J

AGENCY: General Fund Taxes

PAPER: #106

ISSUE: Technology Zones

RECOMMENDATION: Alternative (anything is fine)

SUMMARY: Depending on how other Dems want to go on this issue, I think the gov's technology zones are worth a try.

BY: Barry

Legislative Fiscal Bureau
One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873

June 5, 2001 Joint Committee on Finance Paper #106

Technology Zones
(General Fund Taxes -- Individual and Corporate Income and Franchise Taxes)

[LFB 2001-03 Budget Summary: Page 33, #13]

CURRENT LAW

Wisconsin has two programs that provide tax credits to businesses as incentives to expand and locate in designated economically distressed areas: development zones and enterprise development zones. The programs are designed to promote economic growth through job creation and investment. Designation criteria target areas with high unemployment, low incomes and decreasing property values. Businesses which locate or expand in the different zones are eligible to claim the development zone jobs and environmental remediation tax credits. As of May 1, 2001, the Department of Commerce had designated 20 development zones and certified 40 enterprise development zones. The Department has authority to designate a total of 22 development zones and 79 enterprise development zones. In addition, the state has designated an area in the City of Kenosha as a development opportunity zone.

GOVERNOR

Require Commerce to designate as technology zones up to seven areas in the state in fiscal year 2001-02, up to seven areas in 2002-03 and up to six areas in 2003-04. Designation of an area as a technology zone would be for 10 years. Commerce could change the boundaries of a technology zone at any time that its designation is in effect. A change in boundaries would not affect the designation of the area as a technology zone or the maximum amount of tax credits that could be claimed in the technology zone. A business that was located in a technology zone and that was certified by Commerce would be eligible to claim a technology zones credit that would be created under the bill. The maximum amount of tax credits that could be claimed in a technology zone would be $5 million.

DISCUSSION POINTS

1. The technology zones tax credit would be provided under the individual and corporate income and franchise taxes and would equal the sum of the following: (a) the amount of real and personal property taxes that the business paid in tax year; (b) the amount of state income and franchise taxes that the business paid during the tax year; and, (c) the amount of state, county and special district sales and use taxes that the business paid during the tax year. Credits that were not entirely used to offset income or franchise taxes in the current year could be carried forward up to 15 years to offset future tax liabilities.

When Commerce certified a business as eligible for tax credits, Commerce would establish a limit on the amount of tax credits the business could claim. Generally, unless certification was revoked and subject to the maximum limit on credits that could be claimed, a business could claim a tax credit for three years. However, if the business experienced growth, as determined by Commerce, it could claim a tax credit for up to five years.

Commerce would be required to enter into an agreement with a business that it certified. The agreement would specify the limit on the amount of tax credits that the business could claim, the extent and type of growth that that business would have to experience to extend eligibility for tax credits, the baseline against which growth would be measured, other conditions that would have to be met to extend eligibility for tax credits, and reporting requirements.

2. The Department of Commerce could certify a business as eligible for technology zone tax credits if the business met the following requirements: (a) the business was located in a technology zone; (b) the business was a new or expanding business; and (c) the business was a high-technology business. In determining whether to certify a business for tax credits Commerce would be required to consider: (a) how many jobs the business was likely to create; (b) the extent and nature of the high technology used by the business; (c) the likelihood that the business would attract related enterprises; (d) the amount of capital investment that the business would be likely to make in Wisconsin; and (e) the economic viability of the business.

3. The Department of Revenue (DOR) would be authorized to administer technology zone tax credit claims, take any action, conduct any proceeding and proceed as authorized under income and franchise tax provisions relating to timely claims, assessments, refunds, appeals, collection, interest and penalties. DOR would be authorized to deny any portion of a technology zone credit that was claimed if allowing the full amount of the credit to be claimed would cause the total amount of credits to be claimed to exceed the maximum credit limit for the zone. DOR would also be required to notify Commerce of all technology zone credit claims.

4. Commerce would be required to verify information related to technology zones tax credit claims that was submitted to DOR by businesses. Commerce would also be required to notify DOR of the following: (a) designation of a technology zone; (b) certification of a business and the limit on the amount of tax credits the business could claim; and (c) extension or revocation of a business' certification. Commerce would be directed to promulgate administrative rules for

administering the technology zones program including rules relating to the following: (a) criteria for designating an area as a technology zone; (b) a business' eligibility for certification for tax credits as well as definitions of "new or expanding business" and "high-technology business"; (c) certifying a business, including use of criteria for consideration specified in the bill; (d) standards for establishing a limit on the amount of tax credits that a business may claim; (e) standards for extending a business' certification, including what measures, in addition to job creation, Commerce would use to determine the growth of a specific business and how Commerce would establish baselines for measuring growth; (f) reporting requirements for certified businesses; (g) the exchange of information between Commerce and DOR; (h) reasons for revoking a business' certification; and (i) standards for changing the boundaries of a technology zone.

5. A National Governors' Association (NGA) report submitted to the Wisconsin Economic Summit in November, 2000, indicates that the U.S. economy is undergoing a transformation, moving from a manufacturing base to an economy driven by technology industries and the application of technology in traditional industries. The report notes that to compete in the new economy, states must have an economic base of firms that constantly innovate and maximize the use of technology in the workplace. High-technology firms are integral to a strong and growing state economy. On average, employees in high-technology industries make significantly more than those in other industries. In 1996, the average pay per employee in high-technology industries was 67% higher than the average pay per employee for all other industries ($44,041 vs $26,363). According to the U.S. Department of Commerce, information technology, a component of the high-technology industry, was responsible for one-third of U.S. economic growth between 1995 and 1998.

6. The technology zones program was proposed to promote the development and expansion of high-technology businesses across the state and is based on an economic development concept of promoting industry cluster formation. Supporters of this philosophy point to Stanford Research Park in the Silicon Valley and the Research Triangle in North Carolina as examples of the potential impact of successful technology zones. State research institutions such as the University of Wisconsin System, Marquette University, the Medical College of Wisconsin, and Milwaukee School of Engineering and private organizations such as the Marshfield Clinic can serve as the basis for the development of industrial clusters of new and mature companies and related resources organized around a particular area of expertise. In turn, these clusters would promote the development and attraction of firms engaged in similar pursuits.

7. The industry cluster strategy for economic development views entities like technology zones as vehicles for helping capture, evolve and sustain regional industry clusters (Gollub, 2000). From this view, the most effective way to stimulate economic growth and creation of quality jobs regionally is to create an environment that facilitates the origination, growth and success of high-technology businesses. Localities often compete for companies by trying to outbid each other on a short-term basis, rather than competing on the basis of building a strategic advantage. Industries want to locate where they can obtain an advantage for the enterprise and there is a tendency industrial activities to concentrate in certain locations where there is a common advantage. Industry clusters are groups of industries that share common technological, skill, finance

and logistical inputs and, because of this, tend to locate near one another and both purposefully and inadvertently share innovative practices and economies of scale. One research study indicated that industry clusters account for approximately 25% of regional employment and multipliers tend to explain the balance of employment.

8. Technology zones would differ from other areas of the state because businesses could derive distinguishing advantages from locating and operating there. According to the industrial cluster concept, an entity such as a technology zone would be a vehicle for organizing and delivering strategic types of input advantage to businesses. Seven categories of advantage have been identified including: (a) accessible technology; (b) labor force skill; (c) available financing; (d) adequate physical infrastructure; (e) communications infrastructure; (f) business climate; and (g) quality of life. The technology zones could be designated in areas that accessed research institutions, had well-developed public and private infrastructure, and offered easy contact with technical school and university graduates. The tax credit would address the business climate criterion and possibly provide an indirect source of financing.

9. A recent report on high-technology business growth identified three general factors that are necessary to generate and sustain high-technology companies and employment: (a) equity investment; (b) human resources; and (c) a supply of technologies and business ideas (Leazer, Royko). According to the report, seed capital needs are more substantial for high-tech business start-ups than for most other companies because product, technology, and infrastructure development are more expensive. A strong early-stage capital infrastructure is critical to the development of a successful regional high-tech entrepreneurial community. According to the NGA report, a technology-based economy requires: (a) a strong intellectual infrastructure; (b) efficient mechanisms through which knowledge is transferred from one person to another or from one company to another; (c) excellent physical infrastructure, including high-quality telecommunications systems and affordable, high-speed internet connections; (d) a highly-skilled technical workforce; and (e) good sources of capital. These reports point to what some view as a flaw in the proposed technology zones program. The zones' primary incentive is the technology zones tax credit, yet taxes are generally not identified as a significant economic factor for start-up or young high-technology businesses. Many start-up and young high-technology companies have significant losses before they bring their product to market. As a result, the incentive value of the technology zones tax credit has been questioned since many firms that would locate in the zones would have little or no tax liabilities to offset.

