems design and architecture. This is a basic design for the various components of the system and a description of how they fit together and includes a data model which shows how the data are organized and accessed.

c. Implementation plan. The implementation plan defines the logical sequence of steps for constructing the entire system. It identifies what components should be developed first and describes how to phase out old systems as the new system are constructed.

d. Cost/benefit analysis. A detailed cost/benefit analysis would be completed. The costs for each component of the system would be estimated along with the benefits for that component. Both internal cost savings, potential for increased revenue, and benefits for customers would be estimated. The analysis would provide the basis for making decisions, setting project priorities and developing biennial budget requests.

e. Pilot projects. The Department would select a component of the integrated tax system for a pilot project. The pilot project would be conducted during the 1997-99 biennium as a way to demonstrate the new technologies, including new application development tools, and the new architecture that will be used for the project.

9. A major concern related to this proposal is that the Department indicates that it cannot provide estimates the long-run costs associated with the development of an integrated tax processing system. In part, the cost will depend upon services provided by the private vendor under the terms of the contract. According to the Department, there is a chance that the vendor would be willing to fund some of the system development in order to market the components of the system to other states. Another concern would be that providing initial funding would not guarantee that a fully integrated tax processing system will be developed and implemented.

ALTERNATIVES TO BILL

1. Provide $1,257,100 GPR in 1997-98 and $203,500 in 1998-99 for DOR to contract with a private vendor to develop and implement an integrated tax processing system in the Department. Place the funding in the Joint Committee on Finance's supplemental appropriation. Require the Department to submit a plan for development of an integrated tax system to the Committee for its approval before the funding can be released from the Committee's appropriation.

Alternative 1	GPR
1997-99 FUNDING (Change to Bill)	$1,460,600

2. Maintain current law.

Prepared by: Ron Shanovich

MO#________________

BURKE	Y	N	A
DECKER	Y	N	A
GEORGE	Y	N	A
JAUCH	Y	N	A
WINEKE	Y	N	A
SHIBILSKI	Y	N	A
COWLES	Y	N	A
PANZER	Y	N	A
JENSEN	Y	N	A
OURADA	Y	N	A
HARSDORF	Y	N	A
ALBERS	Y	N	A
GARD	Y	N	A
KAUFERT	Y	N	A
LINTON	Y	N	A
COGGS	Y	N	A

AYE _____ NO _____ ABS _____

To: Joint Committee on Finance

From: Bob Lang, Director
Legislative Fiscal Bureau

ISSUE

Sales Tax Agreements With Direct Marketers (General Fund Taxes)

[LFB Summary: Page 22, #3]

CURRENT LAW

The state sales tax is imposed on the gross receipts from the sale, lease or rental of tangible personal property and services identified by state law. A companion use tax is imposed on the storage, use or other consumption of property or services purchased from out-of-state retailers if the sale would have been taxable if the property or services had been purchased in Wisconsin. A credit is allowed for sales taxes properly paid in the other state.

The sales and use tax is generally collected through one of the following methods:

a. If the seller has adequate nexus (business connection) with the state, the state can require the seller to collect the tax. This is how the tax is generally collected from in-state retailers. In addition, some out-of-state retailers voluntarily collect the tax on behalf of the state. Under state sales and use tax provisions, nexus is generally established if a seller owns, leases or uses property in the state or maintains personnel or agents in the state for the purpose of selling, delivering or taking orders for taxable goods or services.

b. The sales and use tax can be collected at the time of registration for goods which are subject to state registration, such as automobiles.

c. The tax may be paid voluntarily by the purchaser or collected through audit by state tax authorities. Since 1988, state individual income tax forms have contained a line for reporting and paying sales and use tax on out-of-state purchases.

GOVERNOR

Authorize the Department of Revenue (DOR) to enter into agreements with direct marketers about the collection of state and local sales and use taxes and about making quarterly payments of those taxes.

DISCUSSION

Direct Marketers' Agreement

The budget provision would not impose an additional sales or use tax liability on Wisconsin residents. Rather, it would be an attempt to ensure collection of sales and use taxes that are owed by state residents on purchases from out-of-state direct marketers. Under current law, if a Wisconsin resident purchases taxable merchandise through the mail from a seller located in another state, the sale is considered to have occurred in this state and is subject to the Wisconsin sales tax. However, if the out-of-state seller does not have adequate nexus with this state, the seller cannot be required to collect the tax from the customer and remit the proceeds to DOR.

Wisconsin and 11 other states (California, Florida, Illinois, Iowa, Kansas, Missouri, New Jersey, New York, Ohio, Pennsylvania and Texas) are currently involved in negotiations with the Direct Marketing Association (DMA) concerning a multi-state agreement for the collection of sales and use taxes on catalogue sales. The Federation of Tax Administrators (FTA) and the Multi-State Tax Commission (MTC) are also involved in the discussions, which began in June, 1996.

The agreement would benefit states because additional sales and use tax revenues would be collected on sales by out-of-state sellers. Direct mail retailers would benefit because they would be subject to more uniform reporting and payment requirements. In addition, direct marketers would have greater certainty that states will not subsequently assert that the seller has sufficient nexus with the state and assess the retailer for back taxes on prior sales.

According to the Department of Revenue, it is possible that the parties involved in the negotiations will agree to final terms at the national FTA meeting on May 29, 1997. After that occurs, it will take some time for a final agreement to be entered into by state governors and individual retailers. Therefore, the agreement would likely take effect sometime during the first six months of 1998. However, it is anticipated that some of the larger sellers will collect taxes under the agreement on a pilot basis in Wisconsin this summer.

It is expected that each seller will enter into a separate contract with each of the states in the agreement. Retailers will be required to collect taxes for each of the states participating in agreement; they will not be allowed to exclude certain states. The sellers will generally be required to use the tax base and rates (including local taxes) for each individual state; there will be no uniform tax base or rate. It is anticipated that retailers participating in the agreement will receive the current retailers' discount.

Retailers will probably not be required to collect sales and use tax on shipping and handling charges under the agreement. Under current Wisconsin law, the sales tax is imposed on shipping and handling charges by direct marketers. Under the agreement, the state would no longer tax these charges on sales by companies participating in the agreement, even if the retailer is already collecting the state sales tax because it has nexus with Wisconsin. DOR indicates that this provision is included because most of the states involved in the negotiations do not tax shipping and handling charges. It is likely that subsequent legislation will be introduced to eliminate the sales tax on shipping and handling charges by all retailers, not just those under the agreement.

The agreement will likely have a provision for review after a specified time limit. In addition, states and sellers will be able to opt out, if they provide adequate notice.

Other anticipated provisions of the agreement include: (a) joint audits will be conducted, led by the state in which the retailer's headquarters are located; (b) retailers will be required to file returns and pay taxes on a quarterly basis (in Wisconsin, large sellers currently must report monthly); (c) there will be a uniform sales tax return for all states in the agreement; and (d) electronic filing will be allowed. In addition, retailers may be permitted to transfer responsibility for uncollectible taxes to states in cases where the purchaser paid for the merchandise with a check but did not remit the tax.

Fiscal Effect

The bill estimates that an agreement with direct marketers would result in increased state sales and use tax collections of $6,800,000 in 1997-98 and $29,300,000 in 1998-99. These estimates are based on information from a 1994 study by the Advisory Commission on Intergovernmental Relations (ACIR) on proposed federal legislation regarding the collection of state sales taxes from direct marketers and the following additional assumptions:

• The agreement would take effect on January 1, 1998. It is expected that the agreement would encourage retailers to sign on during the first 12 months of the contract, so that a full year of collections would first be received during calendar year 1999.

• Direct marketers accounting for 80% of mail order sales to Wisconsin residents would enter into the agreement. This is based on an estimate by the Direct Marketing Association, which assumes that a relatively large number of states will participate in the agreement. If few states enter the agreement, the number of retailers participating could be lower.

• Wisconsin would receive additional sales and use taxes on 65% of the sales by marketers entering into the agreement. In other words, it is estimated that the tax is currently collected on 35% of these sales, because the seller has adequate nexus with the state. The 35% estimate is greater than the 28% figure which was used for all states in the ACIR study, because a number of relatively large mail order sellers are located in Wisconsin.

Based on the information available at this time, it appears that the administration's estimates are reasonable. However, two points should be noted regarding these figures. First, because the agreement is not expected to be fully implemented until calendar year 1999, the $29.3 million revenue estimate for the 1998-99 fiscal year understates the annualized impact of the proposal. Based on the assumptions outlined above, the annualized fiscal estimate would be approximately $40 million beginning in 1999-2000.

Second, the amount of revenue generated by the proposed agreement could differ significantly from the budget estimates if actual experience varies from the assumptions described above. According to a fiscal estimate prepared by DOR, the assumed January 1, 1998, effective date may be optimistic. Further, the DMA indicates that Wisconsin and other states are unlikely to receive revenue under the agreement until the 1998-99 fiscal year. It also may be optimistic to assume that retailers accounting for 80% of mail order sales would enter into the agreement.

Modifications to these assumptions could significantly reduce the fiscal estimates. For example, if the effective date were delayed by six months to July 1, 1998, no revenues would be generated in 1997-98 and the estimate for 1998-99 would decrease by $13.8 million, for a biennial reduction of $20.6 million compared to the amounts included in the bill. Similarly, if the participation assumption were decreased from 80% to 70%, the estimates would decline by $0.9 million in the first year and approximately $3.7 million in the second year.

Technical Correction

In an April 22, 1997, letter to the Co-Chairs of the Committee, the Department of Revenue indicated that the budget provision should be modified to make the provision broad enough to cover all aspects of the proposed agreement. As noted, the provision in the bill would allow DOR to enter into agreements with direct marketers about "the collection of state and local sales and use taxes and about making quarterly payments of those taxes." Because the agreement would likely encompass additional tax provisions such as audits and nexus requirements for past periods, the Department indicates that the language in the bill should be modified to eliminate the specific references to sales tax collections and quarterly payments. The Department believes that these references would limit the scope of the agreement.

