techknowledge

The Coming Internet Tax Quid Pro Quo?

Issue #61
October 7, 2003

by *Adam D. Thierer and Veronique de Rugy*

The ongoing debate over the taxation of the Internet—or, more specifically, the application of sales tax collection obligations to all interstate vendors—is coming to a head. The Internet Tax Freedom Act of 1997, which didn't deal directly with sales taxes but imposed a moratorium on taxes on Internet access or "multiple or discriminatory" taxes on electronic commerce, is due to expire on November 1, 2003. The Internet Tax Nondiscrimination Act was introduced in the House (H.R. 49) and in the Senate (S. 150) to make the existing ITFA moratorium permanent. The measure already has already passed the House and is advancing through the Senate.

In the other direction, Rep. Ernest Istook (R-Okla.) and several cosponsors recently introduced H.R. 3184, the Streamlined Sales and Use Tax Act, which would eliminate existing federal barriers to state and local taxation of interstate commerce and Internet sales. Specifically, the Istook bill would give congressional blessing to the Streamlined Sales and Use Tax Agreement (SSUTA), an ongoing effort by many state and local leaders to enter into a formal compact that would simplify and harmonize sales tax administration among the states to get around constitutional hurdles to taxing interstate vendors.

Now that the ITFA appears to be sailing toward easy passage, state and local officials are starting to grumble about how it might cut into their future tax revenues if "Internet access" comes to include some of the old telecom services they tax so heavily. But state and local officials have continued to go along with the ITFA extension and kept their eyes squarely focused on the bigger prize: Congressional termination of the 30 years' worth of Supreme Court jurisprudence that has limited their ability to impose sales and use tax collection obligations on interstate activities and vendors. This is what the Istook bill would accomplish.

Thus, despite some complaints about the ITFA's prohibition on Internet access taxes, SSUTA supporters have long understood the benefit of allowing the ITFA to exist, and even be extended. It provides them with a potential legislative *quid pro quo* that roughly reads as follows: We gave you the ITFA moratorium on Internet access taxes, now give us your consent on the SSUTA compact so we can start collecting sales taxes on e-commerce transactions.

By way of background, in a string of Supreme Court decisions over the past 30 years, the Court held that states could only require firms with a physical presence—or "nexus"—in their jurisdictions to collect sales taxes on their behalf. State and local tax officials have worked to eliminate or water down these restrictions on their tax reach but thus far have not been able to get around them or convince Congress to give them the authority to tax interstate vendors. Simply stated, these Supreme Court rulings embodied the timeless principle of "no taxation without representation" and sought to apply sensible Commerce Clause protections to interstate activities since Congress had been silent on the matter.

Section 3 of the new Istook bill would effectively end these protections for interstate vendors by noting, "It is the sense of the Congress that the sales and use tax system established by the Streamlined Sales and Use Tax Agreement. . . provides sufficient simplification and uniformity to warrant Federal authorization to States that are parties to the Agreement to require remote sellers, subject to the conditions provided in this Act, to collect and remit the sales and use taxes of such States and of local taxing jurisdictions of such States." That language would send a clear message to

the Courts during future interstate tax policy or nexus controversies: Congress now cedes to the States—or, more specifically, the "Governing Board" of the SSUTA—authority over interstate commerce for cross-border sales tax collection activities.

Will SSUTA supporters now demand that the price of their general acceptance of the ITFA extension is the Istook bill's congressional blessing on the creation of a multistate compact and the elimination of existing Supreme Court jurisprudence? That's the proverbial million (or perhaps multibillion) dollar question. But such a quid pro quo is a steep price to pay for the mere extension of the ITFA's ban on Internet access taxes. Congress would be wise to think twice before casually disposing of 30 year's worth of sensible Supreme Court nexus jurisprudence, which not only embodied and extended the Founding Fathers' "no taxation without representation" vision but nurtured a vigorous interstate marketplace free from extraterritorial tax and regulatory meddling by state and local officials.

Supporters of the SSUTA are essentially proposing to abandon true federalism and jurisdictional tax competition in exchange for the power to potentially recoup a small amount of tax revenue from interstate sales via a uniform system of third-party tax collection. Sadly, it appears the many state and local officials would prefer tax collusion over a "laboratories of democracy" model of competition between the states. Real federalism, as envisioned by the Founders, is about a friction and tension between competing units of government, not cooperation and harmonization in the name of extending tax burdens. That's the European Union model of federalism, not the U.S. model. Congress should be wary of collusionary tax compacts such as the SSUTA that would grant the states such open-ended tax authority over the channels of interstate commerce. Preserving or enhancing tax competition should be a guiding theme of this ongoing debate.

Finally, some state leaders will claim that they need to tax the Net and interstate sales to curtail their current fiscal policy crisis. But that crisis is of their own doing, brought on by their profligate spending habits particularly at the end of the 1990s. Total state general fund spending grew by 7.7 percent in FY1999, 7.2 percent in FY2000, and 8.3 percent in FY01. Even as economic growth slowed and budget gaps appeared, state spending still increased 1.3 percent in FY02 and will increase further in FY03. And how much money do they really think they're going to squeeze out of the Net sector? Internet business represents a minuscule portion of aggregate retailing activity in the United States. According to the U.S. Department of Commerce, e-commerce activity accounted for just 1.3 percent of all aggregate retail sales in 2002. Some fear the Internet will grow larger, like mail order and catalog, but in reality those sectors represent breadcrumbs compared to the rest of the economy. Do we really want to justify a burdensome and potentially unconstitutional multistate tax compact and taxes on interstate activities on the grounds that the states need more cash in the short term?

After they cut spending, state and local leaders can explore other tax reform options to solve whatever problems they feel they are experiencing. But in doing so, they must abide by the constitutional protections and sensible nexus guidelines that have protected the channels of interstate commerce in previous decades. It would be foolish for members of Congress to abdicate their responsibility to safeguard the national marketplace by giving the states carte blanche to tax interstate commercial activities via a collusionary multistate tax compact.

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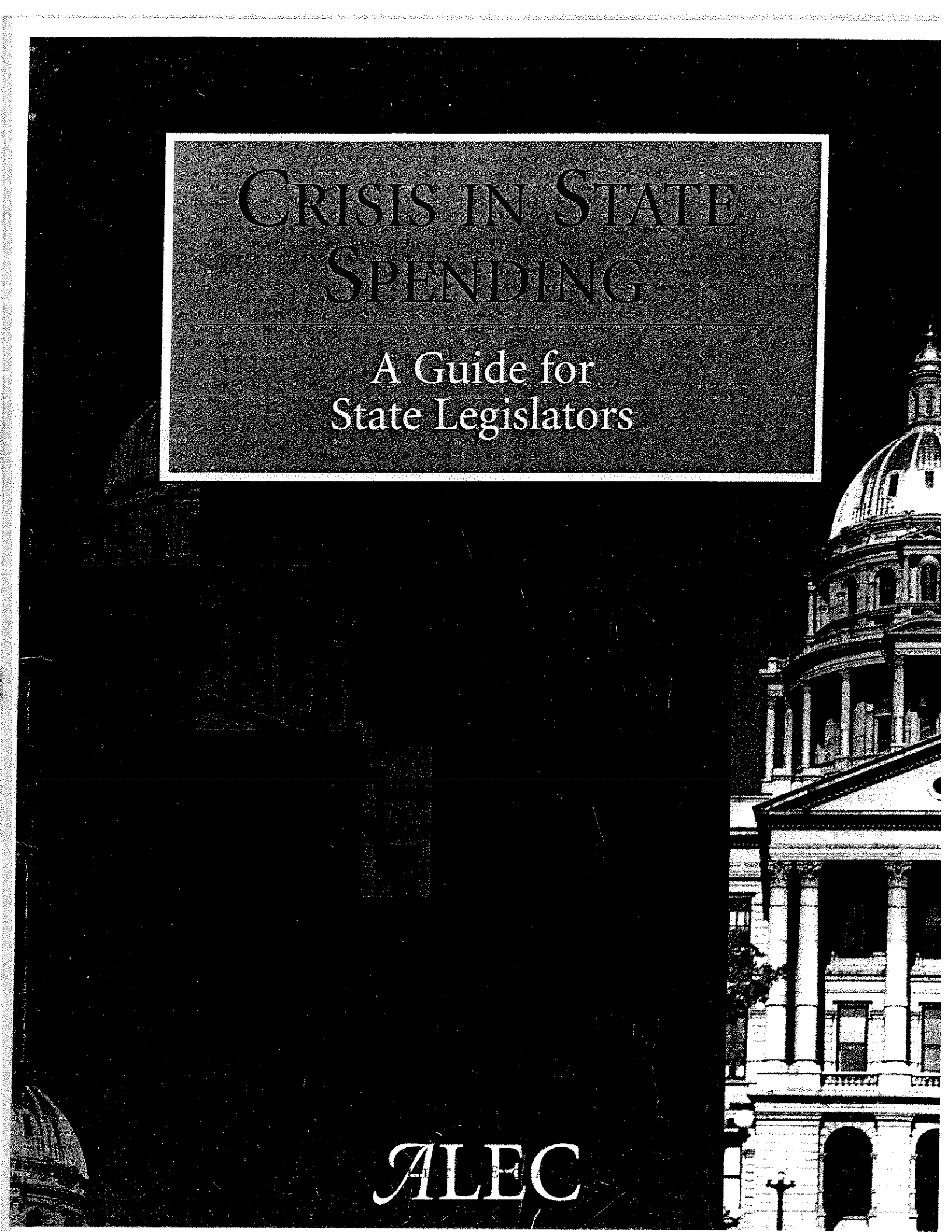

Crisis in State Spending

A Guide for State Legislators

ALEC

By Aaron Thierer and Aaron Lukas, The Cato Institute

With almost every state legislature as well as Congress debating the taxation of electronic commerce, it remains one of America's hottest technology policy issues. It appears likely that Congress will renew, at least for two more years, the moratorium it put in place under the Internet Tax Freedom Act of 1998. This moratorium, which has been the subject of intense and often acrimonious debate, merely prohibits state and local government from imposing "multiple or discriminatory" taxes on the Internet as well as taxes on Internet access.