10. As noted, Wisconsin currently has the development and enterprise development zone programs that provide tax credits as incentives to businesses that expand or locate in the zones. Currently, 20 of the 22 authorized development zones have been designated and include zones located in 14 municipalities, two Native American reservations and nine counties. Of the total $38.155 million in tax credits authorized for the zones, $27.3 million has been allocated to the zones. A total of 40 of the 79 authorized enterprise zones have been created in 41 municipalities across the state. A total of $67.8 million in tax credits has been allocated to businesses in enterprise development zones. There is also a development opportunity zone designated in Kenosha and $7.0 million in tax credits has been allocated to the zone. In total, Wisconsin currently has 68 zones

designated in 75 municipalities, nine counties and two Indian reservations. A total of $102.1 million in tax credits has been allocated to businesses in the zones. Attachments 1 and 2 show the location and credit allocations for the development and enterprise development zone programs. Commerce can still designate two additional development zones and 39 more enterprise development zones. A total of $10.86 million in development zones tax credits and up to $117 million in enterprise development zones tax credits could still be allocated to additional businesses. Finally, the bill would create a development opportunity zone in Milwaukee and provide $4.7 million in tax credits to the businesses in the zone.

11. The proposed technology zones program would require Commerce to designate 20 zones and certify up to $100 million in tax credits between fiscal years 2001-02 and 2003-04. A second criticism of the technology zones program is that it would duplicate the incentives provided through the existing development, enterprise development and development opportunity zones programs. From this view, the effectiveness of using a fourth type of tax incentive zone program as an economic development tool could be questioned. Some research indicates that development zones are only effective if used to target investment into high-unemployment, low-infrastructure use areas of the state (Bartik, 1994). Other research found that when most communities in a metropolitan area were generally able to offer tax and other incentives the effect of the incentives on redirecting economic activity was significantly reduced (Anderson and Wassmer, 2000).

12. The bill does not include a fiscal effect for the technology zones program. Although zones would designated in 2001-02 and 2002-03, the process of Commerce designating the zones, certifying businesses for tax credits and then the business taking actions to claim the credit would delay any significant fiscal effect beyond the current biennium. Therefore, there would be a minimal fiscal effect from providing the technology zone tax credit during the current biennium. However, because unused tax credits could be carried forward up to 15 years, the credit could reduce tax collections by a total of $100 million in future biennia.

13. Under the bill, the technology zones credit could be claimed by sole proprietorships and corporations but partnerships, limited liability by companies and S corporations. The Committee may wish to modify the tax credit provisions to allow these entities to pass on the credit to partners, shareholders or members.

ALTERNATIVES TO BILL

1. Approve the Governor's recommendation to require Commerce to designate as technology zones up to seven areas in the state in fiscal year 2001-02, up to seven areas in 2002-03 and up to six areas in 2003-04. Provide that designation of an area as a technology zone would be for 10 years and authorize Commerce to change the boundaries of a technology zone at any time that its designation is in effect. Provide that a business that was located in a technology zone and that was certified by Commerce would be eligible to claim a technology zones credit that would equal the sum of the following: (a) the amount of real and personal property taxes that the business paid in tax year; (b) the amount of state income and franchise taxes that the business paid during the

tax year; and (c) the amount of state, county and special district sales and use taxes that the business paid during the tax year. Provide that credits that were not entirely used to offset income or franchise taxes in the current year could be carried forward up to 15 years to offset future tax liabilities. Limit the maximum amount of tax credits that could be claimed in a technology zone to $5 million.

2. Approve the Governor's recommendation and provide that partnerships, limited liability companies and S corporations could pass the technology zones credit on to partners and members.

3. Maintain current law.

Prepared by: Ron Shanovich
Attachments

ATTACHMENT 1

Development Zones

Zone Location	Year of Designation	Total Credits Allocated to Zone	Amount of Credits Allocated to Businesses	Number of Businesses Certified*
Beloit	1989	$619,309	$619,309	7
Iron County	1989	795,117	795,117	22
Manitowoc	1989	2,506,078	2,506,078	22
Milwaukee	1989	5,149,485	5,149,485	87
Racine	1989	2,055,556	2,055,556	23
Stockbridge-Munsee	1989	288,720	288,720	4
Sturgeon Bay	1989	1,791,622	1,791,622	43
Superior	1989	1,205,313	1,205,313	31
Fond du Lac	1991	1,309,515	1,309,515	45
Green Bay	1991	1,339,114	1,339,114	22
Lac du Flambeau	1991	448,833	448,833	6
Richland Center/Town of Richland	1991	736,870	736,870	25
Eau Claire	1995	1,449,470	1,449,470	37
Two Rivers	1995	1,229,494	1,229,494	19
Janesville	1996	702,701	702,701	9
Lincoln, Langlade, Florence and Forest Counties	1996	648,982	648,982	21
Grant and Lafayette Counties	1996	1,366,996	1,366,996	32
Juneau, Adams and Marquette Counties	1996	1,611,907	1,611,907	23
Marinette and Oconto Counties	1998	1,042,000	1,042,000	7
Ashland, Bayfield and Price Counties	1998	1,000,000	445,000	4
Total		$27,297,082	$26,742,082	489

ATTACHMENT 2

Enterprise Development Zone Program

City	Company Name Allocation	Certification Date	Zone Investment	Jobs Created	Jobs Retained	Credit
New Berlin	Quad/Graphics	August 14, 1995	$96,500,000	500	0	$3,000,000
Eau Claire	W.L. Gore	September 19, 1995	70,000,000	450	0	1,756,667
Oconto	Cera-Mite Corp.	November 1, 1995	5,000,000	150	0	900,000
Neilsville	Leeson Electric	November 1, 1995	2,500,000	150	0	900,000
Marinette	Karl Schmidt Unisia	January 12, 1996	2,100,000	350	630	2,100,000
Menomonee Falls	Strong Capital Management, Inc.	February 12, 1996	30,000,000	500	450	3,000,000
Wisconsin Rapids	Advantage Learning Systems, Inc.	February 13, 1996	10,000,000	370	130	2,000,000
Kenosha	Chrysler Corp.	April 1, 1996	364,000,000	414	1,405	3,000,000
Franklin	Harley-Davidson Motor Co.	April 1, 1996	20,000,000	200	0	1,200,000
Milwaukee	Waldorf Corp.	June 28, 1996	8,000,000	25	175	1,200,000
Shawano	Aarrowcast, Inc.	July 4, 1996	13,500,000	312	247	1,068,000
Chippewa Falls	Johnson Matthey, Inc.	August 1, 1996	47,700,000	600	0	2,750,000
Prairie du Chien	Cabela's of Wisconsin	August 29, 1996	16,000,000	650	0	2,000,000
Wauwatosa & Menomonee Falls	Harley-Davidson Motor Co.	September 27, 1996	99,000,000	400	1,310	2,400,000
Ladysmith	Weathershield	October 25, 1996	6,200,000	200	0	1,200,000
Janesville	Accudyne	November 10, 1996	3,500,000	0	250	1,000,000
Dodgeville	Land's End	November 20, 1996	62,000,000	666	0	3,000,000
Bellevue & Manitowoc	Krueger Int'l	January 10, 1997	7,600,000	175	449	1,050,000
Sheboygan	J.L. French Corp.	February 1, 1997	43,000,000	220	720	1,320,000
Elkhorn	Snap-On, Inc.	February 14, 1997	2,700,000	160	0	960,000
Saukville & Milwaukee	Charter Manuf.	March 21, 1997	42,000,000	200	676	1,200,000
Green Bay	Schreiber Foods	April 22, 1997	27,000,000	120	791	540,000
Racine	J.I. Case	May 1, 1997	115,476,500	500	1,739	3,000,000
Chetek	Parker Hannifin	June 1, 1997	2,400,000	100	0	600,000
Pewaukee	Applied Power	June 16, 1997	8,600,000	130	51	650,000
Oconto	KCS International	June 18, 1997	10,000,000	600	417	3,000,000
Platteville	Hypro Inc.	July 31, 1997	5,500,000	150	0	900,000
Wausau	Award Flooring	August 1, 1997	13,400,000	175	0	775,000
Manawa	Kolbe & Kolbe	August 18, 1997	2,100,000	200	0	1,500,000
De Pere	Moore Response	September 1, 1997	81,000,000	471	800	3,000,000
Bonduel	Krueger International	November 17, 1997	4,650,000	300	0	2,250,000
Port Washington	Simplicity	March 31, 1998	10,000,000	60	470	2,180,000
Wausaukee/Gillett	Wausaukee Composites	April 15, 1998	2,700,000	200	132	1,000,000
Oshkosh/Appleton	Hoffmaster	August 1, 1998		138	105	2,000,000
Ripon	Alliant Laundry Systems	August 5, 1998	31,000,000	200	480	3,000,000
Ashwaubenon	IDS Property Casualty	February 15, 1999	20,000,000	357	0	1,785,000
Hudson	Cardinal Health	April 1, 1999	8,500,000	71	0	426,000
Wausau	Marathon Electric	December 2, 1999	8,700,000	106	686	700,000
Brodhead	Stoughton Trailers	January 1, 2000	13,700,000	367	14	2,053,000
Waterford	Runzheimer Intl.	January 1, 2001	8,000,000	170	60	1,400,000
TOTAL			$1,324,026,500	11,107	12,187	$67,763,667

Legislative Fiscal Bureau
One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873

June 5, 2001 | Joint Committee on Finance | Paper #107

Internal Revenue Code Update
(General Fund Taxes -- Individual and Corporate Income and Franchise Taxes)

CURRENT LAW

State tax provisions are generally referenced to definitions under federal law. With limited exceptions, changes to federal law take effect for state purposes only after action by the Legislature. Each year, the Legislature reviews the previous year's federal law changes to update state references to the federal Internal Revenue Code (IRC). With exceptions, current state tax provisions reference the code in effect as of December 31, 1999.