Additional Statutory Provisions

The provision in the budget bill would simply authorize DOR to enter into agreements with direct marketers. The administration indicates that, once an agreement has been reached, additional statutory changes will be necessary to allow out-of-state retailers to collect and remit taxes under the terms of the agreement. These changes could include reduced nexus, reporting and audit requirements for retailers under the agreement and elimination of the sales tax on shipping and handling charges.

Because additional legislation would be required before the agreement could be implemented, it appears that the Legislature would have an opportunity to review the final terms of the agreement before it is put into effect. However, in order to ensure that the agreement is not structured and implemented in a way that is contrary to state tax provisions, the Committee may wish to modify the budget provision to specify that DOR could not implement the agreement if its terms do not conform to state law. The intent of this change would be to clarify that the budget provision authorizing the Department to enter into sales tax agreements would not authorize DOR to implement such an agreement without the necessary statutory modifications.

ALTERNATIVES TO BILL

1. Adopt the Governor's recommendation to authorize the Department of Revenue to enter into agreements with direct marketers about the collection of state and local sales and use taxes and about making quarterly payments of those taxes.

2. Adopt the Governor's recommendation with the following modifications:

a. Remove specific references to tax collections and quarterly payments. This alternative would provide broader authority for DOR to enter into agreements with direct marketers about state and local sales and use taxes.

b. Specify that DOR could not implement any sales and use tax agreement if the terms of the agreement do not conform to state law.

3. Maintain current law.

Alternative 3	GPR
1997-99 REVENUE (Change to Bill)	- $36,100,000

Prepared by: Rob Reinhardt

MO#________________________

BURKE	Y	N	A
DECKER	Y	N	A
GEORGE	Y	N	A
JAUCH	Y	N	A
WINEKE	Y	N	A
SHIBILSKI	Y	N	A
COWLES	Y	N	A
PANZER	Y	N	A

JENSEN	Y	N	A
OURADA	Y	N	A
HARSDORF	Y	N	A
ALBERS	Y	N	A
GARD	Y	N	A
KAUFERT	Y	N	A
LINTON	Y	N	A
COGGS	Y	N	A

AYE _____ NO _____ ABS _____

To: Joint Committee on Finance

From: Bob Lang, Director
Legislative Fiscal Bureau

ISSUE

Sales Tax on Interstate Telecommunications That Terminate in This State

[LFB Summary: Page 22, #4]

CURRENT LAW

Under current law, the sales tax is imposed on telecommunications services that originate in this state and are charged to a service address in this state, regardless of the location where the charge is billed or paid.

"Telecommunications services" means sending messages and information transmitted through the use of local, toll and wide-area telephone service; channel services; telegraph services; teletypewriter; computer exchange services; cellular mobile telecommunications services; specialized mobile radio; stationary two-way radio; paging service; or any other form of mobile and portable one-way or two-way communications; or any other transmission of messages or information by electronic or similar means between or among points by wire, cable, fiber optics, laser, microwave, radio, satellite or similar facilities.

"Telecommunications services" does not include sending collect telecommunications that are received outside the state.

GOVERNOR

Impose the sales tax on telecommunications services that either originate or terminate in this state and are charged to a service address in this state, regardless of the location where the charge is billed or paid. This provision would take effect on the first day of the second month beginning after publication of the bill.

DISCUSSION POINTS

1. The budget bill estimates that the Governor's proposal would generate $3,300,000 in 1997-98 and $4,200,000 in 1998-99. The administration indicates that these figures are incorrect and should be increased to $5,200,000 in the first year and $5,400,000 in the second year. These amounts are higher than the budget estimates by $1,900,000 in 1997-98 and $1,200,000 in 1998-99.

The revised estimate for 1997-98 assumes that a full year of collections would be received in that year. However, the new provision would likely take effect on October 1, 1997 (two months after publication). Therefore, the first year estimate should be reduced to $3,900,000 to account for the delayed effective date.

2. In addition to generating state revenue, the budget provision would provide consistent treatment of interstate telephone calls that are billed to a Wisconsin service address. Under current law, such calls are taxable only if they originate in Wisconsin. Under the bill, the tax would also be imposed on calls that originate elsewhere and terminate in Wisconsin.

3. The bill would impose the sales tax primarily on the following types of telephone services: (a) collect calls to a Wisconsin telephone that originate outside this state; (b) calls to a Wisconsin telephone that originate out-of-state and are charged to a service address in this state through the use of a "calling card" or other means; and (c) out-of-state calls to toll-free "800" and "888" numbers in this state.

4. The administration indicates that its intent was to not impose the sales tax on out-of-state phone calls to toll-free numbers in this state. As drafted, such calls would be taxable. Therefore, the administration has proposed a modification to exclude telecommunications services that are obtained by means of a toll-free number, that originate outside this state and that terminate in this state. The fiscal estimates outlined above assume that the tax would not be applied to these phone calls. If they were included, the fiscal estimate would increase by $2,400,000 in 1997-98 and $3,300,000 in 1998-99, assuming an effective date of October 1, 1997.

The administration cites two arguments for its proposal to continue to exempt out-of-state calls to Wisconsin toll-free numbers from taxation. First, it is argued that the exemption is desirable on equity grounds, because calls from Wisconsin residents to toll-free numbers in other states are typically not taxed by the other state. It should be noted, however, that toll-free calls that both originate and terminate in Wisconsin are currently taxable, and would continue to be taxable under the Governor's proposal. Therefore, as under current law, there would be differential treatment of toll-free calls that terminate in this state: the sales tax would be imposed on calls that originate in Wisconsin, but not on calls that originate out-of-state. It can be argued that this situation would also be inequitable. This could be addressed by also providing an exemption for intrastate toll-free calls to Wisconsin locations. However, such an exemption would reduce sales tax revenues by an estimated $3,600,000 in 1997-98 and $5,000,000 in 1998-99.

The second argument in favor of the exemption is that imposing the sales tax on out-of-state calls to toll-free numbers in Wisconsin would place Wisconsin businesses at a competitive disadvantage compared to businesses in other states that do not tax toll-free telephone services. This could be especially significant for firms, such as direct marketers, that make extensive use of toll-free telephone services. As outlined below, most states do not impose sales or excise taxes on interstate telecommunications.

5. The administration also believes that the bill should be modified to allow a credit for taxes paid in the state where the phone call originated. The intent of this provision is to prevent more than one state from imposing the sales tax on the same telephone call and to ensure that the budget provision does not violate constitutional protections regarding interstate commerce. A 1989 U.S. Supreme Court decision (Goldberg v. Sweet) upheld a 5% excise tax imposed by Illinois on interstate telecommunications services, in part, because the Illinois statute avoided the risk of double taxation by providing a credit for taxes paid on services originating in other states. The administration has suggested language that would permit the person remitting the tax (typically the telephone company) to "reduce the amount remitted to this state by an amount equal to the similar tax properly paid to another state on such services or the amount due on services to this state, whichever is less."

Several points should be noted regarding the proposed tax credit:

• The Legislative Reference Bureau (LRB) attorney who drafted the budget provision believes that the credit is not necessary because, under Wisconsin law, the telecommunications services would only be taxed if the charge is billed to a service address in this state. Therefore, it is unlikely that other states would attempt to tax such calls, or even be aware that they occurred. The LRB attorney also indicates that the proposed credit could result in unnecessary administrative efforts to deal with invalid claims. However, it is possible that double taxation could occur if another state attempted to impose a sales or excise tax on interstate calls that are charged to a billing address in that state and to a service address located in Wisconsin. As described below, it appears that no state currently imposes the tax in this manner. Like Wisconsin, the other states that tax interstate telecommunications impose the tax on services that are charged to a service address in the state, regardless of the location where the charge is billed or paid.

• State law currently provides a credit from the use tax for taxes paid to other states. Therefore, it appears that the concern about double taxation raised by the administration may already be addressed under present law. However, the Department points out that the existing credit only applies to the use tax, and that the proposed credit would apply to both the sales and use taxes.

• The proposed credit would allow the telephone company remitting the tax to reduce the amount paid to Wisconsin by an amount equal to any similar tax imposed by another state, but would not specifically require the telephone company to refund the tax back to the Wisconsin customer.

Based on this information, it is difficult to determine whether the proposed credit is necessary. However, in the Goldberg decision, the U.S. Supreme Court specifically cited the Illinois credit as a factor in upholding the constitutionality of that state's tax. Further, it is not clear whether the current use tax credit would be adequate to ensure that the proposed Wisconsin tax would be constitutional. Therefore, the Committee may wish to adopt the proposed credit. If it is determined that the credit should be adopted, the administration's proposal could be modified to require any telephone company or other person receiving the credit to refund the sales tax back to the customer who paid the tax. A similar requirement currently applies to refunds of sales tax to sellers.

6. Most other states do not impose the sales tax on interstate telecommunications services. According to an August, 1996, report by the New York Department of Taxation and Finance, 21 of the 45 states that impose a general sales tax, impose the tax on interstate telephone services.

In addition, a telephone survey of 20 large states conducted in April, 1997, by the Legislative Fiscal Bureau indicates that nine of the states surveyed impose the sales tax on interstate telecommunications. Seven of these states (Florida, Illinois, Massachusetts, Michigan, New Jersey, Ohio and Pennsylvania) impose the tax on services that originate or terminate in the state and are billed to a service address within the state, as under the budget provision. The other two states (Minnesota and Texas) only impose the tax on services that originate in the state and are billed to a service address within the state, as under current law in Wisconsin. Michigan and Ohio provide an exemption for toll-free services; the other seven states that impose the tax on interstate telecommunications do not exempt toll-free services. The remaining 11 states surveyed (California, Colorado, Georgia, Indiana, Iowa, Maine, Maryland, Missouri, New York, North Carolina and Virginia) do not tax interstate telecommunication services.

ALTERNATIVES TO BILL

A. Taxation of Interstate Telecommunications Services

1. Adopt the Governor's recommendation to impose the sales tax on telecommunications services that either originate or terminate in this state and are charged to a service address in this state, regardless of the location where the charge is billed or paid, with a modification to exclude telecommunications services that are obtained by means of a toll-free number, that originate outside this state and that terminate in this state

Reestimate the fiscal effect to be $3,900,000 in 1997-98 and $5,400,000 in 1998-99 to account for the administration's revised estimates and the delayed effective date. These amounts exceed the estimates used in the bill by $600,000 in the first year and $1,200,000 in the second year.