Importantly, however, the ITFA moratorium does not prohibit state and local governments from attempting to collect sales taxes on goods purchased over the Internet. What currently ties the hands of state and local governments is not the ITFA, but rather 30 years of Supreme Court jurisprudence surrounding "remote" (i.e., interstate) commerce.

In *National Bellas Hess v. Illinois* (1967), *Complete Auto Transit, Inc. v. Brady* (1977), and *Quill v. North Dakota* (1992), the Supreme Court ruled that states could only require firms physically present in their jurisdiction to collect taxes on their behalf. Those decisions, which have never been overturned or altered by Congress, provide a sensible guideline for taxing remote sales. In essence, the logic of the Court's jurisprudence can be summarized by the classic phrase used by the Founders: "No taxation without representation." More specifically, a state or local government may only place tax collection obligations on companies or consumers that receive something in return for those taxes. Forcing companies to collect taxes for jurisdictions they receive few benefits from would be blatantly unfair and massively inefficient given the complexity of the sales tax system in America (currently over 7,000 taxing jurisdictions with a multiplicity of rates and product definitions).

This explains why interstate mail order and catalog companies are not required to pay taxes in states where they have no physical commercial presence, or "nexus" as the Court refers to it. Companies are required to collect taxes only in the states where they have tangible business operations. Their customers, however, *are* expected to remit taxes to their state or local governments. That compliment to the sales tax is called the "use tax," but enforcement remains problematic, if not impossible, given the difficulty associated with tracking direct-to-the-door sales.

Largely because of use tax collection problems, many state and local officials have undertaken a new effort to collectively "simplify" their sales tax systems. Specifically, they hope to establish a multi-state compact to jointly set sales tax policies such as rates, definitions, and collection obligations. Eventually they hope that simplification will render the Supreme Court nexus requirement moot. The effort has been dubbed the "Streamlined Sales Tax Project" (SSTP) and its promoters say it is the pro-"states' rights" solution to the Net tax debate.

But state and local officials who have a proper understanding of the Constitution will quickly realize that this version of "states' rights" is not consistent with the vision of American federal-

ism that the Founding Fathers conceived of long ago. Their federalism established the world's first free trade agreement by ensuring that different levels of government would rule within different spheres. Those few matters that truly involved a national scope would be administered by the federal government; all other parochial matters were left to state and local governments. The dynamic tension among various levels of government and among the states helped ensure that no level of government would grow too large or encroach the liberties of the citizenry.

By proposing an interstate tax cartel, the supporters of the SSTP project are, in reality, proposing to scrap the constitutional framework and revert back to an Articles of Confederation-style arrangement for interstate commerce. Under the Articles, few barriers existed to prevent state taxation and regulation of interstate commerce. As a result, economic anarchy existed among the states with every commercial dispute having the potential to ignite a full-blown trade war. To remedy that, the Founders abandoned the "anything goes" vision of untrammeled "states' rights" and included several clauses within the Constitution to help keep the commercial peace within the union. Article 1, Section 8, Clause 3, "the Commerce Clause," is the most well-known in this regard, but the Founders also made it clear in Article 1, Section 10, Clause 3, "the Compacts Clause," that states were not to enter into compacts that might unduly burden the free flow of commerce.

The beauty of this constitutional system is that it helps ensure commercial harmony among the states while also encouraging them to establish distinct policies within their own domain. This allows consumers and companies to "vote with their feet" and find more hospitable tax and regulatory jurisdictions when they feel burdened by their current government.

That model should also be applied to the debate over Internet taxation. Policymakers should not simply drop all barriers on the taxation of the interstate marketplace and allow state and local governments to collude and craft a multi-state tax authority. Such a de facto national sales tax cartel would not only be a slap in the face of the Founding Fathers, it would also have disturbing economic consequences for the future governance of the interstate marketplace. Thus, state and local policymakers who uphold the Jeffersonian and Madisonian vision would do well to consider the proposed ALEC model legislation, *The Interstate Compact Sunshine Act*, which would shine light on current efforts to craft such a system.

Moreover, while some pro-tax state and local officials would have us believe that the Internet and electronic commerce are drastically eroding their sales tax bases, the reality is something much different. Electronic commerce sales constituted only about 0.8 percent of aggregate retail sales in 2000, according to U.S. Department of Commerce data. In fact, the correlation between tax revenues and spending is the opposite of what Internet tax supporters assert: when online retailers were thriving, tax revenues soared; when retailers were hurting, revenues declined. In light of those trends, it's hard to see how the Internet is to blame for revenue short-

falls. The one thing we do know is that more data is needed. ALEC's model bill, the *Electronic Commerce and New Economy Data Collection Act*, will give states the tools to have an informed debate on this issue for a change.

Of course, the most compelling justification given for changing the rules on remote taxation is the "level playing field" argument. It is unfair, tax supporters argue, that when a consumer makes a purchase in a local store, a sales tax is collected at the point of sale. If, however, a consumer goes online, he can mail-order the same product from an out-of-state business that won't collect the tax. Because use taxes are not enforced, the result is a de facto tax advantage for online shopping that, for expensive purchases, may even outweigh shipping charges.

That's not a theoretically ideal state of affairs. All things being equal, there is no reason to purposefully favor out-of-state over local sellers, and so the tax advantage makes for bad policy. Economists worry that such favoritism leads some consumers to make purchases based on tax savings rather than price—a loss of efficiency that may leave society poorer overall. Brick-and-mortar businesses argue that the tax advantage is simply unfair.

Both groups have a point. In a perfect world, tax policy would be absolutely neutral and, while we're musing about perfection, tax rates would only be high enough to fund essential government services. But in the real world, of course, all things *aren't* equal.

First of all, the sales tax is not a neutral tax, so extending it to remote sales won't necessarily lead to greater economic efficiency. Consider, for example, the fact that few sales taxes in the United States cover services, even though service purchases account for about 60 percent of consumer spending. In addition, states purposefully exempt items like food and clothing from the sales tax base. The result is a tax that arbitrarily favors producers of certain goods—and all services—over others. At best, extending that biased system to online purchases merely trades one inefficiency for another.

Second, the ability of consumers to shop online fosters healthy tax competition among the states. Because sales taxes collect only a few pennies at a time, it is difficult for taxpayers to know how much they have paid over the course of a year. Consequently, it is easier for states to hike sales tax rates than alternatives such as income or property taxes. When sales taxes were first introduced during the Great Depression, rates were extremely low; today, they average over six percent and run as high as ten percent.

While e-commerce is a miniscule component of consumer spending, its mere existence serves to inhibit excessive taxation. Politicians fear that if they raise tax rates too much, consumers can take advantage of low tax rates elsewhere. Just like shoppers that drive from high- to low-tax states, the Internet will induce state and local governments to keep overall tax rates at a more reasonable level.

Third, requiring tax collection on mail-order sales wouldn't just flatten the playing field, it would tilt it in the other direction. Consider the fact that local businesses are forced to collect sales taxes only for a single jurisdiction: the one where they are located. Local

Electronic commerce sales constituted only about 0.8 percent of aggregate retail sales in 2000, according to U.S. Department of Commerce data.

stores don't ask where their customers live and then collect the tax for that jurisdiction. Thus, sales taxes are—rhetoric aside—actually based on where the seller, not the buyer, resides.

To truly *level* the playing field, states would have to either make local businesses collect background information on all customers (including out-of-state customers) and then remit taxes to the proper revenue agency or, alternatively, instruct Internet-based businesses to collect the local sales tax at the point of sale—an "origin-based" system—ignoring where their customers reside. Although either of those systems would remove the de facto tax advantage for online sellers, the former would be monstrously expensive and complex to administer. The later system is workable and constitutionally sensible, but most pro-tax state officials fear it because tax competition among the states would be strengthened. Unless they are ready to defend one of those options, proponents of expanding sales tax collection authority should stop lecturing about fairness.

In all likelihood, Internet sales will never be a serious drain on state revenues. But even if they eventually are, states would have options that would not upset the constitutional balance. One would be to apply sales taxes at the origin, as discussed above. Another would be to abandon the current sales tax system altogether and move toward a savings-exempt income tax (SEIT) that would tax consumption through the income tax code. Under a SEIT, all of an individual's savings would be exempt from tax leaving only the consumed income portion to be taxed. This would guarantee that 100 percent of individual consumption would be taxed, without all the holes and exemptions that riddle the current system.

One obvious benefit of the SEIT approach is that it obviates the need to track individual commercial transactions to the "destination of sale." In a world where goods and services increasingly cross borders, that is a significant advantage. In addition, a SEIT is economically neutral. No matter where a taxpayer buys a good or service, or who she buys it from, her consumption activity is taxed the same.