GOVERNOR

No provision.

DISCUSSION POINTS

1. In a letter dated May 21, 2001, the administration requested that the Joint Committee on Finance incorporate an IRC update into the Committee's version of the budget. The majority of changes in federal law that affect the IRC were part of the Federal Sales Corporation Repeal and Extraterritorial Income Exclusion Act, the Community Renewal Tax Relief Act and the Installment Tax Correction Act.

2. The administration recommends that, beginning in tax year 2001, the state individual income and corporate and franchise income tax provisions referenced to the federal IRC would refer to the code in effect on December 31, 2000.

3. State references to federal law generally provide greater simplicity for taxpayers in

preparing returns and reduce the administrative burden and cost for both taxpayers and DOR in assuring compliance with tax laws. The IRC references are used to determine which items of income are subject to taxation prior to specific state modifications. The state uses separate tax rates and brackets and separate provisions regarding standard deductions, itemized deductions and tax credits.

4. The Department of Revenue estimates that the IRC update provisions would have a minimal effect on individual income tax revenues and would decrease corporate income and franchise tax revenue from businesses by $2.0 million in 2001-02 and by $2.95 million in 2002-03. The following table provides a summary of the corporate and business items that are estimated to have an impact on state revenues.

Summary of Federal Law Changes with Fiscal Effects
($ in Millions)

Corporate and Business	2001-02	2002-03
Environmental Remediation Costs	-$0.35	-$0.90
Corporate Donations of Computer Technology	-0.50	-0.60
Duplication or Acceleration of Loss Through Assumption of Certain Liabilities	0.10	0.10
Foreign Sales Corporations	-1.25	-1.55
Total	-$2.00	-$2.95

5. The following sections briefly describe the new federal provisions that would have a state fiscal effect. The Appendix identifies the other federal provisions that would be adopted, but are estimated to have a minimal state fiscal effect.

Environmental Remediation Costs

6. Extend the expiration date for the election to deduct certain environmental remediation expenditures that would otherwise be charged to a capital account to include expenses paid or incurred before 2004. The requirement that expenditures be in a targeted area is eliminated so that most other sites certified by state environmental agencies as containing hazardous substances are eligible.

This provision is effective for expenditures made after December 21, 2000. The estimated fiscal effect is a revenue decrease of $350,000 in 2001-02 and $900,000 in 2002-03.

Corporate Donations of Computer Technology

7. Extend the expiration date for deductions of certain computer equipment donated to elementary and secondary schools through 2003. The deduction is extended to include donations to

public libraries, donations of property up to three years after acquisition, rather than two years under prior law, and donations of property reacquired by a computer manufacturer.

This provision applies to donations made after December 31, 2000. The estimated fiscal effect is a revenue decrease of $500,000 in 2001-02 and $600,000 in 2002-03.

Duplication or Acceleration of Loss Through Assumption of Certain Liabilities

8. Require that the basis of stock received in certain tax-free exchanges be reduced by the amount of any liability assumed in exchange for the stock that does not otherwise reduce the transferor's basis. Stock cannot be reduced below its fair market value. The provision would generally not apply if the trade or business with the liability or substantially all of the assets associated with the liability is transferred to the corporation in the exchange.

This provision is effective for assumption of liabilities on or after October 19, 1999. The estimated fiscal effect is a revenue increase of $100,000 in 2001-02 and 2002-03.

Foreign Sales Corporations

9. Repeal the present foreign sales corporation (FSC) rules and replace them with an exclusion for extraterritorial income. The tax benefit under the exclusion is expected to mirror the tax benefit under the FSC rules, but apply to a greater number of taxpayers. Corporations could use the new benefit directly rather than having to create specifically defined FSC subsidiaries.

The law change is in response to a decision by the World Trade Organization (WTO) that the FSC provisions breach WTO rules by providing subsidies to assist U.S. exports, thus giving U.S. companies an unfair advantage in international trade. The European Union initially brought the complaint to the WTO and has indicated that it expects to ask the WTO to rule on the new scheme, suggesting that it may still not be compliant with WTO rules. Regardless of whether the new scheme would ultimately withstand such a challenge, it would remain in effect during the dispute.

This provision is effective for transactions entered into after September 30, 2000. No corporation may elect to be an FSC after that date. Transition rules are included for current FSCs. The estimated fiscal effect is a revenue decrease of $1.25 million in 2001-02 and $1.55 million in 2002-03.

ALTERNATIVES TO BILL

1. Adopt the provisions requested by the Department of Revenue to update state tax references to the federal IRC in effect as of December 31, 2000. Decrease projected corporate income tax revenues by $2,000,000 in 2001-02 and $2,950,000 in 2002-03 to reflect the modifications.

Alternative 1	GPR
2001-03 REVENUE (Change to Bill)	- $4,950,000

2. Adopt provisions to update state tax references to the federal IRC in effect as of December 31, 2000, except for provisions relating to: (a) environmental remediation costs; (b) corporate donations of computer technology; and (c) foreign sales corporations. This option would not adopt the new federal provisions that would result in decreased state tax revenues.

Alternative 2	GPR
2001-03 REVENUE (Change to Bill)	$200,000

3. Maintain current law.

Prepared by: Ron Shanovich and Faith Russell

APPENDIX

Federal Law Changes That Have a Minimal or Unknown Fiscal Effect

Individual Income Tax

- Medical Savings Accounts
- Tax Benefits with Respect to Kidnapped Children
- IRAs for Nonworking Spouses

Corporate and Business Taxes

- Renewal Communities
- Empowerment Zones
- Securities Futures Contracts
- Installment Method for Accrual Method Taxpayers

GENERAL FUND TAXES

Individual And Corporate Income Taxes

Bill Agency

LFB Summary Items for Which No Issue Paper Has Been Prepared

Item #	Title
4	Other State Tax Credit
5	Taxation of Trusts
7	Minnesota-Wisconsin Income Tax Reciprocity Payments
8	Interest on Overpayment of Taxes
11	Corporate Members and Partners of Corporate Limited Liability Companies and Partnerships
14	Development Zones Tax Credit -- Definition of Target Group Member
15	Development Zones Sales Tax Credit
16	Development Zones Job Tax Credit
17	Development Zones Location Tax Credit
18	Development Zones Investment Tax Credit
19	Pollution Abatement Equipment Deduction Approval

LFB Summary Item Addressed in a Separate Paper

Item #	Title
1	Tax Relief Fund Tax Credit
20	Recycling Surcharge -- Noncorporate Farms (Paper #??)

General Fund Taxes

General Sales and Use Tax

Bill Agency

(LFB Budget Summary Document: Page 39)

LFB Summary Items for Which Issue Papers Have Been Prepared

Item #	Title
1	Sales Tax on Custom Computer Programs (Paper #110)
2	Sales Tax Treatment of Services to Tangible Personal Property (Paper #111)

Legislative Fiscal Bureau
One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873

June 5, 2001 | Joint Committee on Finance | Paper #110

Sales Tax on Custom Computer Programs (General Fund Taxes -- General Sales and Use Tax)

[LFB 2001-03 Budget Summary: Page 39, #1]

CURRENT LAW

Under current law, the 5% sales and use tax is imposed on all sales of tangible personal property, unless specifically exempted, but only on those services specifically identified in the statutes. Pre-written, or "canned," programs--programs held for general or repeated sale or lease--are considered tangible personal property and are subject to the sales tax. Custom computer programs, however, are specifically excluded from the definition of "tangible personal property" in state statutes. Although pre-written computer programs are in general subject to the sales and use tax, they may be non-taxable under other provisions. For example, programs used in manufacturing may be exempt under the exemption for manufacturing equipment.

The Wisconsin Administrative Code defines "custom program" as utility and application software which accommodates the special processing needs of the customer. The Code identifies several criteria that can be used to determine whether a program is a custom program. Among these are: (1) the extent to which a vendor or independent consultant engages in significant presale consultation and analysis of the user's requirements and system; (2) whether the program is loaded into the customer's computer by the vendor and the extent to which the installed program must be tested against the program's specifications; (3) the extent to which use of the software requires substantial training of the customer's personnel and substantial written documentation; and (4) the extent to which enhancement and maintenance support by the vendor is needed for continued usefulness.

In addition, the rule specifies that programs costing $10,000 or less generally are not considered to be custom programs. Further, the rule indicates that if an existing program is selected for modification, there must be a "significant modification" to the program before it can be used in the customer's specific environment in order for the program to be deemed a custom program.

GOVERNOR

Change the definition of tangible personal property to include custom computer programs and, thereby, subject these programs to the sales and use tax. This change would take effect on the first day of the second month beginning after publication.

DISCUSSION POINTS

1. The administration estimated that subjecting sales of custom computer programs to the state's sales tax would raise additional revenues of $16.0 million in 2001-02 and $36.0 million in 2002-03. These estimates assumed that the change would take effect on January 1, 2002.

2. Based on a more recent (lower) forecast of computer software purchases and a different assumption regarding the effective date of the Governor's recommendation, it appears that the administration's estimates should be revised to be a revenue gain of $20.5 million in 2001-02 and $31.0 million in 2002-03. These estimates are higher than the administration's figures by $4.5 million in the first year and lower by $5 million in the second year, for a net reduction of $0.5 million over the 2001-03 biennium. The revised estimate for 2001-02 is higher because it assumes an effective date of October 1, 2001, instead of January 1, 2002. The October date assumes the budget bill will be enacted in August, 2001. If passage of the budget were delayed, the fiscal estimate in the first year would have to be reduced.