Alternative 1	GPR
1997-99 REVENUE (Change to Bill)	$1,800,000

2. Adopt the Governor's recommendation, as drafted in the bill. This option is the same as Alternative 1 except that toll-free calls that originate outside Wisconsin and terminate in this state would be subject to tax. Compared to current law, this alternative would increase sales tax revenues by an estimated $6,300,000 in 1997-98 and $8,700,000 in 1998-99. These amounts are higher than the estimates used in the bill by $3,000,000 in the first year and $4,500,000 in the second year.

Alternative 2	GPR
1997-99 REVENUE (Change to Bill)	$7,500,000

3. Adopt the Governor's recommendation with a modification to exclude telecommunications services that are obtained by means of a toll-free number and that terminate in this state, regardless of where the services originate. This option is the same as Alternative 1 except that intrastate toll-free calls would no longer be subject to the sales tax.

Compared to current law, this alternative would increase sales tax revenues by an estimated $300,000 in 1997-98 and $400,000 in 1998-99. These amounts are lower than the estimates used in the bill by $3,000,000 in the first year and $3,800,000 in the second year.

Alternative 3	GPR
1997-99 REVENUE (Change to Bill)	- $6,800,000

4. Maintain current law.

Alternative 4	GPR
1997-99 REVENUE (Change to Bill)	- $7,500,000

B. Credit for Taxes Paid to Other States (These options are relevant if Alternative 1, 2 or 3 above is adopted)

1. Provide a credit for sales taxes properly paid to another state on interstate telecommunications services and require any person claiming the credit to refund the sales tax back to the customer who paid the tax.

2. Do not provide the credit.

Prepared by: Rob Reinhardt

MO#________________

BURKE	Y	N	A
DECKER	Y	N	A
GEORGE	Y	N	A
JAUCH	Y	N	A
WINEKE	Y	N	A
SHIBILSKI	Y	N	A
COWLES	Y	N	A
PANZER	Y	N	A
JENSEN	Y	N	A
OURADA	Y	N	A
HARSDORF	Y	N	A
ALBERS	Y	N	A
GARD	Y	N	A
KAUFERT	Y	N	A
LINTON	Y	N	A
COGGS	Y	N	A

AYE ____ NO ____ ABS ____

To: Joint Committee on Finance

From: Bob Lang, Director
Legislative Fiscal Bureau

ISSUE

Sales Tax on Coin-Operated Laundries (General Fund Taxes)

[LFB Summary: Page 22, #5]

CURRENT LAW

Under current law, the sales tax is imposed on laundry, dry cleaning, pressing and dyeing services, except when the service is performed: (a) on raw materials or goods in process destined for sale; (b) on cloth diapers by a diaper service; or (c) by the customer through the use of coin-operated, self-service machines. The Department of Revenue (DOR) has interpreted this provision to mean that coin-operated laundry services are not taxable, but laundry services purchased with a token or other non-coin method of payment are subject to tax. This interpretation has been upheld by the Tax Appeals Commission and the Eau Claire County Circuit Court.

GOVERNOR

Impose the sales tax on laundry, dry cleaning, pressing and dyeing services performed by the customer through the use of coin-operated, self-service machines. This provision would take effect on the first day of the second month beginning after publication of the bill.

DISCUSSION POINTS

1. The budget provision would make the tax treatment of coin-operated laundry services comparable to the taxation of professional laundry and dry cleaning services and laundry services purchased with a token or other non-coin method of payment.

2. The budget bill estimated that the Governor's recommendation would generate \$2,300,000 in 1997-98 and \$2,800,000 in 1998-99. The administration indicates that these estimates should be revised to \$2,200,000 in the first year and \$2,300,000 in the second year.

Two offsetting adjustments should be made to these estimates. First, the \$2,200,000 amount for 1997-98 is based on a full year of collections. However, the budget provision would likely take effect on October 1, 1997 (two months after publication). Therefore, the first year estimate should be reduced to \$1,700,000 to reflect the delayed starting date.

In addition, the estimates were based on receipts of commercial coin-operated laundry services. However, the budget provision would also impose the tax on coin-operated washers and dryers located in apartment buildings and other residences. Although it is difficult to estimate the amount of tax that would be collected on these machines because the number of apartment buildings providing such services is not known and it is possible that noncompliance would be significant, the fiscal estimates could be increased to \$2,000,000 in 1997-98 and \$2,500,000 in 1998-99 to account for this factor.

3. It has been suggested that the Governor's proposal would be regressive, because lower-income individuals and families are more likely to rent their homes and use coin-operated laundry services than persons with higher income levels. This is demonstrated by the following data, which shows the distribution, by adjusted gross income level, of state individual income taxpayers who claimed a property tax credit or rent credit in 1995.

		Count	% of Total
Less Than \$20,000	Rent Credit Only	314,650	54.9%
	Property Tax Credit Only	243,988	42.6
	Both	14,699	2.6
	Total	573,337	100.0%
\$20,000 to \$50,000	Rent Credit Only	241,163	34.4%
	Property Tax Credit Only	432,195	61.7
	Both	27,021	3.9
	Total	700,379	100.0%
\$50,000 to \$100,000	Rent Credit Only	29,645	8.0%
	Property Tax Credit Only	332,001	89.5
	Both	9,190	2.5
	Total	370,836	100.0%
\$100,000 or more	Rent Credit Only	1,714	2.6%
	Property Tax Credit Only	64,283	96.4
	Both	678	1.0
	Total	66,675	100.0%

As this data shows, taxpayers at lower income levels were much more likely to be renters than were higher-income taxpayers. This information is from aggregate income tax data for 1995, and does not include Wisconsin residents who were not required to file a tax return because their income level was below the filing requirement. It is likely that most of these families rent rather than own their homes.

On the other hand, it can be argued that the impact of the Governor's recommendation on individual families would be relatively insignificant because expenditures for coin-operated laundry services are small compared to expenditures for other items such as rent, food, clothing and transportation. For example, if a family spends $10 per week on coin-operated laundry services, they would pay about $29 annually (55 cents per week) in additional state and county sales taxes under the Governor's recommendation. The impact on relatively large families who spend more on laundry services would be more significant. The impact would be less significant for families and single individuals that spend less than $10 per week.

4. As noted, under the current statute, laundry services purchased with a token or other non-coin method of payment are subject to tax. It can be argued that such services are essentially the same as coin-operated laundry services. Therefore, the current provision could be amended to specify that all laundry services performed by the customer through the use of self-service machines (not just coin-operated) would be exempt from tax. Compared to current law, this modification would reduce sales tax collections by an estimated $100,000 annually.

ALTERNATIVES TO BILL

1. Adopt the Governor's recommendation to impose the sales tax on laundry, dry cleaning, pressing and dyeing services performed by the customer through the use of coin-operated, self-service machines. Reestimate the fiscal effect of the provision to be $2,000,000 in 1997-98 and $2,500,000 in 1998-99. These amounts are lower than the estimates used in the bill by $300,000 in each year.

Alternative 1	GPR
1997-99 REVENUE (Change to Bill)	- $600,000

2. Delete the Governor's recommendation and, instead, modify current law to specify that all laundry services performed by the customer through the use of self-service machines (not just coin-operated) would be exempt from the sales tax. Compared to current law, this option would reduce sales tax collections by an estimated $100,000 annually, which would be a reduction of $2,400,000 in 1997-98 and $2,900,000 in 1998-99 from the amounts included in the bill.

Alternative 2	GPR
1997-99 REVENUE (Change to Bill)	- $5,300,000

3. Maintain current law.

Alternative 3	**GPR**
1997-99 REVENUE (Change to Bill)	- $5,100,000

Prepared by: Rob Reinhardt

MO#________________

BURKE	Y	N	A
DECKER	Y	N	A
GEORGE	Y	N	A
JAUCH	Y	N	A
WINEKE	Y	N	A
SHIBILSKI	Y	N	A
COWLES	Y	N	A
PANZER	Y	N	A
JENSEN	Y	N	A
OURADA	Y	N	A
HARSDORF	Y	N	A
ALBERS	Y	N	A
GARD	Y	N	A
KAUFERT	Y	N	A
LINTON	Y	N	A
COGGS	Y	N	A

AYE _____ NO _____ ABS _____

To: Joint Committee on Finance

From: Bob Lang, Director
Legislative Fiscal Bureau

ISSUE

Sales Tax on Telephone Answering Services (General Fund Taxes)

[LFB Summary: Page 23, #6]

CURRENT LAW

The sales tax is imposed on certain mechanical or electronic telephone answering services as telecommunications services if the service originates in this state and is charged to a service address in this state. Nonmechanical telephone answering services are not taxable.

GOVERNOR

Impose the sales and use tax on telephone answering services that consist of: (a) taking messages by telephone and transferring them to the purchaser of the service or at the purchaser's direction, but not including such services if they are an incidental element of another service that is sold to the purchaser; and (b) recording messages for a particular person into a central computer data base and activating those messages for that person when the computer is accessed for the messages. This provision would take effect on the first day of the second month beginning after publication of the bill.

DISCUSSION POINTS

1. The provision in the bill which would impose the sales tax on services that consist of taking and transferring telephone messages is similar to an existing statute in the state of New York. Other states typically do not tax telephone answering services.

The provision to impose the tax on services that consist of recording messages for a particular person into a central computer data base and activating those messages when the computer is accessed is intended to clarify the Department's interpretation that current law imposes the sales tax on answering services provided through mechanical or electrical means.

2. The following sections present examples, prepared by the Department of Revenue, of telephone answering services, and how they are treated under current law and would be treated under the budget bill:

• A voice messaging service that provides its customers access to an office message system computer through which a customer can deposit or retrieve telephone messages using a touch-tone telephone is considered a mechanical or electronic voice messaging and telephone answering service that is currently subject to tax as a telecommunications service. Such services would remain taxable under the budget bill.

• A telephone answering service retained by a business to answer incoming telephone calls during periods when employes are not available, take messages and transmit the messages to the business or particular employes would be taxable under current law and under the bill, if these services are performed by mechanical or electronic means. If an employe of the service answers the calls and takes the messages, the service is not currently taxable, but would be subject to tax under the bill.