The point, of course, is that states have options. They should not be lobbying Congress to authorize a tax cartel, especially when it is far from clear that the Internet is eroding tax revenues. The Streamlined Sales Tax Project aims to reduce healthy tax competition and overturn sensible legal precedent, with no real gains in terms of fairness or efficiency. Thoughtful state and local legislators should not buy the bill of goods that their pro-tax colleagues are selling.

❖ ❖ ❖

Halverson, Vicky

From: Gates-Hendrix, Sherrie
Sent: Wednesday, October 29, 2003 11:57 AM
To: Lehman, Michael; Halverson, Vicky
Subject: streamlined info

Rep. Lehman, Vicky -- Notes for the caucus discussion this afternoon.

Why enact streamlined:

Why enact AB 547 in 2003 Rev.d...

Response to Rep. Nass letter:

Nass Letter Rev.doc

Also, Rep. Gard had asked for the list of states that have Republican governors where the streamlined provisions have been enacted:

Texas
Ohio
Nebraska
Nevada
South Dakota
Utah
North Dakota
Arkansas
Vermont

Let me know if you need anything from us or have questions. I will drop Tom off at 1:00.

Sherrie

Streamlined Sales Tax --- Why enact AB 547 / SB 267 in 2003?

- It's a tax cut of $5.37 million annually for Wisconsin citizens.
  - Expanded medical equipment exemption – ($3 million)
  - More reductions related to food and miscellaneous – ($2.37 million)

- Wisconsin printers support it because it simplifies sales tax collection by printers on sales of direct mail (catalogs) and levels the tax playing field for in-state and out-of-state printers.

- New product definitions will make it easier for businesses to understand what's taxable and what's not. Everyone from grocers to telecommunications companies, from convenience stores to small businesses and from computer software providers to leasing companies and multi-state retailers will have new, clearer definitions to rely on.

- Protection from collection mistakes if sellers rely on the information states provide (state certified software or tax collection companies). States won't hold sellers liable for collection problems if sellers have been using state-certified software.

- The requirements placed on sellers who take exemption certificates from purchasers will be less burdensome. For example, when Fleet Farm sells parts to a farmer, the 16-year old clerk at Fleet Farm only needs to take minimal information from the buyer in order to grant an exemption. She won't have to argue with the buyer about whether an exemption is allowed.

- Uniform tax return across states that can be electronically filed (although electronic filing is not required).

- Businesses have been working with the consortium of streamlined states from the beginning and the result is a product that really helps them help us collect our tax.

- Widespread support from business community including General Electric, Kohl's Department Store, Lands End, Shopko, Target, Ward Brodt Music Mall, Wisconsin Merchants Federation, Midwest Hardware Association, Wisconsin Grocers Association, AT&T, Worldcom MCI and Sprint.

Stephen L. Nass Letter

Representative Nass is absolutely right when he says there are many positive items built into the Streamlined Sales and Use Tax Agreement.

There is no hidden agenda here. This bill is solely about simplifying tax collection and uniformity with other states so that businesses and the public can better understand what's taxable and what's not.

Fiscal Estimate

DOR's fiscal estimate for the bill is accurate. It makes no assumptions about future legislative action in Wisconsin. Right now Wisconsin can't require internet and mail order sellers to collect our sales tax for us. The streamlined bills won't change that, it only provides the simplifications the national streamlined project has recommended.

In 2001, the Wisconsin Legislature authorized DOR to participate in interstate discussions about simplifying sales tax laws and making them more uniform. AB 547 would now adopt a variety of simplifications to our sales tax system. For Wisconsin to require those internet and mail order sellers to collect our sales (use) tax and potentially collect the $150 million in tax, two more pieces of legislation would have to pass, one at the federal level and one at the state level:

1. Congress would have to act to reverse U.S. Supreme Court rulings.

2. The Wisconsin Legislature would have to amend state tax laws to require collection of tax by out-of-state seller (internet and mail order marketers) with no physical presence in Wisconsin.

DOR Should Have Been Doing This Before

DOR has been working on the Streamlined Sales Tax Project since March 2000. Small and large businesses have been equal partners in the Project. States have been collectively addressing the interests and concerns of businesses operating in a multi-state environment.

Halverson, Vicky

From: Gates-Hendrix, Sherrie
Sent: Wednesday, October 29, 2003 3:38 PM
To: Lehman, Michael; Halverson, Vicky
Subject: durable medical equipment explanation

Hello -- here is the document you asked about regarding durable medical equipment.

Let me know if you need anything else.

Sherrie

Durable Medical Equipment.doc

Durable Medical Equipment Becomes Exempt under Streamlined

"Durable medical equipment" means equipment, including the repair parts and replacement parts for the equipment, that is for use in a person's home; that is primarily and customarily used for a medical purpose related to a person; that can withstand repeated use; that is not generally useful to a person who is not ill or injured; and that is not placed in or worn on the body. "Durable medical equipment" does not include mobility–enhancing equipment. Exemption extends to accessories.

Alternating pressure pads
Bed rails
Bedside commodes
Bone fracture therapy devices
Continuous passive motion devices
Decubitus bed pads
Foam seating pads not for wheelchairs
Foam wedges not for wheelchairs
Hospital beds
Hydro-collators
Hydro-therm heating pads
I.V. stands
Leg weights (rehab. related)
Lift recliners
Muscle stimulators
Overbed tables
Paraffin baths
Patient transport devices, boards
Patient lifts
Patient lifts slings
Posture back supports
Respiratory therapy equipment not used to administer oxygen
Restraints
Sitz baths
Specialized seating, desks, workstations
Standing frames, devices and accessories
Stethoscopes
Toilet safety frames
Traction stands, pulleys, etc.
Trapeze bars/bar stands
Ultraviolet cabinets
Urinals
Ventilators not administering oxygen
Whirlpool bath equipment

Halverson, Vicky

From: Gates-Hendrix, Sherrie
Sent: Thursday, October 23, 2003 3:04 PM
To: Rep.LehmanM; Sen.Brown; Halverson, Vicky; Mnuk,
Subject: FW: Support Streamlined Sales Tax
FYI from the Merchants Federation

-----Original Message-----
From: WMF [mailto:WMF@supranet.net]
Sent: Thursday, October 23, 2003 10:55 AM
To: Rep. Dan Meyer; Rep. Dan Schoof; Rep. David Ward; Rep. Dean Kaufert; Rep. Jeff Stone; Rep. Kitty Rhoades; Rep. Mike Huebsch; Rep. Spencer Coggs; Sen. Alberta Darling; Sen. Bob Welch; Sen. Gwen Moore; Sen. Mary Lazich; Sen. Russ Decker; Sen. Scott Fitzgerald; Sen. Sheila Harsdorf; Sen. Ted Kanavas
Subject: Support Streamlined Sales Tax

To: **Joint Finance Committee**

From: Chris Tackett
Doug Johnson

Attached please find a letter of support for SB 267/AB 547, the Streamlined Sales Tax bills. We will also mail a packet of support letters from our major members.

Thank you for your attention. Please let us know if you have any questions.

Wisconsin Merchants Federation

1 E. Main St., Ste. 305
608-257-3541
wmf@supranet.net

October 23, 2003

Senator Alberta Darling, Chair
Joint Finance Committee
317 East
State Capitol
Madison, WI 53702

Representative Dean Kaufert, Chair
Joint Finance Committee
308 East
State Capitol
Madison, WI 53702

RE: Support Streamlined Sales Tax/SB 267 & AB 547

Dear Senator Darling and Representative Kaufert and Committee Members:

The Wisconsin Merchants Federation joined by the Midwest Hardware Association has been working for more than three years as part of a national effort to set the stage for states to require out-of-state sellers to collect and remit sales taxes. SB 267 and AB 547 is legislation critical to that goal.

Why is this important? Simple. Does your competition pay taxes? This question cuts across the entire retail industry statewide and nationally. This question cuts across all shapes and sizes of retailers from Land's End to Kohl's Department Stores to hardware, jewelry and music stores. This is truly a main street issue.

Main street retailers should not become "catalog/internet showcases" for consumers to come in, kick the tires and then order merchandise over the internet to save the sales tax. SB 267 and AB 547 don't create a new tax or set the stage for one. The tax liability is already imposed. This is a collection issue. This is a national issue that requires all states to work together to fix this problem.

The National Governor's Association is in strong support and fears that there is

only a small window of opportunity to enact uniform sales tax codes now. As internet sales grow stronger and become more established the governors fear that this problem will grow too big to fix.

The devil is truly in the details on this issue. States have to review obscure sales tax codes to uniformly decide if marshmallows should be taxed or not. If peanuts are sold they are considered food but if you put chocolate on them they become candy and taxable.

According to the National Retail Federation, the states' sales tax systems are nearly as complicated as the IRS tax code. It's not just the states that collect sales tax. So do more than 7,000 local jurisdictions. Sales tax simplification should make everyone's life easier but it won't be easy to get this done. Progress has been made but the heavy lifting starts now with the passage of SB 267 and AB 547.

In addition to evening the competitive playing field for state retailers now competing at a disadvantage there are huge tax issues. The WI Department of Revenue estimates that as much as $300 million biennially could be collected once out-of-state sellers are required to collect and remit sales taxes. Tax fairness underscores this issue. All retailers and consumers should pay their fair share.