3. The administration has identified the creation and development of technology-related industries as an important state priority. Subjecting custom software to the sales tax may be inconsistent with the expressed development goal.

4. Determining how much a standard program must be modified before it is deemed to be customized has been problematic for taxing authorities. The Department of Revenue has issued an administrative rule and a number of private-letter rulings in an attempt to clarify the matter. Despite these efforts to provide guidance, the current provisions continue to present administrative difficulties. Subjecting custom programs to the sales tax, as recommended by the Governor, represents one way of resolving the issue.

5. An alternative approach would be to exempt canned programs from the sales tax so that neither custom nor canned programs would be taxable. It is estimated that such an exemption would result in reduced revenues to the general fund of approximately $85 million annually.

6. According to information compiled by Commerce Clearing House, 13 states and the District of Columbia currently subject custom computer programs to the sales and use tax. The states are Arkansas, Connecticut, Hawaii, Louisiana, Mississippi, Nebraska, New Mexico, Ohio, South Carolina, South Dakota, Tennessee, Texas, and West Virginia.

ALTERNATIVES TO BILL

1. Adopt the Governor's recommendation to subject custom computer programs to the sales and use tax. Reestimate the fiscal effect of the change to be an increase in revenues of $20.5 million in 2001-02 and $31.0 million in 2002-03. This estimate assumes that the change would take effect on October 1, 2001.

Alternative 1	GPR
2001-03 REVENUE (Change to Bill)	- $500,000

2. Maintain current law.

Alternative 2	GPR
2001-03 REVENUE (Change to Bill)	- $52,000,000

Prepared by: Drew B. Larson

Legislative Fiscal Bureau
One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873

June 5, 2001 Joint Committee on Finance Paper #111

Sales Tax Treatment of Services to Tangible Personal Property (General Fund Taxes -- General Sales and Use Tax)

[LFB 2001-03 Budget Summary: Page 40, #2]

CURRENT LAW

Additions or Capital Improvements to Real Property. Currently, the sales tax is generally imposed on the repair, service, alteration, fitting, cleaning, painting, coating, towing, inspection and maintenance of all items of tangible personal property. However, the tax is not imposed on the original installation or complete replacement of tangible personal property if the installation or replacement would result in an addition or capital improvement to real property. These provisions appear in s. 77.52(2)(a)10.

A separate section of the statutes [s. 77.51(15)(c)(2)] provides that the amount received for labor or services for installing or applying property which, when installed or applied, will constitute an addition or capital improvement of real property is excluded from the definition of sales price so long as the amount is separately stated from the amount charged for the property. Therefore, services that meet these criteria are not subject to the sales tax.

Business Equipment. The current statutes regarding the taxation of services to tangible personal property also specify a number of types of property that are deemed to have retained their character as tangible personal property, regardless of the extent to which any such item is fastened to or built into real property. Among these are "office, restaurant and tavern type equipment."

GOVERNOR

Modify s. 77.52(2)(a)10 by eliminating the exception for installing or applying tangible personal property which, when installed or applied, will constitute an addition or capital improvement of real property. The provision excluding amounts paid for such services from the definition of taxable sales price under in s. 77.51(15)(c)(2) would be retained.

Specify that items that remain tangible personal property, regardless of the extent to which those items are attached to real property, include "equipment in offices, business facilities, schools and hospitals," rather than "office, restaurant and tavern type equipment" to clarify that any equipment used in these nonresidential settings would retain its character as tangible personal property, regardless of the type of equipment.

DISCUSSION POINTS

1. The Department of Revenue (DOR) indicates that its long-standing position has been that the repair, service, alteration, fitting, cleaning, painting, coating, towing, inspection, and maintenance of tangible personal property are subject to the sales tax, even though performing these services arguably could result in an addition to or capital improvement of real property. In contrast, the original installation or complete replacement of an item which results in an addition to or capital improvement of real property is not subject to the state's sales tax. The Governor's provisions are intended to clarify the statutes to reflect DOR's current treatment of such transactions. Therefore, no fiscal effect is estimated.

2. However, DOR indicates that, as drafted, the bill could have the unintended effect of imposing the sales tax on all installations of tangible personal property, including installations that become a part of real property when installed. Therefore, DOR recommends that the Committee adopt a technical modification specifying that the sales tax would apply to the service of installing or applying tangible personal property to the items deemed to retain their character as tangible personal property, regardless of whether the installation or application constitutes an addition or capital improvement of real property; but not to the original installation or complete replacement of an item listed if the installation or replacement constitutes a real property construction activity as defined in s. 77.51 (2). In recommending these changes, DOR hopes to clarify existing policy.

3. As evidence of the need to clarify current policy by adopting the bill's provisions, in combination with the suggested modification, DOR cites a 1996 case decided by the Wisconsin Tax Appeals Commission in which a taxpayer argued that the application of a resin surface to a worn, discolored bathtub constituted the application of tangible personal property which in turn brought about a capital improvement to real property. As a result, the taxpayer argued, the application services should not have been subject to the sales tax. In response, DOR argued that the taxpayer merely was repairing the worn bathtub. DOR presented expert testimony that the refinishing did not increase the value of the property and eventually prevailed in the case. Nonetheless, the Department remains concerned that, under current law, its long-standing position is in question and, as a result, it could face a similar case in the future with a possibly adverse outcome. DOR indicates that reversal of its policy could cost the state substantial revenue.

ALTERNATIVES TO BILL

1. Approve the Governor's recommendation with the technical modifications recommended by DOR.

2. Maintain current law.

Prepared by: Drew B. Larson

GENERAL FUND TAXES

General Sales and Use Tax

Bill Agency

LFB Summary Item Addressed at a Previous Committee Executive Session

Item #	Title
3	Sales Tax on Noncommercial Aircraft (Paper #900)

General Fund Taxes

Public Utility Taxes

Bill Agency

(LFB Budget Summary Document: Page 41)

LFB Summary Items for Which Issue Papers Have Been Prepared

Item #	Title
1	Utility Tax on Wholesale Electricity Sales (Paper #115)

AGENCY: General Fund Taxes - Public Utility Taxes

PAPER: #115

ISSUE: Utility Tax on Wholesale Electricity Sales

RECOMMENDATION: Alternative (anything is fine)

SUMMARY: If you want to capture the GPR eliminate or change the tax break. Otherwise, this will probably be part of the large tax motion.

BY: Barry

Alt 2

Legislative Fiscal Bureau
One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873

June 5, 2001 | Joint Committee on Finance | Paper #115

Utility Tax on Wholesale Electricity Sales (General Fund Taxes -- Public Utilities Taxes)

[LFB 2001-03 Budget Summary: Page 41, #1]

CURRENT LAW

Under current law, light, heat and power companies (LHPs) [including qualified wholesale electric companies] and electric cooperatives are generally subject to a state 3.19% gross revenues tax (license fee) on revenues from electricity sales. Gross revenues from the sale of gas services by an LHP are subject to a state tax at the rate of 0.97%. The state tax is in lieu of local property taxes.

In the case of an LHP that is not a qualified wholesale electric company, if the company's property is located entirely within a single town, village or city, it is subject to local assessment and taxation. For municipal LHPs subject to the tax, gross revenues from operations within the municipality are subtracted from total gross revenues for the purpose of determining the tax.

A qualified wholesale electric company is a generation facility in Wisconsin that is operated for the sale of electricity to an entity that sells electricity directly to the public. In addition, to meet the definition of a qualified wholesale electric company, the company must sell at least 95% of its net production of electricity to an entity that sells electricity directly to the public and must have a minimum total power production capacity of 50 megawatts. Under current law, a qualified wholesale electric company is interpreted by the Department of Revenue (DOR) as including a wholesale merchant plant (a generating company that sells electricity at wholesale, typically on the spot market) as long as it meets this minimum capacity requirement.

The gross revenues tax is paid in semi-annual installments of either 55% of the tax on gross revenues for the prior year or 50% of the estimated tax on gross revenues for the current year on May 10 and November 10. On the following May 10, a final adjustment payment or refund is made to reconcile the two prior installment payments with the actual assessment.

Currently, the 3.19% tax applies to sales of electricity whether they are at wholesale or retail. However, certain deductions can be made for the cost of power purchased by a public utility for resale. A private LHP may deduct from gross revenues either: (a) the actual cost of power purchased for resale if the company purchases more than 50% of its electric power from a nonaffiliated utility that reports to the Public Service Commission (PSC); or (b) 50% of the actual cost of power purchased for resale if that company purchases more than 90% of its power and has less than $50 million in gross revenues. An electric cooperative may deduct from its gross revenue the actual cost of power for resale, as long as it purchases more than 50% of the power it sells from a seller that pays the state gross revenues tax.

GOVERNOR

Reduce the tax on wholesale electricity sales from 3.19% to 1.59% for a six-year period, beginning with gross revenues from calendar year 2003. Specify that all merchant plants would be subject to state taxation in lieu of local property taxes. [The provisions specific to merchant plants are discussed under Issue Paper #828.] In addition, modify current utility aid provisions under the shared revenue program to apply to property of LHPs subject to the proposed tax for selling electricity at wholesale and to property of wholesale merchant plants. [The shared revenue provisions are described under Issue Paper #829.]