• A telephone answering service whose employes answer calls to a firm's "800" number, record the comments of callers, and forward them by electronic or other means to the business is not currently taxable but would be subject to tax under the budget bill.

• An answering service that is retained by an individual to answer phone calls to the individual's residence while he or she is away, keep a log of calls received and transmit the log to the customer is not currently taxable, if these services are performed by employes of the answering service rather than through mechanical or electronic means. These services would be subject to tax under the bill.

• An office management service that answers and routes incoming telephone calls as well as providing receptionist, typing, filing, scheduling, bookkeeping and similar services would not be taxable under current law or under the bill, if the telephone answering services are incidental to the other services provided.

• A company that is hired by a mail order retailer to receive phone calls, fill out order forms, verify the availability of merchandise and perform other services relating to handling sales orders is providing a sales processing service that is not taxable under current law and would not be taxable under the budget bill. The telephone answering services would be considered incidental to the other services provided by the company.

• A company whose employes answer a manufacturer's "800" telephone number and respond to the callers' inquiries, but generally do not take and transmit messages to the manufacturer, is providing a service that is not taxable under current law and that would not be a taxable telephone answering service under the bill. The telephone answering would be considered incidental to the primary service of responding to the callers' inquiries.

3. The bill estimates the fiscal effect of this provision to be an increase in sales tax collections of $800,000 in 1997-98 and $1,100,000 in 1998-99. The administration has issued a revised estimate of $700,000 in the first year and $800,000 in the second year. However, based on information in the 1992 Wisconsin Census of Service Industries, it appears that the estimate originally included in the bill is reasonable.

4. It can be argued that the budget provision would increase the progressivity of the sales tax because telephone answering services are purchased primarily by higher-income individuals and businesses. However, any impact on progressivity would be minimal because such purchases would represent less than 0.04% of taxable goods and services.

5. DOR has identified several concerns regarding the provisions of the bill, as currently drafted. First, the Department suggests that the language should be changed to apply the tax to services that consist of "recording telecommunications messages" rather than "taking messages by telephone." In addition, DOR recommends deleting the second part of the budget provision (which would impose the tax on services that consist of recording messages for a particular person into a central computer data base and activating those messages for that person when the computer is accessed for the messages). These changes are intended to ensure that all currently taxable mechanical and electronic answering services remain subject to tax. For example, the phrase "taking messages by telephone" could potentially exclude from tax taking messages with some other device, such as a computer. The phrase "recording telephone messages" is broader and would include such services.

The Department also indicates that the bill should be modified to specify that the exclusion for services that are incidental to another service would apply only if the other service is not taxable. The intent of this change is to assure that all currently taxable services remain taxable. The Department also believes that a cross reference should be added to the bill to clarify that the current definition of "incidental" under the sales tax statutes would apply to this provision.

Finally, DOR notes that the language currently in the bill and the language that would result from the revisions outlined above could be interpreted to impose the sales tax on certain types of burglar alarm services and similar security monitoring services. It was not the administration's intent to impose the tax on these services, and the fiscal estimates used in the bill do not include such services. Therefore, the bill could be modified to specifically exclude burglar alarm and security services from taxation. If this modification is not adopted, the fiscal effect would increase by an estimated $1,100,000 in 1997-98 and $1,500,000 in 1998-99.

ALTERNATIVES TO BILL

1. Adopt the Governor's recommendation to impose the sales and use tax on telephone answering services with a modification to specify that burglar alarm and similar security monitoring services would not be taxable. It is estimated that this provision would increase general fund revenues by $800,000 in 1997-98 and $1,100,000 in 1998-99.

2. Adopt the Governor's recommendation with modifications to: (a) impose the sales tax on services that consist of "recording telecommunications messages" rather than "taking messages by telephone"; (b) delete the portion of the bill that would impose the tax on services that consist of recording messages for a particular person into a central computer data base and activating those messages for that person when the computer is accessed for the messages; (c) specify that the exclusion for services that are incidental to another service would apply only if the other service is not taxable; (d) provide a cross reference to clarify that the current definition of "incidental" under the sales tax statutes would apply to this provision; and (e) specify that burglar alarm and similar security monitoring services would not be taxable. This option would have the same fiscal effect as Alternative 1.

3. Adopt the Governor's recommendation with modifications to: (a) impose the sales tax on services that consist of "recording telecommunications messages" rather than "taking messages by telephone"; (b) delete the portion of the bill that would impose the tax on services that consist of recording messages for a particular person into a central computer data base and activating those messages for that person when the computer is accessed for the messages; (c) specify that the exclusion for services that are incidental to another service would apply only if the other service is not taxable; and (d) provide a cross reference to clarify that the current definition of "incidental" under the sales tax statutes would apply to this provision. This alternative is the same as Alternative 2, except that a specific exclusion for burglar alarm and security monitoring services would not be provided. This option would increase revenues by $1,100,000 in 1997-98 and $1,500,000 in 1998-99.

Alternative 3	GPR
1997-99 REVENUE (Change to Bill)	$2,600,000

4. Maintain current law.

Alternative 4	GPR
1997-99 REVENUE (Change to Bill)	- $1,900,000

Prepared by: Rob Reinhardt

MO#______________________

BURKE	Y	N	A
DECKER	Y	N	A
GEORGE	Y	N	A
JAUCH	Y	N	A
WINEKE	Y	N	A
SHIBILSKI	Y	N	A
COWLES	Y	N	A
PANZER	Y	N	A
JENSEN	Y	N	A
OURADA	Y	N	A
HARSDORF	Y	N	A
ALBERS	Y	N	A
GARD	Y	N	A
KAUFERT	Y	N	A
LINTON	Y	N	A
COGGS	Y	N	A

AYE _____ NO _____ ABS _____

To: Joint Committee on Finance

From: Bob Lang, Director
Legislative Fiscal Bureau

ISSUE

Sales Tax on Fabricated Building Units and Manufactured Buildings (General Fund Taxes)

[LFB Summary: Page 23, #7]

CURRENT LAW

Under current law, real property construction is not subject to the sales tax. However, building contractors and subcontractors are considered the consumers of tangible personal property used by them in real property construction activities, and the sales tax applies to the sale of tangible personal property to them.

"Real property construction activities" include the fabrication of modular units if all of the following apply:

a. The units are designed and fabricated for a specific prefabricated building.

b. The prefabricated building is to be affixed to land at a particular location designated by the purchaser before the fabrication of the modules.

c. The modular units will have a realty function and will become a permanent accession to the realty.

If these criteria are met, the fabrication of such units is considered a real property construction activity, and sales of such modular units are considered nontaxable sales of real property. The fabricators of such units must pay sales tax on supplies and materials that become part of these units when fabricated in Wisconsin.

Building materials that are not designed and fabricated for a specific prefabricated building which will be erected at a specific, predetermined location are considered tangible personal property, and the final sales of such items are subject to sales tax.

GOVERNOR

Definition of Real Property Construction Activities

Delete the current definition of "real property construction activities" and, instead, define real property construction activities as activities that occur at a site where tangible personal property that is applied or adapted to the use or purpose to which real property is devoted is affixed to that real property, if the intent of the person who affixes that property is to make a permanent accession to the real property. Specify that "real property construction activities" would not include affixing to real property tangible personal property that remains tangible personal property after it is affixed.

Sales Tax on Certain Manufactured Buildings

Allow retailers of manufactured buildings to exclude a portion of the gross receipts and sales price of such buildings from the sales tax. Specifically, the retailer would have the option to exclude either: (a) 35% of the gross receipts or sales price; or (b) an amount equal to the gross receipts or sales price minus the cost of the materials that become an ingredient or component part of the building (this is approximately equivalent to an exclusion for labor and overhead costs). Once a retailer chooses one of these options, the retailer could not use the other option for other sales without written approval from the Department of Revenue (DOR).

"Manufactured building" would mean any structure or component thereof which is intended for use as a dwelling and: (a) is of closed construction and fabricated or assembled on-site or off-site in manufacturing facilities for installation, connection, or assembly and installation, at the building site; or (b) is a building of open construction which is made or assembled in manufacturing facilities away from the building site for installation, connection, or assembly and installation, on the building site and for which certification is sought by the manufacturer.

"Manufactured building" would not include a mobile home or a manufactured home which is built on a permanent chassis, as defined under provisions relating to the regulation of buildings and safety. Current law provides a 35% sales tax exclusion for new sales of these items if they are used as a primary residence.

These provisions would take effect on the first day of the second month beginning after publication of the bill, and would first apply to sales of property pursuant to contracts entered into on that date.

INTENT OF GOVERNOR'S RECOMMENDATIONS

Taxation of Property Used in Fabricating Modular Building Units

The intent of the Governor's recommendation regarding the definition of real property construction activities is to reverse a 1979 Wisconsin Supreme Court decision (Wisconsin Department of Revenue v. Sterling Custom Homes Corporation) which determined that the fabrication of modular units and modular homes by a fabricator for a specific building site was a real property construction activity, even though the units or homes were constructed in a factory and sold to a dealer who then erected the units or homes on the building site.

The Court's decision in the Sterling Homes case was based on several findings including: (a) Sterling used materials it purchased to construct custom-designed houses to be assembled at predetermined locations on foundations which were specifically designed for its prefabricated components; (b) Sterling's employes, like ordinary builders, were generally members of the Carpenters and Joiners Union; and (c) Sterling was substantially involved in the on-site erection process. Therefore, the Court ruled that Sterling Homes was engaged in real property construction activities, even though most of these activities occurred at its factory rather than at the building site.

The current definition of real property construction was enacted in 1991 Wisconsin Act 39 (the 1991-93 biennial budget) to make the statutes conform to the Department's treatment of such sales following the Sterling decision.

The Governor's recommendation is intended to, instead, treat modular units and homes as tangible personal property when they are sold from a fabricator to a dealer. As a result, the sale of the units in Wisconsin from the fabricator to the dealer would be subject to sales tax, and the purchase by the fabricator of materials and supplies that become part of the units would be exempt from tax as a sale for resale. The Governor's recommendation is consistent with DOR's interpretation of the statute prior to the Sterling Homes decision.