According to the New York Times editors, "Most online purchases generate no sales tax, a fact that deprived states of more than $19 billion last year or more than half of their collective budget shortfalls. One easy way for Congress to help states facing fiscal devastation is to allow them to collect taxes from online retail transactions...Congress must strive to make (collection) possible...the country can not afford to see a vast swath of its retail sector transformed into a duty-free zone."

Thank you all for your attention to this matter of state and national significance.

Sincerely,

Chris Tackett
President & CEO

Doug Johnson
Sr. VP & General Counsel

cc: Governor Doyle
WMF Board

Focus

October 22, 2003 • Number 22

Here comes the "streamlined" sales tax

In brief

A major move to simplify, streamline and reconcile state sales tax levies is being pushed by tax officials and legislators in a number of states, including Wisconsin. Although individuals may not see much difference between current state law and the revamped one, the proposal potentially offers compliance relief to businesses. With later federal and state action, it could also lead to taxing internet and direct-mail sales.

Capitol notes

■ *Rep. G. Spencer Coggs (D-Milw.) defeated incumbent Sen. Gary George (D-Milw.) in the primary recall election for the 6th Senate District. The general election will be November 18.*

■ *Governor James Doyle (D) has called for a summit of local government leaders in early December.*

■ *Meanwhile, GOP lawmakers seek to revise state mediation-arbitration law to ease fiscal pressure on local governments. Sen. Jon Erpenbach (D-Middleton) calls the changes "union-busting."*

■ *The state Department of Commerce has created a Bureau of Entrepreneurship to: assist emerging technology companies; help Wisconsin firms win federal R&D funding; and help them comply with regulations.*

One of the most sweeping changes ever made in the sales tax is quietly making its way across the states. Wisconsin would follow suit if lawmakers approve enabling legislation (AB547/SB267), as expected, this fall.

Called the "streamlined" sales tax, or SST for short, it has gone largely unnoticed by the press and public. So, where did the idea originate, and why? How will SST work? What will it mean for consumers and businesses—both Main Street and internet? And, what might be some advantages and disadvantages of this revamped tax?

Where did SST come from?

SST's roots lie in several court decisions and in the changed habits of American shoppers. As mail-order sales grew after the 1940's, some states imposed sales and use taxes on items out-of-state firms shipped to in-state customers. Direct marketing firms that had no presence in those states objected.

In two opinions—one in 1967 and another (*"Quill"*) in 1992—the U.S. Supreme Court sided with the out-of-state firms: Physical presence, such as employees or outlets, was necessary if a firm was to collect sales taxes. The court left it to congress to resolve the issue, but it never has.

With the growth of internet sales in the 1990's, the issue was even more hotly debated. States looking for additional revenue and in-state businesses collecting sales taxes wanted out-of-state firms to do the same. Not surprisingly, these companies and internet advocates resisted.

After several false starts in the 1990's, state tax officials began the Streamlined Sales Tax project in March 2000. The goal was to simplify and reconcile the many conflicting state-local sales tax laws, streamline administration, lessen compliance burdens, and, with congressional approval, begin taxing direct-mail and internet firms.

Initially, 12 state revenue departments, the National Governors' Association and the National Conference of State Legislatures were involved. Within a year, the number of participating states tripled and industry representatives joined the discussions.

By November 2002, a final interstate agreement was approved by 31 states. That this many states could hammer out a common approach to taxing sales has been called "miraculous" by a leading Wisconsin tax official who co-chaired the SST project. The number of participating states has continued to grow, and they now seek approval of their respective legislatures for the agreement, with implementation slated for July 2004.

What will SST do?

For the typical consumer, many key features of SST will not be apparent.

☐ *Cost?* For example, many Wisconsinites will see little, if any, change in the amount of sales tax paid. In fact, the state's pending SST law is estimated to reduce sales taxes by $5.3 million (m) annually. Offsetting this will be about $2m in new sales taxes collected voluntarily by multistate retailers.

☐ *Tax rates, base, etc.* Wisconsin already satisfies some SST requirements, including: a uniform tax base for all taxing units within a state; a single state tax rate on all items; no dollar "caps" on the amount of sales tax charged on a single purchase; no partial exemptions for part of a purchase price; and no limited sales tax holidays, i.e., an exemption for specific items (such as clothes) during a certain time period.

☐ *Exemptions.* Other SST features likely to go unnoticed by the retail consumer include a new approach to tax-exempt organizations and individuals. Currently, an exempt party, such as a church or a farmer purchasing farm machinery, must present an exemption certificate to the seller, and the seller is responsible for any tax owed by the "exempt" purchaser.

Under SST, exemption certificates would be standard across participating states and, in many cases, replaced with an indentifying number given to the seller. Buyers, not sellers, would have to prove exemption eligibility.

☐ *"Sourcing."* SST also adopts "sourcing rules" that, with limited exceptions, apply sales taxes at destination. Thus, for over-the-counter purchases, a sale would be taxed at a seller's place of business, while a product shipped elsewhere would be taxed at its destination.

☐ *Product definitions.* This is the SST aspect most likely to draw consumer attention. To arrive at a multistate approach to sales taxes, common product definitions were essential. For example, many states exempt food and tax candy, but differ in how they define the two. States may continue to tax, or exempt, either or both, but definitions of food, candy and many other items would be uniform across SST states. In other words, member states could tax or not tax articles covered under the same definition.

Selected Food and Related Items: Taxed or Exempt (Ex.), Wis. vs. SST

Food Item	Wis.:	SST:
Soda, pop	Tax	Tax
Bottled water (carbonated, sweetened)	Tax	Tax
Bottled water (non-carbonated, sweet'd)	Tax	Tax
Bottled water (carbonated, nonsweet'd)	Tax	Ex.
Bottled water (non-carbonated, nonsweet'd)	Ex.	Ex.
Bottled tea, sweetened	Ex.	Tax
Bottled tea, unsweetened	Ex.	Ex.
Alcoholic beverages	Tax	Tax
Cooking wine	Ex.	Ex.
Nonalcoholic beer	Tax	Ex./2
Nonalcoholic champagne	Tax/1	Ex./2
Cookies	Ex.	Ex.
Candy with flour	Tax	Ex.
Marshmallows	Ex.	Tax
Chocolate chips	Ex.	Tax

1/Fruit drink not 100% juice. 2/Exempt, unless sweetened.

The table above summarizes the current Wisconsin and SST treatment for selected items. Most food and food-like items would continue to be exempt under SST. However, the addition of a sweetener would change an item from a tax-exempt food to a candy-like confection. Thus, candy that contains flour would be "food-like" and exempt, while items like marshmallows and chocolate chips would be taxed. Similarly, sweetened bottled water or tea would be taxed; nonsweetened bottled water or tea would not.

Advantages/Disadvantages

A major advantage of the SST is that its uniform rules and definitions make it easier for firms to operate in multiple states. Sellers could register once online, rather than separately with each state. Internet databases would offer companies one-stop information on sales tax rates and the taxability of products in 7,500 tax jurisdictions.

New technologies would also offer vendors the opportunity to greatly simplify tax filing, payment, and subsequent audits. Of these, the most far reaching, certified service providers (CSP), would shift tax compliance duties from the seller to the CSP at no cost to the former. Audits would be done once, rather than in individual states.

Another feature of SST has pluses and minuses. With enactment of companion federal and state laws, states would be able to tax direct marketers. In-state retailers now collecting sales taxes would welcome the "level playing field" with out-state competitors. Internet advocates and affected firms might have a different view.

One area that may cause some concern is the modified tax treatment of computer software. With taxes collected by the final seller, rather than "middlemen," who collects and pays the tax on software could shift in some circumstances.

One other group disadvantaged by SST may be state lawmakers. Since tax definitions would be uniform across states, there would be less opportunity to introduce bills granting narrow or special-interest exemptions.

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JIM DOYLE
GOVERNOR
STATE OF WISCONSIN

October 16, 2003

The Honorable Mary Panzer
State Senate Majority Leader
Room 211 South Capitol
P.O. Box 7882
Madison, WI 53707-7882

The Honorable John Gard
Speaker of the Assembly
Room 211 West Capitol
P.O. Box 8952
Madison, WI 53708

The Honorable Jon Erpenbach
Senate Minority Leader
Room 202 South Capitol
P.O. Box 7882
Madison, WI 53707-7882

The Honorable Jim Kreuser
Assembly Minority Leader
Room 201 West Capitol
P.O. Box 8952
Madison, WI 53707-7882

Dear Senators Panzer and Erpenbach and Representatives Gard and Kreuser:

I'm writing to indicate my strong support for Assembly Bill 547 and Senate Bill 267 (companion bills that would add Wisconsin to the growing number of states that have adopted the provisions of the Streamlined Sales and Use Tax Agreement.) This legislation is very important to me and I would like to offer my assistance as well as the assistance of my staff at the Department of Revenue in moving these bills along as quickly as possible. This bi-partisan, multi-state initiative marks the culmination of years of work on the part of states, business groups, tax professionals, legislators and many others to simplify and make more uniform the sales tax laws and administration across the states.

Rep. Mickey Lehman and Sen. Ron Brown have championed the legislative efforts here in Wisconsin. Wisconsin businesses that support these bills including Lands End, Kohl's Department Store, General Electric, and Shopko as well as Wisconsin business associations including the Wisconsin Grocers Association, the Wisconsin Merchants Federation and Printing Industries of Wisconsin are also strong supporters of the bills. Perhaps even more important, main street businesses are praising the benefits of the simplifications in the legislation.