The 1.59% tax on revenues from wholesale electricity sales would generally be administered under current law provisions for administering the 3.19% tax. In addition, the bill would specify that the term "apportionment factor" would have the same meaning for purposes of the tax on wholesale electricity sales as that used for the 3.19% assessment on LHPs. The apportionment factor combines payroll, property and sales factors to determine the fraction of a company's total gross revenues attributable to Wisconsin and therefore subject to the tax. [In other provisions, the bill would modify the definition of the "payroll factor" to specify that management and service fees paid by an LHP to an affiliated public utility holding company would be considered to be compensation paid by the LHP. The fiscal effect of this modification is expected to be minimal.]

DISCUSSION POINTS

1. Under the bill, gross revenue from sales of electricity at wholesale by an LHP or electric cooperative that owns an electric utility plant would be exempt from the 3.19% tax. Instead, a tax at the rate of 1.59% would be imposed on such sales. According to the administration, these provisions were included in the bill to encourage the development of merchant power plants and enhance energy supplies in the state.

2. The proposed tax rate for wholesale electricity would apply to tax assessments starting May 1, 2004, and ending with the assessment on May 1, 2009. Taxes are assessed on or before May 1 of the year following a calendar year in which revenues are generated. Therefore, these provisions would apply to gross revenues from calendar years 2003 through 2008.

3. The administration estimates that the annualized fiscal effect would be $7.8 million (in current dollars). Based on historical growth in revenues from wholesale electricity sales, it is now projected that, under the bill, tax collections would be reduced by $9.0 million annually.

4. As the reduced rate would first apply to tax assessments starting May 1, 2004, no fiscal effect was estimated by the administration for the 2001-03 biennium. However, the due date for the first installment of the May 1, 2004, assessment is in May, 2003. Therefore, it is estimated that the effect of these provisions would be a reduction in general fund tax collections of $4.0 million in 2002-03.

5. It was the administration's intent that the tax for wholesale electricity sales would return to the 3.19% rate for revenues earned starting January 1, 2009. However, as drafted, the bill could be interpreted as completely excluding wholesale electricity sales from taxation after the expiration of the proposed 1.59% tax. The administration supports a modification to the bill to clarify that the tax rate on revenues from wholesale electricity sales would return to 3.19% for tax periods starting January 1, 2009.

6. The administration has indicated that it would not be opposed to delaying for one year the applicable date for the reduced tax rate. Under this option, the 1.59% tax rate for wholesale electricity would apply to tax assessments starting May 1, 2005, and ending with the assessment on May 1, 2010 (these assessments would be based on gross revenues from calendar years 2004 through 2009). The tax rate would return to 3.19% starting January 1, 2010. This change would eliminate the $4.0 million fiscal effect in the 2001-03 biennium.

7. 1997 Wisconsin Act 204, an act relating to electric reliability, provided authorization for wholesale merchant plants to operate in the state. Act 204 defined a wholesale merchant plant as electric generating equipment and associated facilities in this state that do not provide retail service. A wholesale merchant plant may be owned by a person that is not a public utility or, with PSC approval, by an affiliated interest of a public utility. In the electric industry, the term "merchant plant" generally refers to a plant that sells on the spot market (rather than through long-term contracts with utilities, as is the case with some other wholesale electric companies).

8. In addition to authorizing merchant plants, Act 204 made it easier for such a plant to obtain the necessary certificate of public convenience and necessity (CPCN) from the PSC. It was expected that, under a deregulated environment, merchant plants would become a common means of meeting the state's need for additional generation.

9. Currently, there is one merchant plant operating in Wisconsin, the Mid-American Power plant in Cassville. Another merchant plant is under construction, and others that have been proposed. If a merchant plant has a minimum generating capacity of 50 MW, then it is subject to the state gross revenues tax on LHPs (in lieu of local property taxes). Smaller plants are taxed locally. [Under the bill, all merchant plants would be subject to the tax, including those with a capacity of less than 50 MW.]

10. In December, 2000, the Department of Revenue convened a study group to consider whether utility tax laws were appropriate for an electric power industry undergoing significant regulatory and structural change. The Department explained that the purpose of the group would be information gathering, to stimulate dialogue regarding the state's energy tax laws in the new environment. The group consisted of legislators, representatives of various components of the electric industry and representatives of electricity consumers. The group met four times between December, 2000, and February, 2001. After considerable debate as to whether to consider broad changes to the electric utility tax structure or narrower issues thought to be more urgent in nature, the study group focused on the narrower issues.

11. After the final meeting, the Secretary of DOR forwarded a recommendation to the Governor on behalf of the group that was consistent with the provisions under the bill to reduce the gross revenues tax on wholesale power sales from 3.19% to 1.59% for revenues from calendar years 2003 through 2008. The study group recommended limiting the tax reduction to a six-year period in recognition that the issue of the appropriate tax structure for this changing industry may need to be revisited. [In addition, there were two other recommendations from the group. The first pertained to repealing certain limits on utility shared revenue payments and to fully funding increases in such payments that would result from the repeal of the limits and the siting of future power plants. The final recommendation was to expand the use of new utility tax revenues to include other incentive payments to local governments, such as payments to communities to allow location of new transmission lines within their boundaries.]

12. A proposal to reduce taxes on wholesale electricity was first advanced by developers of merchant plants. One of the arguments was that power sold by a merchant plant to a Wisconsin investor-owned utility (IOU) would be subject to double taxation; first when sold by the merchant plant to the IOU and again when sold by the IOU to the final customer. Similar to the sales tax, the gross revenues tax applies to sales revenues. But a sales tax is applied only to the final retail sale, whereas the gross revenues tax applies each time that power is sold in the state.

13. The tax is imposed in lieu of local property taxes. Therefore, it is reasonable that both a merchant plant and the IOU in the situation described above should pay tax. Yet the equity of the tax can be questioned when it applies twice if the power is sold from an in-state merchant plant to an in-state utility but only once if the power is either: (a) generated and sold by a single in-state utility; or (b) purchased by an in-state utility from an out-of-state generator. Merchant plant developers believe that the nature of the state tax puts them at a competitive disadvantage with out-of-state electric companies that could sell to in-state utilities without paying the fee.

14. This issue is not unique to sales involving merchant plants. The state tax also applies twice in the case of an in-state utility selling power at wholesale to another in-state utility that subsequently sells the power to Wisconsin consumers. As described above under "Current Law," the state recognizes the concern with double taxation by offering certain deductions for purchased power. At present, there are no IOUs that can use the purchased power deduction provided for a private LHP that buys more than 50% of its electric power from a nonaffiliated utility regulated by the PSC, as none purchases more than 50% of its power. However, if non-utility generators in the

state begin to provide more of the state's power supply, IOUs will probably begin to qualify for this deduction. If the reduced rate on wholesale electricity were in effect and an IOU were to get the purchased power deduction, total tax collections would be reduced through the lower tax rate on the wholesale sale as well as the deduction of the power cost from the IOU's gross revenues.

15. The proposed rate reduction would lessen the effect of applying the tax twice on the sale of the same power. But it would not correct the structural problem of a tax that varies in total amount depending on who the sellers and buyers are. An alternative approach that would address the structural problem would be to maintain the 3.19% tax, but to eliminate the current law requirement that the 100% purchased power deduction applies only when an LHP or electric cooperative buys more than 50% of its power. This change would allow utilities to deduct 100% of the cost of power purchased from a nonaffiliated company that also pays the state tax. Under such a plan, a merchant plant selling to a Wisconsin IOU or electric cooperative would pay the 3.19% tax on the sale. The IOU or electric cooperative would deduct the cost of the purchase from its gross receipts when determining its tax. Based on information provided by DOR, it is estimated that this proposal would reduce general fund tax revenues by $3.0 million annually (in 2002-03 dollars). If the proposal took effect starting with gross revenues from tax year 2003, the estimated effect would be a reduction in general fund tax revenues of $1.5 million in 2002-03.

16. The tax on LHPs was imposed at a time when IOUs were primarily responsible for all three components of electricity supply: generation, transmission and local distribution to the end-user. The tax was typically imposed just once and yet encompassed all three components of the industry. A new landscape in which there is greater separation of the components may require a different kind of tax.

17. In May, 2000, the House Research Department of the Minnesota House of Representatives released a publication entitled "Electric Utilities: Taxation and Retail Restructuring." The report reveals that state taxes on the electric industry are complex and varied. A small number of states, including Wisconsin, rely on a tax on gross receipts. [Several states have recently replaced the gross receipts tax with a consumption tax.] The majority of states have some form of property tax (either state, local or a combination of both), sometimes in conjunction with other taxes. In Illinois, for example, electric utilities are subject to local property taxes on real property and to a state "electricity excise tax" that is collected by electricity suppliers.

18. The state of Iowa recently revised its electric utility tax structure. Through 1998, electric utilities in Iowa were subject to local property taxes. But effective January 1, 1999, Iowa replaced local property taxes on the industry with excise taxes on generation, transmission and local delivery of electricity. In addition, the state imposes a small state property tax on the industry.