As under current law, if the fabricator erects the modules into a building at a location in Wisconsin, instead of first selling the modules to a dealer, the transaction would be considered a real property construction activity, and would not be subject to sales tax. In such cases, the fabricator would be required to pay sales tax on its purchases of materials used in the fabrication process.

Sales Tax on Final Sales of Manufactured Buildings

The Governor's recommendation to permit retailers of certain manufactured buildings to exclude 35% of the sales price or the share of sales price represented by labor and overhead costs is similar to the current statute which excludes 35% of the price of new, primary-housing mobile homes (including manufactured homes which are built on a permanent chassis) from gross receipts and sales price subject to the sales tax. This provision is intended to treat manufactured dwellings similarly to sales of other homes in that the cost of materials used in constructing or fabricating the buildings would be subject to sales tax, but the cost of labor and overhead would not be taxable.

The optional exclusion would not apply to manufactured buildings, modules or fabricated structural components that are not for dwellings. The apparent rationale for limiting the exclusion to residential buildings is to limit the state revenue loss associated with this provision.

IMPACT ON BUILDING FABRICATORS

Prefabricated Homes

Manufacturers of modular homes in Wisconsin would generally benefit from the Governor's proposal. As outlined below, these entities would pay approximately the same amount of sales tax on units that are sold and erected in Wisconsin. However, because they would no longer be required to pay tax on their purchases of materials for units sold to dealers in other states, Wisconsin fabricators would pay less overall taxes under the budget provision.

Out-of-state fabricators would pay additional taxes to Wisconsin, because sales of building units to dealers in this state would become taxable. As under current law, the state would not collect sales tax on their purchases of materials because these transactions would occur in the other state.

Fabricated Building Materials

Wisconsin sellers of fabricated building materials for structures that are not dwellings would pay additional taxes on their Wisconsin sales. Under DOR's current interpretation of the statutes, these sales are considered exempt real property construction activities; therefore, the sales tax is imposed on the manufacturer's purchases. Under the budget bill, the final sales in Wisconsin would be taxed rather than the purchases of inputs. The optional deduction for labor and overhead costs would not apply to these sales because that provision would only be available for buildings that are dwellings. However, these in-state firms would pay reduced taxes on their out-of-state sales, because the Wisconsin sales tax would no longer be imposed on their purchases of materials.

Out-of-state sellers of fabricated building materials for nonresidential buildings would also pay additional taxes on their Wisconsin sales, because the transaction would be taxed as a sale of tangible personal property rather than treated as a nontaxable real construction activity.

FISCAL EFFECT

For modular homes, the effect of the Governor's proposal on state revenues would differ depending upon where the manufacturing takes place, who affixes the modular home to real property and the site where the modular home will be affixed:

• In cases where the home is manufactured in Wisconsin and sold to a dealer for placement at a site in Wisconsin, the proposal would be approximately revenue-neutral. The state would impose the sales tax on the sale of the home from the manufacturer to the dealer, less the exclusion for labor and overhead. This would be approximately equal to the amount of tax currently collected on the manufacturer's purchases of materials.

• In cases where the home is manufactured in Wisconsin and sold to a dealer in another state for placement at a site in that state, the state would lose revenue, because tax would no longer be collected on the manufacturer's purchases of materials. As under current law, Wisconsin would not collect tax on the sale occurring in the other sate.

• In cases where the home is manufactured in Wisconsin and affixed by the manufacturer at a Wisconsin site, there would be no change. Under both current law and the Governor's recommendation, the sale by the manufacturer to the customer would be a real property construction activity, which is not subject to tax. The manufacturer would pay sales tax on its purchases of material.

• In cases where the home is manufactured in another state and affixed by the manufacturer at a site in Wisconsin, the state could have a revenue gain, because the manufacturer would be subject to Wisconsin use tax on its purchases of materials. The manufacturer is the consumer of materials (the modular home) it stores in Wisconsin and uses in real property construction activities in Wisconsin. However, state law allows a credit for state and local taxes properly paid on the materials in the other state. Therefore, depending on the laws of the state where the manufacturer is located, any revenue gain could be offset by taxes paid on the manufacturer's purchases in the other state.

• In cases where the home is manufactured in another state and sold in Wisconsin to a dealer to be affixed at a Wisconsin site, the state would gain revenue because the sale by the manufacturer to the dealer would become taxable. However, the revenue increase would be partially offset by the optional exclusion for labor and overhead costs.

For manufacturers of fabricated structural materials and prefabricated buildings that are not dwellings, the budget provision would have similar effects, except that no exclusion would be provided for labor and overhead expenses. Therefore, the state would receive additional taxes on sales of these items from the manufacturer to the dealer.

The bill estimated that the Governor's proposal would reduce sales tax collections by $700,000 in 1997-98 and $900,000 in 1998-99. However, the administration indicates that the original estimates should be revised because they did not account for fabricated structural materials. In addition, an assumption regarding the materials cost for prefabricated buildings was modified. The revised estimate is a revenue loss of $1,100,000 in 1997-98 and $1,130,000 in 1998-99.

The Department's revised estimate for 1997-98 includes a full year of collections; however, the budget provisions probably would not take effect until October 1, 1997 (two months after publication). Therefore, the first year estimate should be reduced to $830,000 to account for the delayed effective date. The following table outlines the components of the revised fiscal estimates. The figures for fabricated structural materials are based on an ongoing audit by DOR; therefore, the Department did not provide detailed information regarding how the estimates were calculated.

**Estimated Fiscal Effect of Budget Provisions Regarding
Sales Tax on Prefabricated Buildings
($ in Millions)**

	1997-98	1998-99
Prefabricated Modular Homes		
Revenue gain from imposing tax on final sales	$0.690	$0.950
Revenue loss from optional exclusion for labor and overhead	-0.380	-0.520
Revenue loss from not imposing tax on purchases of materials by Wisconsin firms	-0.920	- 1.270
Net revenue loss	-$0.610	- $0.840
Fabricated Structural Materials		
Net revenue loss from imposing tax on final sales and not imposing tax on purchases of materials by Wisconsin firms	- 0.220	- 0.290
Total Revenue Loss	-$0.830	-$1.130

POLICY ARGUMENTS

The administration maintains that the Governor's proposal would provide for more equitable treatment of Wisconsin home manufacturers compared to out-of-state fabricators. In addition, the proposed statute would be easier to administer than current law.

Under current law in Wisconsin, the sales tax is not imposed on sales of manufactured homes to Wisconsin dealers. Instead, the tax is imposed on purchases of materials by building fabricators located in Wisconsin. According to a survey by DOR, the opposite treatment is provided in most other states (including Illinois, Iowa, Michigan and Minnesota). That is, the tax is imposed on the sale of the manufactured home to the dealer, and the manufacturer's purchases of inputs are exempt from tax as sales for resale. It is argued that this situation results in a competitive advantage for out-of-state building fabricators compared to in-state firms.

This occurs because, on sales to Wisconsin dealers, neither in-state nor out-of-state building manufacturers are currently required to collect the sales tax on the sale to the dealer. However, Wisconsin manufacturers must pay tax on their purchases of materials, while the sales tax is typically not imposed on purchases by fabricators located in other states. Under the bill, the sales tax (less the optional exclusion for labor and overhead costs on sales of dwellings) would be imposed on sales to Wisconsin dealers by both in-state and out-of-state fabricators, and the tax would no longer be imposed on purchases of inputs by Wisconsin firms.

A similar situation may exist for sales to dealers in other states. Under current law, Wisconsin fabricators must pay sales tax in this state on their purchases of materials. In addition, the other state's sales tax is typically imposed on the final sale to the dealer in the other state (in Iowa, a 40% exclusion is provided; in the other surrounding states, the full sales price to the dealer is taxable). Therefore, the Wisconsin firm is taxed twice on the same building. However, fabricators located in the other state are only taxed on the sale to the dealer, and are not required to pay tax on their purchases of materials. Under the bill, for these types of transactions, the Wisconsin sales tax would no longer be imposed on the Wisconsin firm's purchases of materials, and the double taxation would be eliminated.

The administration believes that the proposed statute would be easier to administer, because, under current law, it can be difficult to determine whether a specific manufacturing firm is engaged in real property construction or in sales of tangible personal property. Further, for individual companies, there are tax advantages in being taxed as a construction contractor or as a retailer of tangible personal property, depending upon the amount of sales occurring in other states. Therefore, disputes may arise over which treatment should be applicable to a specific manufacturer. The administration believes that the proposed language would clarify the treatment of these transactions, because building activities would have to occur on-site in order to be considered real property construction.

The primary argument for maintaining the current provision is that the fabrication of modular building units in a factory is essentially the same as constructing these items at a building site. Therefore, it can be argued that these activities should be treated as real property construction, as under the Sterling Homes decision and the current statute. As noted, however, the Governor's recommendation would result in a similar tax treatment for on-site construction and prefabricated homes, because of the optional exclusion for labor and overhead expenses.

EFFECTIVE DATE OF THE BUDGET PROVISION

Concern has been expressed regarding a potential audit of a manufacturer of prefabricated metal building materials which has a plant located in Wisconsin and sells much of its products out-of-state. The Department of Revenue has taken the position, based on the current statute and the Sterling Homes decision, that this firm is engaged in real property construction. Therefore, the final sales of its products are exempt from the sales tax, but its purchases of materials are taxable.

This is a departure from the way the firm has been paying sales tax. [Under administrative rules for the sales tax, contractors determine, based on specified criteria, whether a particular contract or transaction results in an improvement to real property or in the sale and installation of personal property.] Based on its belief that it is a seller of tangible personal property rather than a construction contractor, the firm has been charging sales tax on its final sales in Wisconsin and remitting the tax to DOR, but has not been paying tax on its purchases of materials used in fabricating the final products.

Based on DOR's position for 1990 through 1993, the Department would refund the sales tax collected by Wisconsin on the company's final sales in this state and the manufacturer would be assessed a use tax liability on its purchases of materials during that period. From January 1, 1990, through September 30, 1991, the use tax assessment would only apply to materials used in buildings located in Wisconsin. For October 1, 1991, through the end of 1993, the use tax would be assessed on all purchases of materials. Because the company has a plant in Wisconsin and sells much of its output in other states, this arrangement would result in a net loss of several million dollars to the company.