I believe that the Streamline Sales Tax legislation is so important that included it in my *Grow Wisconsin* plan. I'm asking that you swiftly approve these bills and make Wisconsin the 21st state in the nation to do so. I have directed the Department of Revenue to work with you to ensure enactment of the bills before the end of the year. Enactment now is

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important for Wisconsin to continue its leadership role and significant voice in the Streamlined Sales and Use Tax Agreement.

I look forward to a cooperative effort between the Legislature and my Administration to adopt this historic legislation and bring the administration of the sales and use tax into the 21st century.

Sincerely,

Jim Doyle
Governor

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

October 20, 2003

TO: Members
Wisconsin Legislature

FROM: Bob Lang, Director

SUBJECT: Assembly Bill 547 and Senate Bill 267: Streamlined Sales and Use Tax Provisions

This document presents information regarding 2003 Assembly Bill 547 and Senate Bill 267, which are companion bills that would amend Wisconsin's sales and use tax statutes so that they conform to the provisions of the multi-state Streamlined Sales and Use Tax (SSUT) Agreement.

This document is written in five parts:

- **PART 1** provides an executive summary of the bills.
- **PART 2** is a comprehensive summary of each provision of the bills.
- **PART 3** presents information regarding the bills' fiscal effects.
- **PART 4** includes two attachments relating to the treatment of food and beverages and durable medical equipment under the bills.
- **PART 5** is an appendix, which summarizes the Streamlined Sales and Use Tax Agreement.

Prepared by: Rob Reinhardt

TABLE OF CONTENTS

Part 1: Executive Summary

Background 1
Duties and Responsibilities of the Department of Revenue 2
Modifications to the Tax Base 3
Non-Exempt Use of Property After Purchase 4
Treatment of Drop-Shipments 5
Sourcing 5
Agreements with Direct Marketers; Retailer's Compensation 5
"Amnesty" Provision 6
Erroneous Collection of Tax 6
Rounding 7
SSUT Agreement Agents 7
Business Tax Registration 7
Exemption Certificates 7
Program for Children and Families 8
Other Provisions 8
DOR Administrative Funding 9
Fiscal Effect 9

Part 2: Comprehensive Summary of Assembly Bill 547/Senate Bill 267

Introduction 10
Overview of Current Law 10
Uniform Sales and Use Tax Administration Act -- Duties and Authority of DOR 11
Definition of Taxable "Tangible Personal Property" 15
Animal Medicine 17
Definitions of "Gross Receipts," "Sales Price," and "Purchase Price" 17
Bundled Property 18
Definition of "Lease or Rental" 18
Definition of "Retail Sale" 20
Definition of "Sale" and Similar Terms 20
Definition of "Sale for Resale" and Similar Terms 20
Drop-Shipments 21
Exemptions for Food and Beverages 21
Exemption for Prescription Drugs 25
Medical Equipment Exemption 26
Exemption for Cloth Diapers 28
Exemption for Water Sold Through Mains 28

Exemption Certificates 28
Non-Exempt Use of Property After Purchase 30
Sourcing Provisions 30
Agreements With Direct Marketers; Retailer's Compensation 40
"Amnesty" Provision 41
Return Adjustments 42
Erroneous Collection of Tax 44
Rounding 44
SSUT Agreement Agents 45
Business Tax Registration 45
Items Purchased from Out-of-State Sellers and Delivered Directly to End-Users in Wisconsin 46
Content of Sales and Use Tax Returns; Information Requirements 47
Penalties for Misusing Documents 48
Surety Bond for Certified Service Providers 48
Use of Personally Identifiable Information by Certified Service Providers 49
Vehicle, Vessel, and Aircraft Sales by Retailers Who are not Dealers 49
Administration of Local Taxes 49
Program for Children and Families 51
Cross Reference Changes in Other Programs 52
DOR Administrative Funding 52
Effective Date 52

Part 3: Fiscal Effect

Fiscal Effect 53

Part 4: Attachments

Attachment 1: Modifications Relating to Food and Beverages Under AB 547/SB 267 58
Attachment 2: Durable Medical Equipment That Would be Exempt from Sales Tax Under AB 547/SB 267 60

Part 5: Appendix (Summary of the Streamlined Sales Tax and Use Tax Agreement) 61

PART 1

EXECUTIVE SUMMARY

EXECUTIVE SUMMARY

BACKGROUND

AB 547/SB 267 would make a number of modifications to the state's sales and use tax statutes, most of which are required in order to conform to the terms of the multi-state Streamlined Sales and Use Tax (SSUT) Agreement.

Under current federal law and U.S. Supreme Court decisions, states may not require sellers to collect and remit sales and use taxes unless the seller has a sufficient business connection (or "nexus") with the state, which is established by the seller having a physical presence in the state. In Wisconsin, a seller has nexus if it does any of the following: (a) owns real property in this state; (b) leases or rents out tangible personal property located in this state; (c) maintains, occupies, or uses a place of business in this state; (d) has any representative or solicitor operating in this state under the authority of the retailer or its subsidiary for the purpose of selling, delivering, or taking orders for any tangible personal property or taxable services; (e) services, repairs, or installs equipment or other tangible personal property in Wisconsin; or (f) performs construction activities in this state.

Sellers that do not have nexus with Wisconsin can voluntarily agree to collect and remit the tax on their sales to Wisconsin residents. Such agreements also are permitted in other states. In Wisconsin and other states, if a seller does not have nexus and has not voluntarily agreed to collect the tax, the state imposes a use tax on taxable purchases from the seller by state residents. However, collecting the use tax from individual purchasers presents a very difficult enforcement issue. Multi-state retailers have long resisted efforts by the states, and legislation introduced in Congress, to compel use tax collection, citing the high costs and difficulty of complying with numerous, disparate state and local sales tax systems.

One of the principal aims of the SSUT Agreement is to make sales and use taxes more uniform across states and local taxing jurisdictions. In addition, in order to streamline administration of the tax, states participating in the Agreement would jointly certify sales tax service providers and automated systems. Retailers could contract with certified service providers (CSPs) to assume the seller's sales and use tax responsibilities or use certified automated systems (CASs) for tax calculation and record-keeping purposes. Participating states would also be required to maintain databases that retailers could use to determine whether a transaction is taxable and the appropriate tax rate. The Agreement also includes an "amnesty" provision that would forgive back taxes for sellers that agree to collect and remit taxes. It is hoped that these modifications will encourage additional sellers to voluntarily agree to collect the tax or persuade Congress to pass legislation permitting states to require additional out-of-state sellers to collect and remit taxes. It is also believed that the provisions of the Agreement will improve administration of the tax for in-state sellers.

The SSUT Agreement is the product of the Streamlined Sales Tax Project, a multi-state effort begun by state revenue departments in March, 2000. Representatives of state legislatures, local governments, and business organizations have also been active participants in the Project. Currently 41 states (including Wisconsin) and the District of Columbia are voting members in the Project, which means that the legislatures of these states have enacted enabling legislation or their state executives have issued orders authorizing their participation. Wisconsin's participation was authorized under 2001 Wisconsin Act 16 (the 2001-03 biennial budget act). The SSUT Agreement was adopted by the Project's implementing states on November 12, 2002. The next step is for individual states to enact statutory modifications to bring their sales and use tax systems into conformance with the terms of the Agreement, which is the purpose of AB 547/SB 267.

The Agreement will take effect and become binding when at least 10 states comprising at least 20% of the total population of all states imposing a state sales tax have petitioned for membership and have been found to be in compliance with the Agreement's requirements by the Agreement's governing board. As of this writing, 20 states, which comprise approximately 32% of the total population of all states with a sales tax, have adopted legislation to make their statutes conform to the Agreement. These states include Arkansas, Indiana, Iowa, Kansas, Kentucky, Minnesota, Nebraska, Nevada, North Carolina, North Dakota, Ohio, Oklahoma, South Dakota, Tennessee, Texas, Utah, Vermont, Washington, West Virginia, and Wyoming. However, no states have yet been found to be in compliance by the Agreement's governing board. It is anticipated that the governing board will begin reviewing certificates of compliance in early 2004.

This Executive Summary highlights the most significant changes to state law included in AB 547/SB 267. The next three parts of this memorandum provide a comprehensive analysis of the bills' provisions and their fiscal effects. Finally, a description of the SSUT Agreement is presented in the Appendix. AB 547/SB 267 would take effect on July 1, 2004. All of the statutory changes under the bills would take effect on that date, regardless of when, or whether, the SSUT Agreement takes effect.

DUTIES AND RESPONSIBILITIES OF THE DEPARTMENT OF REVENUE

Under 2001 Act 16, the Department of Revenue (DOR) was authorized to enter into the Streamlined Sales and Use Tax Agreement to simplify and modernize sales and use tax administration in order to reduce the tax compliance burden for all sellers and all types of commerce. DOR may promulgate rules to administer the SSUT provisions, procure goods and services jointly with other states that are signatories to the Agreement in furtherance of the Agreement, and take other actions reasonably required to implement these provisions.

Current law also authorizes the Department to act jointly with other states that are signatories to the Agreement to establish standards for the certification of certified service providers and certified automated systems and to establish performance standards for multi-state sellers. A "certified service provider" is an agent that is certified by the signatory states to perform all of a seller's sales tax and use tax functions related to the seller's retail sales. A "certified automated

system" is software that is certified by the signatory states and that is used to calculate state and local sales and use taxes on transactions by each appropriate jurisdiction, to determine the amount of tax to remit to the appropriate state, and to maintain a record of the transaction.