Iowa's revised tax system was designed to be revenue-neutral. By separating the tax into components, Iowa's approach avoids the issue of double taxation. As the tax is spread among all components of the industry, no single component is overburdened. The system insures that activity within the state is taxed by the state, regardless of the final destination of the power. However, the excise tax on in-state generation is low enough that it is not viewed as a deterrent to out-of-state competition.

19. In addition to the scope of the ways in which states tax the electric utility industry, the Minnesota report makes it clear that many states are currently exploring how to revise existing taxes in a changing environment. One approach would be to make incremental adjustments to the existing tax system to address current issues and to make additional changes as the restructured industry evolves. The administration's proposed temporary reduction in the tax on wholesale electricity sales is an example of this approach, which is supported by the DOR study group. Another option would be to follow Iowa's example and design a completely new tax structure that would work currently and that could also accommodate anticipated industry changes. In evaluating the administration's plan for Wisconsin, it is important to consider several issues: (a) the urgency of the need for additional generation; (b) the need for a tax cut to secure additional generation; (c) whether merchant plant development is a clear priority for the state; (d) other issues related to the electric industry; and (e) the cost of the proposal.

20. *The Need for Additional Generation.* The energy crisis in California has raised a general concern throughout the country about the adequacy of power supplies. In recent years, Wisconsin utilities have had to make public appeals for reduced power usage on hot summer days when high demand led to power failures in the area. It appeared that the state was in critical need of additional generation. However, the supply situation for the coming summer looks more promising. The Mid-America Interconnected Network (MAIN), an organization that oversees the region's electric reliability [including the transmission activities of the American Transmission Company (ATC) of Wisconsin], reports that power supplies for the Midwest this summer are expected to be more plentiful than in recent years because of power purchases, plant construction and transmission system improvements. The region is expected to have about 18% of its power supply in reserve at peak usage this summer.

21. *The Need for a Tax Cut to Secure Additional Generation.* The slightly longer-term supply picture also looks promising. State officials have estimated that Wisconsin needs 300 MW of new generation annually to meet growing demand. Based on information provided by the PSC, roughly 500 MW of generation capacity was added in the year 2000. In addition, plans to add more than 8,000 MW of capacity have been announced. Not all of the proposed plants will be built and not all of the power will be sold to in-state users. Nonetheless, the fact that there is so much interest in adding capacity calls into question the immediacy of the need for the state to provide tax incentives to power plant developers.

22. *The Need to Encourage Merchant Plant Development.* The administration has stated that the intent of the proposed tax cut on wholesale power sales is to encourage merchant plant development. When merchant plants were authorized in Wisconsin under Act 27, they were expected to become a significant source of additional power for the state. However, the energy crisis in California has illustrated some potential disadvantages of relying too heavily on non-regulated power producers.

The price of electricity sold by merchant plants is not subject to regulation, nor is there any requirement that a merchant plant sell in the state in which it is located. When California's energy supplies tightened in recent months, prices of power increased significantly (along with speculation about power price gouging by independent electricity generators). Both California and New York, two of the first states to deregulate energy markets, are now considering punitive measures to prevent electricity generators from charging excessively high prices. Generators in the two states have argued that such measures could cause producers to avoid selling to markets in these states. Potential problems with the lack of regulation of independent suppliers have become more evident as states gain experience with a less regulated environment.

At least one Wisconsin IOU that had previously been in favor of encouraging utilities to purchase power from independent producers on the competitive wholesale market is now proposing to add its own power plants (as well as to buy some power from independents). A second Wisconsin IOU, with the support of a consumer advocacy group, has proposed an alternate structure that would provide for expanded capacity while maintaining state regulation. While independent power producers clearly will continue to have a role in supplying power, in the wake of California's experience, opinions may be changing on the extent of the desired role for merchant plants.

23. *Other Issues.* In the immediate future, a more pressing concern than whether enough power is being produced may be whether or not Wisconsin's transmission system will be able to deliver the power. MAIN reports that there have frequently been restricted transfer capabilities into and within Wisconsin in the past several years. The American Transmission Company has stated that Wisconsin's transmission system is being stressed and that there was recently a near overload of the line that could have caused rolling blackouts through a large portion of the Midwest. Company officials report that the United States Department of Energy recognizes a stretch of the ATC's transmission line carrying power into Wisconsin from Minnesota as one of the significant logjams in the nation's transmission system. [One of the recommendations of the DOR study group is that the state expand the use of new utility tax revenues to include other incentive payments to local governments (for example to provide incentives to communities to allow location of new transmission lines within their boundaries). However, no specific proposal was generated, nor is there a budget provision addressing this issue.]

Other issues related to the electric industry that should be considered along with any tax restructuring include the following:

a. Currently, the gross revenues tax is based, in part, on the proportion of a company's sales that are in the state. Yet there is no clarification on how the situs for inter-state sales is determined. The definition needs to be clarified to guarantee consistent treatment of such sales for purposes of the tax.

b. The DOR study group recommended the repeal of certain limits on the value on which utility aid payments for power plants are based and the per capita caps on such aid payments to municipalities and counties. The study group also recommended full funding increases for shared revenue for aid payments that would result from the repeal of the caps and limits and from the siting of future power plants. The bill would address these recommendations only in part, by providing that shared revenue payments would be increased by any additional amount of utility aid resulting from the property of a wholesale merchant plant, beginning in 2002 (if the property did not exist in the previous year). The part of the study group recommendation on increasing incentives to local communities to accept a new power plant (whether or not the plant is a merchant plant) is not included in the bill, but it may be an important factor in the siting of new plants.

24. *The Cost of the Tax Cut.* The reduced tax on wholesale electricity has been referred to as a method of promoting merchant plant development. However, the bulk of the estimated $9.0 million annual cost of these provisions would come from reducing taxes on existing companies (which include one merchant plant). Because the provisions would apply to all wholesale sales of electricity (including those by IOUs and electric cooperatives), they would also reduce future growth of the existing tax base, even if no additional merchant plants were built.

25. Regardless of the exact future of the electric industry, it is clear that there will be at least some separation of the components of generation, transmission and local delivery of electricity. It is also clear that it is important to address concerns related to transmission and siting of plants in addition to generation. Based on these observations, it may be reasonable to take a comprehensive approach to the taxation of the electric utility industry, rather than making incremental changes to the current tax system.

ALTERNATIVES TO BILL

1. Approve the Governor's recommendation to reduce the gross revenues tax for wholesale electricity sales to 1.59%, with modifications to do the following: (a) estimate a reduction in general fund revenues of $4.0 million in 2002-03; and (b) specify that the tax rate on wholesale electricity sales would be 3.19% starting with revenues from such sales for calendar year 2009.

Alternative 1	GPR
2001-03 REVENUE (Change to Bill)	- $4,000,000

2. Approve the Governor's recommendation to reduce the gross revenues tax rate for wholesale electricity sales to 1.59%. However, specify that the reduced rate would apply to tax assessments starting May 1, 2005, and ending with the assessment on May 1, 2010 (these assessments would be based on gross revenues from calendar years 2004 through 2009). Provide that the tax rate would return to 3.19% of gross revenues earned starting January 1, 2010.

3. Delete the Governor's recommendation. Instead, provide a 100% deduction from gross revenues for the cost of power purchased at wholesale (from a supplier that included the revenue from the sales in its gross revenues subject to the state tax) for the purpose of determining the tax for the LHP or electric cooperative purchasing the power. Provide that these provisions would take effect starting with the May, 1, 2004, assessments.

Alternative 3	GPR
2001-03 REVENUE (Change to Bill)	- $1,500,000

4. Approve Alternative #3. However, specify that the 100% deduction for the cost of power purchased at wholesale would apply to tax assessments starting May 1, 2005.

5. Maintain current law. However, request that a Legislative Council Study Committee be appointed to study the question of state taxation of LHPs and electric cooperatives including taxes, the situs of a sale and incentives for local communities to accept power plants and transmission facilities.

6. Maintain current law.

Prepared by: Faith Russell

GENERAL FUND TAXES

Public Utility Taxes

Bill Agency

LFB Summary Item for Which No Issue Paper Has Been Prepared

Item #	Title
3	Property Tax Assessment of Telephone Companies

LFB Summary Item Addressed at a Previous Committee Executive Session

Item #	Title
2	Public Utility Holding Companies Affiliated with Light, Heat and Power Companies

AGENCY: General Fund Taxes

ISSUE: Regulation of Alcoholic Beverages (Paper 120)

ALTERNATIVE: 1

SUMMARY:

This adopts the governor's recommendation, representing months of negotiations between people at all levels of the industry.

Notable among the changes:

- 30-day limit on keeping beer on shelf to protect quality and freshness.
- Prohibitions on shipments from out-of-state to prevent illegal mail order sales and loss of state excise taxes.
- Easier access to training courses for servers through on-line opportunities.
- Greater flexibility for brewers, wholesalers and retailers that would more closely reflect current industry practices.
- Increased flexibility for advertising and promotions that could help promote the tavern industry -- which has been under significant pressure.
- Makes fair dealership provisions consistent with those applying to liquor industry.

By: Bob

Legislative Fiscal Bureau
One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873

June 5, 2001 | Joint Committee on Finance | Paper #120

Regulation of Alcoholic Beverages
(General Fund Taxes -- Excise Taxes and Regulation of Alcohol and Tobacco)

[LFB 2001-03 Budget Summary: Page 45, #2]

CURRENT LAW

Sales of Alcohol by Secured Third Parties

Under current law, no license or permit is required for the sale of alcohol by a secured third party in good faith under the terms of a security agreement if the sale is not for purpose of avoiding state alcoholic beverage regulations or the state excise taxes on alcoholic beverages. Such sales must be in the ordinary course of the business of lending money secured by a security interest in alcoholic beverages, warehouse receipts or other evidence of ownership.