The budget provision would address this firm's situation prospectively. However, the company would still owe tax under the Department's position for the period dating from 1990 through the late summer or fall of 1997. [The current audit period covers four years, 1990 through 1993. In addition, the period from 1994 through the date of the budget provision is still open for assessment.]

The company has suggested that the bill be modified to "clearly state that the metal building materials manufacturing industry is, and always has been, subject to the sales tax, and that the DOR position is not a correct interpretation of Legislative intent." It appears that this proposed language is intended to preclude DOR from proceeding with the assessment against the firm. A similar result could be attained by making the recommended change to the definition of real property construction activities retroactive to January 1, 1990, for manufacturers of prefabricated metal building materials. Under this option, the effective date currently in the bill (two months after publication) would be retained for other types of building fabricators and for the provision allowing an optional exclusion for costs of labor and overhead.

The company believes that the Department's current interpretation of the Sterling Homes decision and the statutes is incorrect because its activities differ from those of other fabricators of buildings. The company indicates that its products typically account for about 20% of a finished building, in contrast to manufactured home builders which construct the material for the entire home (other than mechanicals such as plumbing, wiring, heating and drywall) and ship the homes ready to be placed together and erected to form the building. The firm also indicates that builders often must alter its products (sizing or cutting out windows, for example) before they can be pieced together to form part of a building. The company further argues that, unlike the manufactured home industry, it provides almost no oversight or other involvement once its products have been shipped to the customer.

The Department indicates that the firm's activities often account for significantly more than 20% of the finished structure. In addition, DOR believes that the most important factor in determining whether the Sterling Homes decision should apply in cases such as this is the fact that the company's products are fabricated for a specific building at a predetermined location for a specific customer. According to DOR, the firm does not produce generic construction materials that are held in inventory for sales to multiple customers. Therefore, the Department believes that the company's activities should be treated as real property construction rather than sales of tangible personal property.

The company also maintains that it is the largest manufacturer of these types of metal building materials in this state and that Wisconsin is a net importer of these products. Therefore, the Department's current interpretation could result in the state being liable to similar companies for refunds of taxes previously collected on the final sales of these products in Wisconsin. However, because most of these other firms are not located in Wisconsin, DOR could not assess the use tax on their purchases of materials. This could put the Wisconsin firm at a competitive disadvantage and result in a net loss to the state when all other companies are considered

DOR agrees that its interpretation could place the Wisconsin company at a disadvantage compared to out-of-state firms. However, the Department believes that its position in this case is the correct interpretation of the existing statutes and case law. The Department also agrees that similar out-of-state companies could apply for refunds, although it appears that none have done so at this time. However, it is unclear whether making the budget provision retroactive could prevent this from occurring. The retroactive effective date would clearly benefit the Wisconsin firm, but may or may not prevent a loss of state revenues on refunds to similar firms in other states.

Other Wisconsin firms that have significant sales in other states may also pay higher taxes under the Sterling Homes case and the current statutory provision. Therefore, if the budget change were made retroactive, some of these firms could potentially file for refunds.

Two other points should be noted. First, it can be argued that it would be inappropriate to retroactively modify an existing statute in order to affect the outcome of an administrative action by DOR. However, there is precedent for retroactive changes to state tax laws. For example, under 1989 Wisconsin Act 336, a modification regarding the sales tax nexus provisions for out-of-state publishers was adopted with a January 1, 1980, effective date for publishers of books and periodicals other than catalogues and a January 1, 1990, effective date for all other publishers. Second, at this point, the Department has not audited the Wisconsin firm's records or issued a determination of tax due. If that occurs, several levels of appeal are available to the company, the first of which is to file for a redetermination by DOR of the amount due. If that does not result in an outcome that is acceptable to the company, the firm may file for appeal with the Tax Appeals Commission and then with the circuit court.

ALTERNATIVES TO BILL

1. Adopt the Governor's recommendation to modify the definition of real property construction activities and to allow retailers of certain manufactured buildings to exclude a portion of the gross receipts and sales price of such buildings from the sales tax. Specifically, the retailer would have the option to exclude either: (a) 35% of the gross receipts or sales price; or (b) an amount equal to the gross receipts or sales price minus the cost of the materials that become an ingredient or component part of the building.

In addition, reestimate the fiscal effect to be a revenue loss of $830,000 in 1997-98 and $1,130,000 in 1998-99. These amounts exceed the decrease estimated in the bill by $130,000 in the first year and $230,000 in the second year.

Alternative 1	GPR
1997-99 REVENUE (Change to Bill)	- $360,000

2. Adopt the Governor's recommendation with a modification to make the provision regarding the definition of real property construction activities retroactive to January 1, 1990, for manufacturers of prefabricated metal building materials. The fiscal effect of this alternative could be significant. However, because the net fiscal impact would depend upon the outcome of a potential audit and whether additional firms apply for refunds of sales tax paid since 1990, a reliable estimate is not possible.

3. Maintain current law.

Alternative 3	GPR
1997-99 REVENUE (Change to Bill)	$1,600,000

Prepared by: Rob Reinhardt

MO#____________________

BURKE	Y	N	A
DECKER	Y	N	A
GEORGE	Y	N	A
JAUCH	Y	N	A
WINEKE	Y	N	A
SHIBILSKI	Y	N	A
COWLES	Y	N	A
PANZER	Y	N	A
JENSEN	Y	N	A
OURADA	Y	N	A
HARSDORF	Y	N	A
ALBERS	Y	N	A
GARD	Y	N	A
KAUFERT	Y	N	A
LINTON	Y	N	A
COGGS	Y	N	A

AYE _____ NO _____ ABS _____

To: Joint Committee on Finance

From: Bob Lang, Director
Legislative Fiscal Bureau

ISSUE

Sales Tax on University Food Contracts (General Fund Taxes)

CURRENT LAW

Under current law, the sales tax is generally imposed on sales of meals, food, food products and beverages for direct consumption on the premises. However, meals, food, food products and beverages furnished in accordance with any contract or agreement by a public or private institution of higher education are not taxable. The exemption does not apply to beer, other alcoholic beverages, soda and certain other soft drinks.

GOVERNOR

No provision.

DISCUSSION POINTS

1. The exemption for food and beverages sold under university contracts is intended to assist college students in purchasing meals, because students living in dormitories do not have the opportunity to prepare their own meals.

2. The current statutory provision does not limit the exemption to purchases by students, and the Legislative Audit Bureau indicates that UW-Madison and other state universities have made broader use of this provision. For example, at UW-Madison and other state campuses, debit cards may be used by faculty and staff (in addition to students) to purchase tax-free meals at student unions and other campus locations. In addition, the student union at UW-Madison

operates a catering business for events held at Memorial Union, and applies the sales tax exemption to sales of food through this catering business.

Other UW campuses and private colleges have used the exemption for similar purposes and for food contracts with organizations outside the university, such as professional football teams that train on the campuses. Officials for the Wisconsin Technical College System indicate that these schools are currently not making use of the exemption for any sales of meals, food or beverages.

3. It can be argued that, even though they are allowed under current law, the additional uses of the exemption by the UW system campuses and private institutions are contrary to the original intent of the Legislature in creating the exemption. Further, the sales tax exemption could provide a competitive advantage to university catering services over private banquet facilities and catering services.

4. The exemption could be modified to apply only to meals, food, food products and beverages furnished to students who are enrolled at the institution of higher education. This modification would increase sales tax revenues by an estimated $100,000 in 1997-98 and $200,000 in 1998-99. These figures assume an effective date of August 1, 1997, and that the new provision would first apply to contracts entered into on or after that date. The lower fiscal effect in the first year reflects the fact that many of the university food contracts have already been signed. Such a provision would require campuses that currently allow faculty members to purchase food tax-free with debit cards to modify these systems.

5. Another option would be to apply the exemption only to meals, food, food products and beverages furnished for a purpose that is consistent with the institution's educational mission, and to specify that the exemption could not be used for purchases of meals by faculty members. The intent of this alternative would be to allow universities and colleges to make use of the exemption for adult continuing education programs, educational programs for high school students, conferences and other educational services and activities provided to individuals who are not enrolled at the institution. However, the exemption could not be used for meal purchases by faculty members or for other activities that are not related to the institution's educational mission, such as catering weddings or providing meals to professional football teams. This modification would increase sales tax revenues by a minimal amount in 1997-98 and $100,000 in 1998-99. These estimates also assume an effective date of August 1, 1997, and that the new provision would first apply to contracts entered into on or after that date.

ALTERNATIVES TO BILL

1. Modify the current sales tax exemption for meals, food, food products and beverages furnished in accordance with any contract or agreement by a public or private institution of higher education to provide the exemption only if these items are furnished to

students who are enrolled at the institution. Specify that this provision would take effect on the day after publication of the bill, and first apply to contracts entered into on or after that date. This alternative would increase sales tax revenues by an estimated $100,000 in 1997-98 and $200,000 in 1998-99.

Alternative 1	GPR
1997-99 REVENUE (Change to Bill)	$300,000

2. Modify the current sales tax exemption for meals, food, food products and beverages furnished in accordance with any contract or agreement by a public or private institution of higher education to provide the exemption only if these items are furnished for purposes that are consistent with the institution's educational mission. In addition, provide that the exemption could not be used for purchases of meals by faculty members and specify that this provision would take effect on the day after publication of the bill, and first apply to contracts entered into on or after that date. This alternative would increase sales tax revenues by a minimal amount in 1997-98 and an estimated $100,000 in 1998-99.