Current law provides that a certified service provider is the agent of the seller with whom the provider has contracted and is liable for the sales and use taxes that are due the state on all sales transactions that the CSP processes for a seller, except in cases of fraud or misrepresentation by the seller. A person that provides a certified automated system is responsible for the system's proper functioning and is liable to this state for tax underpayments that are attributable to errors in the system's functioning. A seller that uses a CAS is responsible and liable to this state for reporting and remitting sales and use tax. A seller that has a proprietary system for determining the amount of tax due and that has signed an agreement with the signatory states establishing a performance standard for the system is liable for the system's failure to meet the performance standard.

Current state law also provides that no law of this state, or the application of such law, may be declared invalid on the ground that the law, or the application of such law, is inconsistent with the SSUT Agreement. No provision of the Agreement in whole or in part invalidates or amends any law of this state and the state becoming a signatory to the Agreement does not amend or modify any law of this state.

Under AB 547/SB 267, DOR would be authorized to certify compliance with the SSUT Agreement and, pursuant to the Agreement, certify certified service providers and certified automated systems. The Department would also be authorized to maintain databases that indicate: (a) whether specific items are taxable or nontaxable; and (b) tax rates, taxing jurisdiction boundaries, and zip code or address assignments related to the administration of state and local taxes imposed in Wisconsin. These databases would have to be accessible to sellers and CSPs.

AB 547/SB 267 would also specifically permit DOR to audit (or authorize others to audit) sellers and certified service providers who are registered with the Department pursuant to the SSUT Agreement.

MODIFICATIONS TO THE TAX BASE

The sales tax base is the array of goods, services, and transactions that are subject to the tax. The SSUT Agreement does not require participating states to have identical tax bases. However, the Agreement does require states to use uniform definitions in establishing their tax bases. AB 547/SB 267 include the following changes to the current sales and use tax base in Wisconsin:

- Most types of food sales would be treated the same as under current law. However, some food sales that are now exempt would become taxable and certain sales that are now taxable would become exempt. These modifications are listed in Attachment 1.

- AB 547/SB 267 would expand the types of medical equipment that are exempt from

tax to include items such as hospital beds, patient lifts, and I.V. stands that are purchased for in-home use. A more detailed list of items that would become exempt under this provision is presented in Attachment 2.

- AB 547/SB 267 would eliminate the current exemption for antiembolism elastic hose.

- The current exemptions for equipment used in the treatment of diabetes and equipment used to administer oxygen would be limited to equipment purchased for in-home use.

- AB 547/SB 267 would repeal the current exemption for cloth diapers.

- Certain currently exempt sales of pre-written computer software that is customized for a specific purchaser would become taxable.

- The tax would be imposed on the entire sales price of products comprised of exempt items that are bundled with taxable items by the seller (such as a fruit basket that includes candy, or a cheese tray that includes a cutting board and knife). Currently, the seller is not required to pay tax on the value of the nontaxable items.

- Under AB 547/SB 267, if tangible personal property (such as a construction crane) is provided along with an operator, the transaction would be considered a service (which may or may not be taxable) rather than a lease (which generally is taxable) as long as the operator is necessary for the property to perform in the manner for which it is designed and the operator does more than maintain, inspect, or set up the property. Under current law, the determination of whether such transactions are a lease of property or a service depends upon the amount of control maintained by the operator and the degree of responsibility for completion of the work assumed by the operator.

- Purchases of items (such as catalogs, telephone directories, or candy) that are sold by an out-of-state seller to a Wisconsin purchaser and distributed directly by the seller by common carrier or U.S. mail to Wisconsin residents without the purchaser ever taking possession of the items would become taxable regardless of whether or not the out-of-state seller has nexus with Wisconsin. Under current law, as interpreted by the courts, such sales are not subject to the sales or use tax if the seller is located out-of-state and does not have nexus with Wisconsin.

According to DOR, all of these modifications are required in order to conform to the terms of the SSUT Agreement.

NON-EXEMPT USE OF PROPERTY AFTER PURCHASE

Currently, if a purchaser certifies that the items purchased will be used in a manner entitling the sale to be exempt from tax and the purchaser subsequently uses the property in some other manner, the purchaser is liable for payment of the sales tax. The tax is measured by the sales price

of the property to the purchaser unless the taxable use first occurs more than six months after the sale. In that case, the purchaser may base the tax either on that sales price or on the fair market value of the property at the time the taxable use first occurs. AB 547/SB 267 would eliminate the option to base the tax on fair market value if the taxable use first occurs more than six months after the purchase, so that the tax would always be based on the sales price to the purchaser.

TREATMENT OF DROP-SHIPMENTS

A Wisconsin "drop-shipment" occurs when a purchaser located in Wisconsin orders an item from an out-of-state retailer not registered to collect Wisconsin sales or use tax and the product is delivered to the customer directly from a Wisconsin manufacturer, without the retailer taking possession. Under current law, the Wisconsin manufacturer is required to collect the sales tax from the purchaser on such transactions. Under AB 547/SB 267, Wisconsin manufacturers would no longer be liable for the sales tax on drop-shipments to Wisconsin purchasers. Instead, the purchaser would be liable for use tax.

SOURCING

AB 547/SB 267 includes detailed provisions for determining the taxing jurisdiction in which a sale or lease of property or services occurs (sourcing). In general, the sourcing rules under the bills are destination-based, which is consistent with the current sourcing provisions in Wisconsin. However, the Department of Revenue has identified several situations where the SSUT provisions would differ from current law and practice. The most significant change would be to relieve sellers (printers) of direct mail of the burden of determining the destination of each piece of mail for tax purposes if the purchaser does not provide this information. Other sourcing changes involve towing services, admissions, certain sales by florists, leases, software and services (such as cable television) delivered electronically, and post-paid telecommunications services.

AGREEMENTS WITH DIRECT MARKETERS; RETAILER'S COMPENSATION

Under current law, sellers may deduct the retailer's discount from taxes due as compensation for administrative costs. The retailer's discount is equal to 0.5% of the tax liability per reporting period, with a $10 minimum. Also, under current law, DOR may enter into agreements with out-of-state direct marketers to collect state and local sales and use taxes. An out-of-state direct marketer that collects such taxes may retain 5% of the first $1 million of the taxes collected in a year and 6% of the taxes collected in excess of $1 million in a year. This provision does not apply to direct marketers who are required to collect sales and use taxes in Wisconsin because they have nexus with this state. To date, no agreements have been entered into under this provision.

AB 547/SB 267 would repeal the current provisions regarding agreements with direct

marketers. Instead, under the bills, the following persons could retain a portion of sales and use taxes collected on retail sales in an amount determined by DOR and by contracts that the Department enters into pursuant to the SSUT Agreement: (a) certified service providers; (b) sellers that use a certified automated system; and (c) large, multi-state sellers that have a proprietary system that calculates the amount of tax owed to each taxing jurisdiction. Under the bills' provisions, there would be no statutory limit on the amount of retailer compensation paid to such persons. Also, such compensation could be paid to in-state sellers, out-of-state sellers that have nexus with Wisconsin, and out-of-state sellers that do not have nexus. However, DOR indicates that, under the Agreement, only non-nexus sellers that voluntarily agree to collect taxes would receive additional compensation under item (c). Sellers that do not meet the above criteria would continue to receive the regular 0.5% retailer's discount.

"AMNESTY" PROVISION

Under AB 547/SB 267, a seller would not be liable for uncollected and unpaid state and local sales and use taxes (including penalties and interest) on previous sales made to Wisconsin purchasers if the seller registers with DOR to collect and remit state and local sales and use taxes on such sales in accordance with the SSUT Agreement. In order to receive amnesty, the seller would have to: (a) register within one year after the effective date of this state's participation in the Agreement; and (b) collect and remit state and local sales and use taxes on sales to purchasers in this state for at least three consecutive years after the date on which the seller registers.

The amnesty would not be available to: (a) sellers that were already registered with DOR during the year immediately preceding the effective date of Wisconsin's participation in the Agreement; (b) sellers that are being audited by DOR; or (c) sellers that have committed or been involved in a fraud or an intentional misrepresentation of a material fact.

ERRONEOUS COLLECTION OF TAX

AB 547/SB 267 would establish a procedure to settle disputes between purchasers and sellers regarding erroneous collections of sales or use tax. Under the bills, customers who believe that the amount of sales or use tax assessed on a sale is erroneous could send a written notice to the seller requesting that the alleged error be corrected. The seller would have to review its records within 60 days to determine the validity of the customer's claim. If the review indicates that there is no error as alleged, the seller would have to explain the findings of the review in writing to the customer. If the review indicates that there is an error as alleged, the seller would have to correct the error and refund the amount of any tax collected erroneously, along with the related interest. A customer could take no other action, or commence any action, to correct an alleged error in the amount of sales or use tax assessed unless the customer has exhausted his or her remedies under this provision.

Under current law, such disputes are handled through the court system. The bills' provisions

are intended to provide a more efficient dispute resolution process.

ROUNDING

AB 547/SB 267 would modify the rounding rules used by retailers so that sellers would be allowed to compute the amount of tax to be collected based on each invoice (including numerous items) or on each item included in the sale. Under current law, the amount of tax collected must be calculated by multiplying the tax rate by the total transaction price, not by the prices of individual items. These provisions do not affect the amount of tax due to the state from the retailer, only how the retailer may calculate the amount of tax collected from purchasers.