Beer Shipped from Out-of-State

Under current law, the Department of Revenue (DOR) must issue out-of-state shippers' permits, which authorize the permittee to ship beer only to licensed wholesalers. No person may receive beer in this state that has been directly shipped from outside this state by any person other than the holder of an out-of-state shipper's permit. All shipments of beer to a wholesaler in this state, whether shipped from inside or from outside this state, must be unloaded in and distributed from the wholesaler's warehouse in this state.

Upon request by the Secretary of DOR, the Attorney General may represent the state or assist a local district attorney in prosecuting any case arising from the statutes regulating the sale of alcoholic beverages.

Operator's License Training Course

Currently, in order to obtain an alcoholic beverages operator's license (bartender's license), an individual may be required to complete a responsible beverage-server training course that is offered by a technical college district and that conforms to guidelines specified by the Wisconsin Technical College System Board, or a comparable course that is approved by DOR or the Educational Approval Board.

Gifts Provided by Brewers or Wholesalers to Retailers

Current law, with a number of exceptions, prohibits brewers or wholesalers from furnishing, giving, lending, leasing or selling furniture, fixtures, fittings, equipment, money or other things of value to any campus or person holding a Class "B" license or permit (for the retail sale of beer for on-premises consumption), or to any person for the use, benefit or relief of any campus or Class "B" retailer. Some of the exceptions to this general provision are as follows:

Signs, Clocks and Menu Boards. Brewers or wholesalers may provide, for placement inside the premises, signs, clocks or menu boards with an aggregate value of not more than $150. Each recipient must keep an invoice or credit memo containing the name of the donor and the number and value of items received and must make these records available to DOR for inspection upon request. Signs provided by a brewer or wholesaler must be made from paper or cardboard.

Advertising. Brewers and wholesalers may purchase advertising for fair compensation from a bona fide national or statewide trade association which derives its principal income from membership dues of Class "B" retailers.

Business Entertainment. Brewers and wholesalers may provide, in this state, reasonable business entertainment that is deductible under federal tax law to a Class "B" retailer by: (a) providing tickets or free admissions to athletic events, concerts or similar activities; or (b) providing food and beverages and paying for local ground transportation in connection with such activities and business meetings. However, the value of business entertainment provided may not exceed $75 per day.

Contributions to Retail Trade Associations. Brewers that produce 350,000 or more barrels of beer annually may contribute money or other things of value to a bona fide national or statewide trade association that derives its principal income from membership dues of Class "B" licensees.

Fair Dealership Provisions for Beer Wholesalers

Under current provisions of the Fair Dealership Law (Chapter 135 of the statutes), the grantor of a dealership may not (directly or through any officer, agent or employee) terminate, cancel, fail to renew or substantially change the competitive circumstances of a dealership agreement without good cause. The burden of proving good cause is on the grantor of the dealership. In general, a "dealership" is a contract or agreement by which a person is granted the right to sell or distribute goods or services or use a trade name, advertising or other commercial symbol, in which there is a community of interest in the business of offering, selling or distributing goods or services.

GOVERNOR

Sales of Alcohol by Secured Third Parties

The bill would specify that a sale of beer under the provisions relating to secured third parties would have to be made within 30 days after the third party takes possession of the beer unless the third party demonstrates good cause why a sale in compliance with the statutes on secured transactions or the security agreement cannot be made within this time period. This restriction would first apply to security interests entered into on the day after publication.

Beer Shipped from Out-of-State

The bill would require DOR to issue a written warning to any person located outside Wisconsin that sells or ships beer into this state in violation of the provisions relating to out-of-state beer shipments if the person has not previously received a warning. Any person located outside of this state that sells or ships beer in violation of these provisions and that has received a warning from DOR would be subject to a fine of up to $10,000, imprisonment for up to two years or both. This provision would first apply to violations on the first day of the sixth month beginning after publication.

The bill would also authorize the Attorney General, upon request by the Secretary of DOR, to commence an action to enforce the provisions regarding shipments of beer to Wisconsin wholesalers in the Dane County circuit court.

Operator's License Training Course

The bill would specify that beverage server training courses required for licensure could include computer-based training and testing.

Gifts Provided by Brewers or Wholesalers to Retailers

Signs, Clocks and Menu Boards. The bill would modify the provision relating to signs, clocks and menu boards by increasing the dollar limit from $150 to $2,500. In addition, both the donor and the recipient (rather than only the donor) would be required to keep written documentation containing the name of the recipient and donor and the number and value of items provided, and make these records available to DOR. The bill would also allow temporary signs made from plastic or vinyl or from other materials with a useful life of less than one year (rather than just signs made from paper or cardboard). In addition, the bill would specify that temporary signs could be provided without regard to the $2,500 limit ($150 under current law) on the aggregate value of items provided by brewers and wholesalers.

Advertising, Sweepstakes and Promotions. The bill would allow brewers and wholesalers to purchase advertising from any person who does not hold an alcoholic beverages license or permit and who conducts a bona fide advertising, promotional or media business, to promote brewer- or wholesaler-sponsored sweepstakes, contests or promotions on the premises of Class "B" retailers if: (a) the advertising or promotion includes at least five unaffiliated retailers; and (b) the retailer on whose premises the event will occur does not receive compensation, directly or indirectly, for hosting the event. In addition, the bill would allow brewers and wholesalers to conduct their own sweepstakes, contests or promotions on the premises of Class "B" retailers if the above conditions are satisfied.

Business Entertainment. The bill would increase the limit on business entertainment provided by brewers or wholesalers from $75 per day to $500 per day and specify that such business entertainment could be provided on no more than 12 days per year.

Contributions to Retail Trade Associations. The bill would: (a) allow any brewer (not just large brewers) to make contributions to retailer trade associations; (b) allow wholesalers to make such contributions; and (c) allow contributions to local trade associations (instead of just state or national associations).

Fair Dealership Provisions for Beer Wholesalers

The bill would specify that a contract or agreement by which an alcoholic beverages wholesaler is granted the right to sell or distribute beer would be a dealership, even if no community of interest exists. Such agreements would be subject to the provision described above regarding the termination of a dealership. [The grantor of the dealership could not terminate, cancel, fail to renew or substantially change the competitive circumstances of a dealership agreement without good cause.] A similar provision exists under current law for wholesalers of intoxicating liquor, but not for beer wholesalers.

The bill would also create a separate provision in Chapter 135 for dealerships that involve beer wholesalers. Under the bill, any person who assumes, in whole or in part, such a dealership following the grantor's termination, cancellation, or nonrenewal in whole or in part of a prior dealership agreement would be required to compensate the prior dealer for the fair market value of that portion of the dealership unless the grantor terminated the dealership for any of the following reasons: (a) the prior dealer engaged in material fraudulent conduct or made material and substantial misrepresentations in its dealings with the grantor or with others related to the dealership; (b) the prior dealer was convicted of, or pleaded no contest to, a felony crime substantially related to the dealer's ability to operate the dealership; or (c) the prior dealer knowingly distributed dealership products outside the territory authorized by the grantor.

The grantor would be required to advise the person assuming the dealership of these obligations prior to the person's assumption of the dealership. If the person assuming the dealership and the prior dealer agree in writing to the fair market value of that portion of the dealership, the person assuming the dealership would have to pay the agreed upon sum within 30 days of the agreement. If no written agreement for compensation of the prior dealer is reached within 30 days after the grantor's termination of the prior dealership agreement, the prior dealer could submit the dispute for binding arbitration through a nationally recognized arbitration association. Unless the parties agree otherwise, the arbitration would be conducted on an expedited basis to the extent an expedited proceeding is reasonably available through the arbitration association, and each party would have to pay an equal share of the cost of the arbitration.

These provisions would first apply to dealerships entered into on the day after publication.

Retail Beer and Liquor Licenses

The bill would prohibit municipalities and DOR from issuing a retail license or permit for the sale of beer, wine or liquor for a premises that is already covered by the same kind of current license or permit unless all of the following apply:

a. The applicant provides proof that, not less than 15 days nor more than 30 days before submitting the application, the current licensee has provided the applicant the name and address of each beer wholesaler to whom the current licensee is indebted.

b. The applicant provides proof that, not less than 15 days nor more than 30 days before submitting the application, the applicant has notified each such wholesaler of the name and address of the current licensee and that the applicant is applying for the license or permit.

c. The current licensee is not in violation of statutory restrictions regarding purchases of beer, wine or liquor on credit unless the violation consists of an indebtedness discharged in bankruptcy.

d. The current licensee is not the subject of any proceeding related to revocation, suspension or nonrenewal of an alcohol license or permit.

This provision would first apply to an application for a license or permit submitted on the first day of the 12th month beginning after publication.

DISCUSSION POINTS

Sales of Alcohol by Secured Third Parties

1. Under current law, no license or permit is required for the sale of alcohol by a

secured third party in good faith under the terms of a security agreement if the sale is not for purpose of avoiding state alcoholic beverage regulations or excise taxes. The bill would require that such sales be made within 30 days after the third party takes possession of the beer unless the third party demonstrates good cause why a sale in compliance with the statutes on secured transactions or the security agreement cannot be made within this time period.