Alternative 2	GPR
1997-99 REVENUE (Change to Bill)	$100,000

3. Maintain current law.

Prepared by: Rob Reinhardt

MO#________________

BURKE	Y	N	A
DECKER	Y	N	A
GEORGE	Y	N	A
JAUCH	Y	N	A
WINEKE	Y	N	A
SHIBILSKI	Y	N	A
COWLES	Y	N	A
PANZER	Y	N	A
JENSEN	Y	N	A
OURADA	Y	N	A
HARSDORF	Y	N	A
ALBERS	Y	N	A
GARD	Y	N	A
KAUFERT	Y	N	A
LINTON	Y	N	A
COGGS	Y	N	A

AYE _____ NO _____ ABS ___

To: Joint Committee on Finance

From: Bob Lang, Director
Legislative Fiscal Bureau

ISSUE

Reestimate Funding for the Earned Income Tax Credit (General Fund Taxes and Shared-Revenue and Property Tax Relief -- Other Credits)

[LFB Summary: Page 25, #10 and Page 554, #1]

CURRENT LAW

The state earned income tax credit (EITC) is paid from a sum sufficient appropriation. The credit provides a supplement to the wages and self-employment income of lower-income workers with children living with them. The credit is refundable; if the amount of the credit exceeds tax due, a check from the state is issued for the difference. The state credit is calculated as a percentage of the federal EITC. In 1996 and thereafter, the percentages are as follows: 4% for families with one child; 14% for families with two children; and 43% for families with three or more children.

GOVERNOR

The Governor's recommendation would provide an increase of $18,500,000 in 1997-98 and $31,000,000 in 1998-99 for estimated costs of the EITC. Total funding would be $75.5 million in 1997-98 and $88.0 million in 1998-99.

DISCUSSION POINTS

1. The administration indicates that the recommended increase in funding includes $11.0 million in 1997-98 and $18.0 million in 1998-99 to reflect increased participation due to implementation of the Wisconsin Works (W-2) program. The remainder, $7.5 million in 1997-98

and $13.0 million in 1998-99, reflects indexing of the credit at the federal level and normal participation growth over the base.

2. Funding for the EITC has been reestimated to include an increase of $21.7 million in 1997-98 and $31.2 million in 1998-99 from the base to provide total funding of $78.7 million in 1997-98 and $88.2 million in 1998-99. This reestimate would be an increase of $3.2 million in 1997-98 and $200,000 in 1998-99 from the funding provided in the bill.

3. Recent caseload projections indicate that people will be leaving the AFDC and W-2 programs and entering the workforce faster than previously estimated. Based on this data, it is estimated that $13.5 million in 1997-98 and $16.9 million in 1998-99 would be required to provide funding for increased EITC participation due to this factor, which is an increase of $2.5 million in 1997-98 and a decrease of $1.1 million in 1998-99 from funding provided in the bill.

4. In addition, it is estimated that an increase of $8.2 million in 1997-98 and $14.3 million in 1998-99 would be needed to fund normal program growth. These amounts are higher than the amounts provided in the bill by $700,000 in 1997-98 and $1.3 million in 1998-99.

5. There have been two recent federal law changes relating to the EITC for 1996. The first change requires that certain losses be added back to adjusted gross income for taxpayers with earned income above the phase-out income amounts. The second change denies the credit to individuals with certain investment income exceeding a base amount.

Questions have been raised at the federal level regarding the treatment of gains and losses from the sale of business property as it relates to these two law changes. Such property is not considered a capital asset, however, gains or losses from the sale of business property is treated as a gain or loss for both federal and state capital grains treatment purposes. The Internal Revenue Service is currently reviewing this issue and has yet to make a determination. The estimates in this paper assume that gains or losses from the sale of business property will not be counted for purposes of these provisions.

MODIFICATION TO BILL

Reestimate funding for the earned income tax credit at $78.7 million in 1997-98 and $88.2 million in 1998-99. These amounts exceed the base funding level by $21,700,000 in the first year and $31,200,000 in the second year. Compared to the bill, the revised estimates would increase funding by $3,200,000 in 1997-98 and $200,000 in 1998-99.

Reestimate	GPR
1997-99 FUNDING (Change to Bill)	$3,400,000

Prepared by: Kelsie Doty

MO#________________________

BURKE	Y	N	A
DECKER	Y	N	A
GEORGE	Y	N	A
JAUCH	Y	N	A
WINEKE	Y	N	A
SHIBILSKI	Y	N	A
COWLES	Y	N	A
PANZER	Y	N	A
JENSEN	Y	N	A
OURADA	Y	N	A
HARSDORF	Y	N	A
ALBERS	Y	N	A
GARD	Y	N	A
KAUFERT	Y	N	A
LINTON	Y	N	A
COGGS	Y	N	A

AYE _____ NO _____ ABS _____

To: Joint Committee on Finance

From: Bob Lang, Director
Legislative Fiscal Bureau

ISSUE

Individual Income Tax Treatment of Nonresidents and Part-Year Residents (General Fund Taxes)

[LFB Summary: Page 26, #11]

CURRENT LAW

Income may be taxed on the basis of where it is earned or on the basis of the taxpayer's legal residence; an individual may only have one legal residence. Individuals who do not have legal residence in Wisconsin but have income from Wisconsin sources (nonresidents) and individuals who have moved into or out of the state (part-year residents) are required to file a special state tax form called the 1NPR Form in Wisconsin. For nonresidents, Wisconsin taxes only the income from Wisconsin sources such as wages, business income or capital gains. Part-year residents pay taxes on income from all sources during the period the individual was a Wisconsin resident and, during the period the individual was not a resident, taxes on income from Wisconsin sources. A full-year resident may file the 1NPR form if the individual has a spouse who is a nonresident or part-year resident.

There is one exception to the general requirement that nonresidents pay taxes on income from Wisconsin sources. Wisconsin has entered into reciprocity agreements with five states: Illinois, Indiana, Kentucky, Michigan and Minnesota. Under these agreements, the taxpayer is only required to file a return and pay taxes in the state of legal residence. Wisconsin does not tax the wage and salary income earned in Wisconsin by residents of these states and collects taxes from income earned in these states by Wisconsin residents. Likewise, these other states do not impose their income tax on the earnings of Wisconsin residents and tax income earned in Wisconsin by their residents. As a result, an individual who is a resident of a neighboring state, such as Illinois, and works in Wisconsin only files a return and pays taxes to Illinois on their Wisconsin wages and is not required to file the 1NPR return in Wisconsin. However, if the same Illinois resident also had non-wage income (such as capital gains) from a Wisconsin source, taxes would have to be paid to Wisconsin on the capital gain income.

In filing the 1NPR form under current law, the taxpayer calculates their federal adjusted gross income (AGI) and compares that amount to their Wisconsin AGI to determine their ratio (called the proration factor) of Wisconsin AGI to federal AGI. The taxpayer then uses their federal AGI to determine their sliding scale standard deduction, which is based on income and filing status, and multiplies that amount by the proration factor to arrive at their Wisconsin standard deduction. The standard deduction is subtracted from Wisconsin AGI to determine Wisconsin taxable income. The tax rates and brackets are applied to taxable income to determine gross tax liability. The dependent credit, senior credit, itemized deduction credit and property tax/rent credit are each multiplied by the proration factor and subtracted from gross tax. The taxpayer then must determine whether the state alternative minimum tax applies. Finally, the married couple credit is calculated (using only earned income taxable to Wisconsin) and subtracted from gross tax to arrive at net tax liability.

GOVERNOR

The bill requires the Department of Revenue (DOR) to provide the Legislative Reference Bureau (LRB) and the Department of Administration (DOA) with drafting instructions sufficient to enable the LRB to include language in the 1997-99 budget bill that changes the proration factor for nonresident and part-year resident individual income taxpayers. The new proration factor would first apply to taxable years beginning on January 1, 1998. The bill contained a nonstatutory provision that outlined requirements for the drafting instructions.

These instructions provided that a 1NPR filer would first determine net tax using income from all sources. This amount would then be multiplied by a proration factor to determine the final amount owed to Wisconsin. The proration factor would be calculated by dividing: (a) the amount of Wisconsin AGI considering only Wisconsin sources of income; by (b) the amount of Wisconsin AGI considering all sources of income.

DISCUSSION POINTS

1. Approximately 2.5 million tax returns were filed in Wisconsin in 1995, of which about 3.9% were Form 1NPR. These taxpayers paid about 2.4% of all taxes in that year.

2. The bill proposal would allow nonresident and part-year resident taxpayers to use losses from activities in other states to reduce their Wisconsin income and Wisconsin tax. In addition, it would complicate the calculation of the Wisconsin alternative minimum tax. Finally, the initial proposal would have required substantial changes to the 1NPR tax form and instructions.

On March 17, 1997, DOR issued drafting instructions to the LRB and DOA. A letter accompanying the instructions indicated that, due to the concerns outlined above, an alternative method was proposed and instructions were issued based on this alternative. Under the proposal, the income tax brackets would be prorated based on the ratio of Wisconsin AGI to federal AGI, as calculated under current law. All other calculations would remain the same as current law.

3. Since the tax brackets are not prorated under current law, a 1NPR filer generally has a lower effective gross tax rate than full-year residents with the same total income if the percentage of gross tax to Wisconsin AGI is compared. Attachment 1 compares the effective gross tax rates for hypothetical full-year resident taxpayers to the effective gross tax rates of part-year resident and nonresident taxpayers with the same total income. Gross tax is the amount of tax before credits are subtracted.

For example, as shown in Attachment 1, a single full-year resident taxpayer with Wisconsin income of $25,000 would have a gross tax of $1,337 and an effective tax rate of 5.3% ($1,337 / $25,000). A part-year resident with federal AGI of $25,000, of which $15,000 is taxable to Wisconsin, would have a gross tax of $737, which is 4.9% of Wisconsin income. This happens because the 1NPR filer has a greater share of their Wisconsin income being taxed at the lower marginal tax rates than the full-year resident.

If the tax brackets were prorated as proposed, the part-year resident taxpayer in this example would have a gross tax of $802, an increase of $65 compared to current law. The effective tax rate would be 5.3% ($802 / $15,000), which is equal to the effective tax rate of the full-year resident. For this part-year resident individual, the tax bracket would be prorated by multiplying the tax brackets for single taxpayers by the ratio of Wisconsin income to total income ($15,000 divided by $25,000 = 60%). The prorated tax brackets in this case would be as follows:

Current Law Brackets	Multiply by Ratio	Prorated Brackets	Marginal Tax Rates
Less than $7,500	x 60% =	Less than $4,500	4.90%
7,500 to 15,000	x 60% =	4,500 to 9,000	6.55
15,000 and Over	x 60% =	9,000 and Over	6.93

4. Under current law, once taxable income has been determined, 1NPR filers use a table in the instructions to determine gross tax liability, which is similar to how all other taxpayers determine their tax liability. By prorating the tax brackets, a tax table could not be used because the tax brackets would be different for each taxpayer. As a result, 1NPR filers would have to complete a worksheet to determine gross tax. Attachment 2 to this paper contains the steps that would need to be taken for the same hypothetical individual to determine their Wisconsin gross tax liability under the proposal. The $13,140 amount on line 1 of the worksheet is Wisconsin taxable income, which is calculated on the 1NPR form by multiplying the standard

deduction (based on federal AGI) by the 60% proration factor and subtracting that amount from Wisconsin AGI.