SSUT AGREEMENT AGENTS

The bills would authorize sellers to appoint an agent to represent the seller before the states that are signatories to the SSUT Agreement. Under AB 547/SB 267, sellers could designate such agents to: (a) register with DOR for a business tax registration certificate; (b) file an application with DOR for a permit for each place of operations; and (c) remit taxes and file returns under the sales and use tax statutes.

BUSINESS TAX REGISTRATION

Under current law, any person who is not otherwise required to collect Wisconsin sales and use taxes (because of a lack of nexus) and who makes sales to persons within this state of taxable property or services may register with DOR to voluntarily collect the tax. Sellers who register with DOR must obtain a business tax registration certificate, which authorizes and requires the person to collect, report, and remit the state use tax. AB 547/SB 267 would specify that registration with DOR under this provision could not be used as a factor in determining whether the seller has nexus with this state for any tax at any time.

In addition, the bills would specify that registration under the above provision would authorize and require the retailer to collect, report, and remit local use taxes, and local jurisdictions would be specifically authorized to impose the tax on such sellers. Under current law, voluntary registration only obligates out-of-state retailers to collect state use taxes, not local taxes.

The bills would also authorize DOR to waive the business tax registration fee for sellers that voluntarily register to collect sales and use taxes.

EXEMPTION CERTIFICATES

Under current law, it is presumed that all of a seller's receipts are subject to the sales and

use tax until the contrary is established. The burden of proving that a sale is not taxable is upon the seller unless the purchaser provides a certificate to the effect that the purchase is exempt. The exemption certificate must be taken by the seller in good faith. Under AB 547/SB 267, an exemption certificate would relieve the seller from the burden of proof as long as it is taken at the time of purchase. The "good faith" requirement would be deleted. However, an exemption certificate would not relieve the seller of the burden of proof if the seller fraudulently fails to collect sales tax or solicits the purchaser to claim an unlawful exemption.

Under present law, no certificate is required for certain types of tax-exempt livestock sales. AB 547/SB 267 would repeal this provision so that an exemption certificate would be required for such sales.

PROGRAM FOR CHILDREN AND FAMILIES

Under current law, the Department of Health and Family Services has a GPR appropriation for grants to counties for services for children and families. The amount of the appropriation is equal to one-eleventh of the amount of sales tax collected from out-of-state direct marketers who have entered into agreements with DOR, under which the sellers receive compensation over and above the normal 0.5% retailer's discount (described above). AB 547/SB 267 would repeal this appropriation and the statutory language relating to the grants. The program was created in 1999 Wisconsin Act 9. To date, no funding has been provided for the program because no agreements with direct marketers have been entered into.

OTHER PROVISIONS

AB 547/SB 267 would eliminate specific requirements relating to the content of sales and use tax returns and, instead, provide that the return must show the amount of taxes due for the period covered by the return and such other information as DOR deems necessary. This modification is intended to provide DOR with flexibility to simplify sales tax returns and make the returns conform to standards required under the SSUT Agreement.

Under current law, in order to protect the revenue of the state, DOR may require sellers to provide security in an amount determined by the Department, but not more than $15,000. The bills would authorize DOR to require a larger amount of security from certified service providers.

AB 547/SB 267 would restrict the use of personally identifiable information obtained by certified service providers from purchasers, and require CSPs to provide consumers clear and conspicuous notice of their practices regarding such information. CSPs would also have to provide sufficient technical, physical, and administrative safeguards to protect personally identifiable information from unauthorized access and disclosure.

The bills would require additional notice (120 days) of repeal of a county sales tax or

cessation of local baseball park or football stadium taxes.

DOR ADMINISTRATIVE FUNDING

AB 547/SB 267 would provide DOR with $25,000 GPR in both 2003–04 and 2004-05 to pay for administrative costs related to the SSUT Agreement.

FISCAL EFFECT

The Department of Revenue estimates that the changes to the tax base under the bills would reduce state sales tax revenues by $5,370,000 annually beginning in 2004-05, primarily due to expanded exemptions relating to food and durable medical equipment. These revenue losses would be partially offset by an estimated $2,020,000 revenue increase from out-of-state sellers that have voluntarily agreed to collect the use tax on sales to Wisconsin residents in anticipation of the Agreement, for a net annual revenue loss of $3,350,000. In addition, the provision that would provide a higher rate of retailer compensation to certain sellers would also result in a state revenue decrease. At this time, it is not possible to reliably estimate the cost of the higher retailer's compensation, because the rate of compensation and the number and size of sellers that would qualify are not known. However, it is possible that the cost of this provision could be significant. As noted above, the bills would also provide $25,000 GPR to DOR in 2003-04 and 2004-05 to administer the new provisions.

In the aggregate, annual county and stadium sales and use tax collections are estimated to decrease by $240,000, and collections from the exposition district tax would increase by an estimated $250,000 annually, beginning in 2004-05. The sourcing provisions under the bills could also result in tax shifting across counties.

In addition to these short-term fiscal effects, it is possible that the passage of AB 547/SB 267, along with similar laws in other states, could result in a significant increase in sales and use tax collections from remote sales in future years. This could occur if the bills' provisions result in additional retailers voluntarily agreeing to collect and remit use taxes to Wisconsin or if Congress is persuaded to pass federal legislating allowing states to require out-of-state sellers to collect and remit the tax. DOR estimates that such future collections could total $150 million annually.

More detailed information about the bills' fiscal impacts is presented in Part 3 of this memorandum.

PART 2

COMPREHENSIVE SUMMARY OF ASSEMBLY BILL 547/SENATE BILL 267

COMPREHENSIVE SUMMARY OF ASSEMBLY BILL 547/SENATE BILL 267

INTRODUCTION

Assembly Bill 547 and Senate Bill 267 are companion bills that would amend Wisconsin's sales and use tax statutes so that they conform to the provisions of the multi-state Streamlined Sales and Use Tax (SSUT) Agreement. The following sections present a general overview of Wisconsin's sales and use tax under current law and a detailed description of the provisions of AB 547/SB 267.

OVERVIEW OF CURRENT LAW

Under current law, Wisconsin imposes a 5% general sales tax on the gross receipts from the sale and rental of personal property and selected services; counties have the option of imposing an additional 0.5% local sales tax. Other local sales taxes are imposed by professional football and baseball stadium districts, local exposition districts, and premier resort areas. The tax is imposed on the sale, lease, or rental of all tangible personal property not specifically exempted. This contrasts with the treatment of services, where the tax is imposed only on those services specifically listed in the statutes.

A use tax at the same rate is imposed on goods or services purchased out-of-state and used in Wisconsin, if the good or service would be taxable if purchased in Wisconsin. In computing the use tax liability, a credit is provided for sales tax paid in the state in which the good or service was purchased.

Although it is usually collected from the purchaser at the time of purchase, the sales tax is legally imposed on the gross receipts of the seller. In contrast, the use tax is imposed on the purchaser.

Wisconsin taxes a limited number of services, which include: (a) hotel and other short-term lodgings; (b) admissions to amusement, athletic, and entertainment events; (c) certain telecommunications services and telephone answering services; (d) laundry and dry cleaning services, except for coin-operated and diaper services; (e) photographic services; (f) parking and docking of motor vehicles, aircraft, and boats; (g) installation, repair, maintenance, and related services to personal property, other than real property improvements (unless the property being installed or repaired is exempt when sold); (h) producing, fabricating, processing, printing, and imprinting services for consumers who furnish the materials, except for printed advertising services that will be transported and used solely outside the state; (i) cable television services, including installation; and (j) landscaping and lawn maintenance services

A number of exemptions from the general sales tax are provided for specified types of personal property, transactions, and entities. In some cases, exemptions are provided for items used

in the course of business such as manufacturing machinery and equipment, property that becomes an ingredient in the manufacturing process, farm tractors and machines, seeds, and various other farming supplies. In other cases, the exemptions relate to personal and family needs such as food for home consumption, prescription drugs, and water delivered through mains. In addition, exemptions are provided for sales to governmental, educational, and charitable organizations and for specified sales by such organizations.

Sellers of taxable property and services must obtain a business tax registration certificate and a permit for each location from the Department of Revenue (and may be required to make a security deposit not to exceed $15,000) and periodically file a sales tax return and make payment of tax due. Returns and payment are generally due on a quarterly basis, but the Department may require larger retailers to report monthly.

Sellers may deduct the retailers' discount from taxes due, as compensation for administrative costs, equal to the greater of $10 or 0.5% of the tax liability per reporting period, but not more than the amount of tax actually payable.

Under current federal law and U.S. Supreme Court decisions, states may not require sellers to collect and remit sales and use taxes unless the seller has a sufficient business connection (or "nexus") with the state. Nexus is established by the seller having property or personnel in the state. Sellers that do not have nexus may voluntarily agree to collect and remit the tax on their sales to Wisconsin residents. If a Wisconsin resident purchases a taxable good or service from a seller that does not have nexus and has not voluntarily agreed to collect the tax, the purchaser is responsible for paying the use tax.