2. Proponents of this provision argue that beer is a perishable product and the current provision allows third parties to seize beer and hold it as long they desire before resale. The 30-day time period proposed in the bill would help protect product quality in such transactions.

3. On the other hand, it is in the interest of third parties to sell the beer before its shelf life has expired. Therefore, the proposed 30-day limit may be viewed as an unnecessary restriction.

Beer Shipped from Out-of-State

4. The bill would require DOR to issue a written warning to any person located outside Wisconsin that illegally sells or ships beer into this state. A second offense would result in a fine of up to $10,000, imprisonment for up to two years or both. The bill would also authorize the Attorney General, upon request by the Secretary of DOR, to commence an action to enforce the provisions regarding shipments of beer to Wisconsin wholesalers in the Dane County circuit court.

5. The current penalty is a fine of up to $1,000, imprisonment for up to 90 days, or both. The more severe penalties under the bill are intended to help prevent illegal mail order sales of beer into Wisconsin. Such sales can result in a loss of state excise taxes and purchases of beer by underage individuals.

6. The Wisconsin Brewers Guild, which represents 32 small breweries in Wisconsin, maintains that the current prohibition on mail order sales is not enforceable, and would continue to be unenforceable, even with the higher penalties recommended by the Governor. The Guild suggests that an alternative approach would be to permit limited mail order shipments of beer into Wisconsin from brewers in states that have entered into a reciprocity agreement with Wisconsin for such shipments. A similar provision exists under current state law for shipments of wine. The mail order wine provision allows individuals who are over the legal drinking age to purchase up to nine liters annually and prohibits the purchaser from reselling the wine or using it for commercial purposes. A limit for beer that would be roughly equivalent to the nine-liter limit for wine would be six gallons annually.

Operator's License Training Course

7. The bill would specify that beverage server training courses required for licensure could include computer-based training and testing. This provision would provide easier access to such training courses. However, it could be argued that traditional classroom courses are a more effective means of assuring that appropriate training is being provided.

Gifts Provided by Brewers or Wholesalers to Retailers

8. Current law includes a number of prohibitions and limitations on the amounts and types of gifts that may be provided from brewers and wholesalers to beer retailers ("tied-house" provisions). These restrictions are intended to prevent individual brewers and beer wholesalers from having undue influence over the types of products carried by retailers. The tied-house provisions are part of Wisconsin's "three-tier" regulatory system for alcoholic beverages, which is based on independently operating brewers, wholesalers and retailers.

9. The bill would relax the limits on certain gifts that may be provided from brewers and wholesalers to retailers. In general, proponents of these provisions maintain that the proposed modifications would provide greater flexibility to brewers, wholesalers and retailers and would more closely reflect current industry practices. However, others have argued that relaxing these provisions would place small brewers at a competitive disadvantage compared to larger brewers who have greater access to resources that can be used to influence retailers.

Signs, Clocks and Menu Boards

10. The aggregate value limit for permanent signs, clocks and menu boards would be increased from $150 to $2,500. In addition, the bill would allow temporary signs made from plastic or vinyl or from other materials with a useful life of less than one year (rather than just signs made from paper or cardboard) to be provided, and would exempt such signs from any dollar limit. Under current law, temporary signs are subject to the $150 limit.

11. The current $150 limit was established in 1983. If this amount were adjusted for inflation, it would be set at approximately $270 in 2001. Therefore, it could be argued that the $2,500 limit proposed by the Governor is unwarranted. An alternative would be to raise the limit to $270 on the bill's effective date and index it for inflation each year thereafter.

Advertising, Sweepstakes and Promotion

12. The bill would allow brewers and wholesalers to purchase advertising to promote brewer- or wholesaler-sponsored sweepstakes, contests or promotions on the premises of Class "B" retailers if: (a) the advertising or promotion includes at least five unaffiliated retailers; (b) the retailer on whose premises the event will occur does not receive compensation for hosting the event; and (c) the firm from whom the advertising is purchased does not hold an alcoholic beverages license or permit. In addition, the bill would allow brewers and wholesalers to conduct their own sweepstakes, contests or promotions on the premises of Class "B" retailers if the above conditions [(a) and (b)] are satisfied.

13. Proponents of this modification argue that these types of events could help promote the tavern industry, which has experienced stagnant sales in recent years.

14. Others maintain that this provision would permit large brewers to provide a significant amount of financial assistance to retailers with little effective oversight, which could

have an adverse impact on smaller brewers. It is also argued that this provision could create unfair competitive advantages for certain retailers.

Business Entertainment

15. The bill would increase the limit on business entertainment provided by brewers or wholesalers from $75 per day to $500 per day and specify that such business entertainment could be provided on no more than 12 days per year.

16. The $75 limit was established in 1981. If adjusted for inflation, this limit would be increased to approximately $150 in 2001.

17. As with the provision relating to advertising and promotional events, smaller brewers maintain that the proposed increase to $500 would allow excessive influence by larger breweries. The Brewers Guild has endorsed the inflation-adjusted $150 limit.

Contributions to Retail Trade Associations

18. The bill would: (a) allow any brewer (not just large brewers) to make contributions to retailer trade associations; (b) allow wholesalers to make such contributions; and (c) allow contributions to local trade associations (instead of just state or national associations). Proponents of these changes believe that the current provisions discriminate against small brewers and should be changed.

Fair Dealership Provisions for Beer Wholesalers

19. As described above, the bill would make the fair dealership provisions for beer wholesalers similar to provisions for liquor wholesalers that were included in the 1999-01 biennial budget act. The bill would also create a separate provision (which does not apply to liquor wholesalers under current law) requiring beer wholesalers to be compensated if a dealership, or portion of a dealership, is terminated and granted to another wholesaler. If the person assuming the dealership and the prior dealer agree in writing to the fair market value of the portion of the dealership, the person assuming the dealership would have to pay the agreed upon sum within 30 days of the agreement. Otherwise, the prior wholesaler could submit the dispute for binding arbitration through a nationally recognized arbitration association.

20. This provision would typically apply in cases where a supplier transfers a brand of beer from one wholesaler to another within a geographical territory. The rationale is that the prior wholesaler should be compensated for its efforts in building demand for the brand.

21. Opponents argue that the current fair dealership provisions afford adequate protection to wholesalers from unfair terminations of dealership agreements and that the Governor's proposal would violate the spirit of free trade.

Retail Beer and Liquor Licenses

22. The bill would prohibit municipalities and DOR from issuing a retail license or permit for the sale of beer, wine or liquor for a premises that is already covered by the same kind of current license or permit unless all of the following apply: (a) the current licensee has provided the applicant with the name and address of each beer wholesaler to whom the current licensee is indebted; (b) the applicant has notified each such wholesaler of the name and address of the current licensee and that the applicant is applying for the license or permit; (c) the current licensee is not in violation of statutory restrictions regarding purchases of alcohol on credit unless the violation consists of an indebtedness discharged in bankruptcy and (d) the current licensee is not the subject of any proceeding related to revocation, suspension or nonrenewal of an alcohol license or permit.

23. This provision is intended to provide protection to beer wholesalers in cases where the wholesaler is owed money by a retailer that is going out of business.

24. It can be argued that this provision would effectively require municipalities to assist in debt collection on behalf of beer wholesalers. This could be viewed as an undesirable local mandate.

ALTERNATIVES TO BILL

1. Adopt the Governor's recommendations relating to: (a) sales of alcohol by secured third parties; (b) beer shipped from out-of-state; (c) operator's license training courses; (d) gifts provided by brewers or wholesalers to retailers; (e) fair dealership provisions for beer wholesalers; and (f) retail beer and liquor licenses.

2. Delete one or more of the following provisions from the bill:

a. Sales of alcohol by secured third parties
b. Beer shipped from out-of-state
c. Operator's license training courses
d. Signs, clocks and menu boards provided by brewers or wholesalers to retailers
e. Advertising, sweepstakes and promotions by brewers and wholesalers
f. Business entertainment provided by brewers or wholesalers to retailers
g. Contributions to retail trade associations by brewers and retailers
h. Fair dealership provisions for beer wholesalers
i. Retail beer and liquor licenses.

3. Permit mail order sales of beer to Wisconsin residents from brewers located in states that have entered into reciprocity agreements with this state for mail order sales of beer. Limit the amount of beer that may be purchased by an individual under this provision to six gallons per year. Specify that beer could not be shipped to a person who has not attained the legal drinking age and prohibit purchasers from reselling the beer or using it for a commercial purpose.

4. Raise the limit on the aggregate value of signs, clocks and menu boards that may be provided by a brewer or wholesaler to a beer retailer from $150 to $270, and adjust the $270 limit each year to reflect changes in the consumer price index.

a. Specify that the $270 limit would not apply to temporary signs.

b. Specify that the $270 limit would apply to temporary signs.

5. Raise the limit on business entertainment that may be provided by a brewer or wholesaler to a beer retailer from $75 per day to $150 per day, and adjust the $150 limit each year to reflect changes in the consumer price index.

a. Specify that such business entertainment could be provided on no more than 12 days per year.

b. Do not limit the number of days on which business entertainment may be provided.

6. Maintain current law.

Prepared by: Rob Reinhardt