Although it is not known at this time, it is presumed that the 17-step worksheet in the attachment would be similar to the worksheet 1NPR filers would need to complete if this provision is enacted. Requiring 1NPR filers to calculate their gross tax liability on a worksheet rather than using a tax table would complicate the tax form. In addition, this change could result in addition errors, which could increase processing time.

5. Prorating the tax brackets would result in the same effective gross tax on full-year residents and 1NPR filers with the same total income. In addition, since all of the tax credits, except the married couple credit, are also multiplied by the proration factor, the effective net tax would be the same for most full-year residents and 1NPR filers. (Net tax is the amount of tax owed after allowable credits are subtracted from gross tax.)

6. The bill estimated that modifying the taxation of 1NPR filers effective January 1, 1998, would increase individual income tax revenues by $4.0 million in 1998-99, based on the proposal outlined in the bill. The bill provision contained a 1998 tax year effective date because it would have required significant time to rewrite the 1NPR form and instructions and make data processing changes, which may not have been ready for the 1997 tax year.

If the modification submitted by DOR is adopted instead, it is estimated to increase revenues by $5.5 million in 1998-99 from current law, or by $1.5 million from the bill provision. Since the alternative proposal to prorate the tax brackets would not require as substantial of a change to the tax form and instructions and data processing, it could be made effective with the 1997 tax year, which would generate an additional $5.2 million in individual income tax revenues in 1997-98.

7. Attachment 3 presents distributional information from the 1995 Wisconsin tax sample regarding 1NPR filers who would be affected by the proposal. The tax sample includes information from over 20,000 individual income tax returns, weighted to reflect all taxpayers in 1995. Changes over time in the number of taxpayers and the kinds and amounts of income, deductions and credits they claim cannot be shown. To the extent possible, changes in the tax laws between 1995 and later years have been included. The amount shown in the attachment and the estimated fiscal effect differ because the attachment reflects 1995 data and the fiscal effect is for the 1997-99 biennium.

8. The following table, based on the 1995 tax sample, shows the distribution of the tax increase by three categories of 1NPR filers: nonresident tax filers, part-year residents who moved into the state and part-year residents who moved out of the state.

	Count	Percent of Count	Amount	Percent of Amount	Average Increase
Nonresidents	21,000	34.6%	$1,722,000	37.6%	$82
New Residents	20,200	33.2	1,538,000	33.5	76
Former Residents	19,600	32.2	1,327,000	28.9	68
	60,800	100.0%	$4,587,000	100.0%	$75

As shown in the table, approximately one-third of 1NPR filers were nonresidents, one-third were new state residents and one-third were former state residents. Nonresident filers would pay slightly more than one-third of the total increase and former residents would pay slightly less than one-third of the increase. If the distribution of the tax increase from the 1995 tax sample is applied to the estimated fiscal effect for 1998-99, nonresident taxpayers would pay 37.5% of the $5.5 million total fiscal estimate, or $2.1 million, new state residents would pay $1.8 million and former residents would pay $1.6 million of the total.

ALTERNATIVES TO BILL

1. Delete the bill provision and adopt DOR's recommendation to prorate the income tax brackets for nonresident and part-year resident taxpayers, based on the ratio of Wisconsin AGI to federal AGI, effective January 1, 1998.

Alternative 1	GPR
1997-99 REVENUE (Change to Bill)	$1,500,000

2. Delete the bill provision and adopt DOR's recommendation to prorate the income tax brackets for nonresident and part-year resident taxpayers, based on the ratio of Wisconsin AGI to federal AGI, effective January 1, 1997.

Alternative 2	GPR
1997-99 REVENUE (Change to Bill)	$6,700,000

3. Maintain current law.

Alternative 3	GPR
1997-99 REVENUE (Change to Bill)	- $4,000,000

Prepared by: Kelsie Doty

MO# ______________________

BURKE	Y	N	A
DECKER	Y	N	A
GEORGE	Y	N	A
JAUCH	Y	N	A
WINEKE	Y	N	A
SHIBILSKI	Y	N	A
COWLES	Y	N	A
PANZER	Y	N	A
JENSEN	Y	N	A
OURADA	Y	N	A
HARSDORF	Y	N	A
ALBERS	Y	N	A
GARD	Y	N	A
KAUFERT	Y	N	A
LINTON	Y	N	A
COGGS	Y	N	A

AYE _____ NO _____ ABS ____

ATTACHMENT 1

Comparison of Effective Tax Rates for Hypothetical Taxpayers

	Full-Year Residents			Nonresidents or Part-Year Residents							
							Current Law		Proposal		
	WI AGI	Gross Tax	Effective Tax Rate*	Federal AGI	WI AGI	Proration Factor	Gross Tax	Effective Tax Rate*	Gross Tax	Effective Tax Rate*	Tax Increase
Single											
	$75,000	$5,017	6.7%	$75,000	$50,000	66.7%	$3,284	6.6%	$3,345	6.7%	$60
				$75,000	25,000	33.3%	1,552	6.2%	1,672	6.7%	121
	$50,000	3,277	6.6%	$50,000	30,000	60.0%	1,894	6.3%	1,966	6.6%	72
				$50,000	20,000	40.0%	1,202	6.0%	1,311	6.6%	109
	$25,000	1,337	5.3%	$25,000	15,000	60.0%	737	4.9%	802	5.3%	65
				$25,000	10,000	40.0%	450	4.5%	535	5.3%	85
Married-Joint											
	$75,000	$4,957	6.6%	$75,000	$50,000	66.7%	$3,224	6.4%	3,304	6.6%	$80
				$75,000	25,000	33.3%	1,492	6.0%	1,652	6.6%	160
	$50,000	3,155	6.3%	$50,000	30,000	60.0%	1,797	6.0%	1,893	6.3%	96
				$50,000	20,000	40.0%	1,119	5.6%	1,262	6.3%	143
	$25,000	1,084	4.3%	$25,000	15,000	60.0%	584	3.9%	650	4.3%	66
				$25,000	10,000	40.0%	374	3.7%	434	4.3%	60

* The effective tax rate is the ratio of gross tax to Wisconsin AGI.

ATTACHMENT 2

Example of Form 1NPR Worksheet to Determine Gross Tax Under Proposal

1.	Enter Wisconsin taxable income (from line 32 of Form 1NPR).	$13,140
2.	Enter $7,500 if single or head-of-household, $10,000 if married filing jointly or $5,000 if married filing separately.	7,500
3.	Enter the proration factor (from line 28 of Form 1NPR).	60%
4.	Multiply line 2 by line 3.	4,500
5.	Enter the lesser of line 1 or line 4.	4,500
6.	First bracket tax rate.	4.90%
7.	Multiply line 5 by line 6; enter the amount here and on line 15 below.	220
8.	Subtract line 5 from line 1. If line 5 equals line 1, enter $0 on lines 14 and 16 below, and go on to line 17.	8,640
9.	Enter the lesser of line 8 or line 4.	4,500
10.	Second bracket tax rate.	6.55%
11.	Multiply line 9 by line 10; enter the amount here and on line 16 below.	295
12.	Subtract line 9 from line 8. If line 9 equals line 8, enter $0 on line 14 below, and go to line 17.	4,140
13.	Top bracket tax rate.	6.93%
14.	Multiply line 12 by line 13; enter the amount here.	287
15.	Amount from line 7.	220
16.	Amount from line 11.	295
17.	Add lines 14, 15 and 16. This is gross tax. Enter this amount on line 33 of Form 1NPR.	$802

ATTACHMENT 3

Distribution of Tax Increase Under a Proposal to Prorate the Tax Bracket for 1NPR Filers

Federal Adjusted Gross Income	Count	Percent of Count	Amount of Tax Increase	Percent of Increase	Average Increase
Under $5,000	0	0.0%	$0	0.0%	$0
5,000 to 10,000	0	0.0	0	0.0	0
10,000 to 15,000	2,800	4.6	29,000	0.6	10
15,000 to 20,000	7,900	13.0	220,000	4.8	28
20,000 to 25,000	6,300	10.4	206,000	4.5	33
25,000 to 30,000	4,200	6.9	222,000	4.8	53
30,000 to 40,000	7,600	12.5	565,000	12.3	74
40,000 to 50,000	4,900	8.0	450,000	9.8	92
50,000 to 75,000	11,900	19.6	1,164,000	25.4	98
75,000 to 100,000	3,200	5.3	313,000	6.8	98
100,000 to 200,000	7,200	11.8	852,000	18.6	118
200,000 to 300,000	1,600	2.6	149,000	3.3	93
300,000 and Over	3,200	5.3	417,000	9.1	130
TOTALS	60,800	100.0%	$4,587,000	100.0%	$75

SOURCE: 1995 Wisconsin Tax Sample

• Approximately 60,800 taxpayers would be affected by the proposal. Of the 2.5 million total taxpayers in 1995, the proposal would affect approximately 2%.

• According to sample data, there would be no taxpayers with federal AGI below $10,000 affected by this proposal. Because of their low incomes, these taxpayers would have no tax liability under current law or under the modification.

• Taxpayers with federal AGI between $10,000 and $25,000 would pay 9.9% of the tax increase and make up 28.0% of the taxpayers impacted by the proposal.

• Taxpayers with federal AGI above $100,000 make up 19.7% of the count of affected taxpayers and would pay 31% of the tax increase.

• The average tax increase would be $75. By income level, the average increase would range from $10 for taxpayers with income between $10,000 and $15,000 to $130 for taxpayers with income above $300,000.