UNIFORM SALES AND USE TAX ADMINISTRATION ACT -- DUTIES AND AUTHORITY OF DOR

Current Law

Under 2001 Wisconsin Act 16 (the 2001-03 biennial budget act), the Department of Revenue was authorized to enter into the Streamlined Sales and Use Tax Agreement to simplify and modernize sales tax and use tax administration in order to substantially reduce the tax compliance burden for all sellers and for all types of commerce. The Department may act jointly with other states that are signatories to the Agreement to establish standards for the certification of a certified service provider and certified automated system and to establish performance standards for multi-state sellers. DOR also may promulgate rules to administer these provisions, may procure jointly with other states that are signatories to the Agreement goods and services in furtherance of the Agreement, and may take other actions reasonably required to implement these provisions. The Secretary of Revenue or the Secretary's designee may represent this state before the states that are signatories to the Agreement.

The Department may not enter into the SSUT Agreement unless the Agreement requires that a state that is a signatory to the Agreement do all of the following: (a) limit the number of state

sales and use tax rates; (b) limit the application of any maximums on the amount of state sales and use tax that is due on a transaction; (c) limit thresholds on the application of sales and use tax; (d) establish uniform standards for the sourcing of transactions to the appropriate taxing jurisdictions, for administering exempt sales, and for sales and use tax returns and remittances; (e) develop and adopt uniform definitions related to sales and use tax.; (f) provide, with all states that are signatories to the Agreement, a central electronic registration system that allows a seller to register to collect and remit sales and use taxes for all states that are signatories to the Agreement; (g) provide that the state may not use a seller's registration with the central electronic registration system, and the subsequent collection and remittance of sales and use taxes in the states that are signatories to the Agreement, to determine whether the seller has sufficient connection with the state for the purpose of imposing any tax; (h) restrict variances between the state tax bases and local tax bases; (i) administer all sales and use taxes imposed by local jurisdictions within the state so that sellers who collect and remit such taxes are not required to register with, or submit returns or taxes to, local jurisdictions and are not subject to audits by local jurisdictions; (j) restrict the frequency of changes in any local sales and use tax rates and provide notice of any such changes; (k) establish effective dates for the application of local jurisdictional boundary changes to local sales and use tax rates and provide notice of any such changes; (l) provide monetary allowances to sellers and certified service providers as outlined in the Agreement; (m) certify compliance with the Agreement before entering into the Agreement and maintain compliance with the Agreement; (n) adopt a uniform policy, with the states that are signatories to the Agreement, for certified service providers that protects a consumer's privacy and maintains tax information confidentiality; and (o) appoint, with the states that are signatories to the Agreement, an advisory council to consult with in administering the Agreement. The advisory council must consist of private sector representatives and representatives from states that are not signatories to the Agreement.

The current statutes state that the SSUT Agreement "is an accord among cooperating states to further their governmental functions and provides a mechanism among the cooperating states to establish and maintain a cooperative, simplified system for the application and administration of sales and use taxes that are imposed by each state that is a signatory to the agreement."

The SSUT Agreement binds, and inures to the benefit of, only the states that are signatories to the Agreement. Any benefit that a person may receive from the Agreement is established by this state's law and not by the terms of the Agreement. No person may have any cause of action or defense under the Agreement or because of the Department entering into the Agreement. No person may challenge any action or inaction by any department, agency, other instrumentality of this state, or any political subdivision of this state on the ground that the action or inaction is inconsistent with the Agreement.

Current state law also provides that no law of this state, or the application of such law, may be declared invalid on the ground that the law, or the application of such law, is inconsistent with the Agreement. No provision of the Agreement in whole or in part invalidates or amends any law of this state and the state becoming a signatory to the Agreement does not amend or modify any law of this state.

These current law provisions are known as the "Uniform Sales and Use Tax Administration Act."

Separate provisions of current law govern certified automated systems and certified service providers. A "certified automated system" is software that is certified jointly by the states that are signatories to the SSUT Agreement and that is used to calculate state and local sales tax and use taxes on transactions by each appropriate jurisdiction, to determine the amount of tax to remit to the appropriate state, and to maintain a record of the transaction. A "certified service provider" is an agent that is certified jointly by the states that are signatories to the Agreement and that performs all of a seller's sales and use tax functions related to the seller's retail sales.

Current law provides that a certified service provider is the agent of the seller with whom the provider has contracted and is liable for the sales and use taxes that are due the state on all sales transactions that the provider processes for a seller, except in cases of fraud or misrepresentation by the seller, as described in the following paragraph.

A seller that contracts with a certified service provider is not liable for sales and use taxes that are due the state on transactions that the provider processed, unless the seller has misrepresented the type of items that the seller sells or has committed fraud. The seller is subject to an audit on transactions that the certified service provider processed only if there is probable cause to believe that the seller has committed fraud or made a material misrepresentation. The seller is subject to an audit on transactions that the certified service provider does not process. The states that are signatories to the Agreement may jointly check the seller's business system and review the seller's business procedures to determine if the certified service provider's system is functioning properly and to determine the extent to which the seller's transactions are being processed by the certified service provider.

A person that provides a certified automated system is responsible for the system's proper functioning and is liable to this state for tax underpayments that are attributable to errors in the system's functioning. A seller that uses a certified automated system is responsible and liable to this state for reporting and remitting sales and use tax.

A seller that has a proprietary system for determining the amount of tax that is due on transactions and that has signed an agreement with the states that are signatories to the SSUT Agreement establishing a performance standard for the system is liable for the system's failure to meet the performance standard.

Provisions of AB 547/SB 267

Under AB 547/SB 267, DOR would be authorized to do all of the following related to the Uniform Sales and Use Tax Administration Act:

a. Certify compliance with the SSUT Agreement.

b. Pursuant to the Agreement, certify certified service providers and certified automated systems. [The bills would also modify the definition of "taxpayer" to include certified service providers.]

c. Consistent with the Agreement, establish performance standards and eligibility criteria for a seller that sells tangible personal property or taxable services in at least five states that are signatories to the Agreement; that has total annual sales revenue of at least $500 million; that has a proprietary system that calculates the amount of tax owed to each taxing jurisdiction in which the seller sells tangible personal property or taxable services; and that has entered into a performance agreement with the states that are signatories to the Agreement. For purposes of this provision, "seller" would include an affiliated group of sellers using the same proprietary system to calculate the amount of tax owed in each taxing jurisdiction in which the sellers sell tangible personal property or taxable services.

d. Issue a tax identification number to a person who claims a sales tax exemption and who is not required to register with DOR for sales tax purposes and establish procedures for the registration of such a person.

e. Maintain a database that is accessible to sellers and certified service providers that indicates whether items defined in accordance with the Uniform Sales and Use Tax Administration Act are taxable or nontaxable.

f. Maintain a database that is accessible to sellers and certified service providers that indicates tax rates, taxing jurisdiction boundaries, and zip code or address assignments related to the administration of state and local taxes imposed in Wisconsin

g. Set forth the information that the seller must provide to DOR for tax exemptions claimed by purchasers, and establish the manner in which a seller must provide such information.

h. Provide monetary allowances, in addition to the retailer's discount, to certified service providers and sellers that use certified automated systems or proprietary systems, pursuant to the Agreement.

AB 547/SB 267 would also specifically authorize DOR to audit (or authorize others to audit) sellers and certified service providers who are registered with the Department pursuant to the SSUT Agreement.

In addition, the bills would require DOR to notify the Revisor of Statutes of the effective date of this state's participation in the SSUT Agreement, no later than 30 days after such effective date is determined.

Finally, as required by the Agreement, the bills would provide that no seller or certified service provider would be liable for any deficiency or refund that is the result of the seller or certified service provider relying on erroneous information contained in the sales and use tax

databases maintained by DOR under items (e) and (f) above.

DEFINITION OF TAXABLE "TANGIBLE PERSONAL PROPERTY"

General Definition of Tangible Personal Property

Under current law, "tangible personal property" generally means all tangible personal property of every kind and description. Under AB 547/SB 267, consistent with the Agreement, "tangible personal property" would mean personal property that can be seen, weighed, measured, felt, or touched, or that is in any other manner perceptible to the senses. According to DOR, this change would adopt the common law definition of tangible personal property and would not be a substantive modification to current law.

In addition, the definition of tangible personal property under AB 547/SB 267 would no longer specifically mention coins and stamps sold above face value and certain leased property affixed to real estate. Instead, the bills would specifically impose the sales and use tax on these items, resulting in the same treatment as current law.

Computer Software

Under current law, "tangible personal property" that is subject to the sales tax includes computer programs, except custom computer programs. The creation of custom computer programs is an exempt service under current law.

Administrative rules define "custom programs" as utility and application software that accommodate the special processing needs of the customer. The determination of whether a program is a custom program is based upon all the facts and circumstances, including the following: (a) the extent to which the vendor or independent consultant engages in significant presale consultation and analysis of the user's requirements and system; (b) 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; (c) the extent to which the use of the software requires substantial training of the customer's personnel and substantial written documentation; (d) the extent to which enhancement and maintenance support by the vendor is needed for continued usefulness; (e) there is a rebuttable presumption that any program with a cost of $10,000 or less is not a custom program; (f) custom programs do not include basic operational programs or prewritten programs; and (g) if an existing program is selected for modification, there must be a significant modification of that program by the vendor so that it may be used in the customer's specific hardware and software environment.

Taxable basic operational programs (commonly referred to as "systems software") are programs that perform overall control and direction of the computer system and permit it to do the functions basic to the operation of a computer, and permit it to execute the instructions contained in utility software and applications software programs. Taxable prewritten programs (often referred to

as "canned programs") are programs prepared, held, or existing for general use normally for more than one customer, including programs developed for in-house use or custom program use which are subsequently held or offered for sale or lease.

AB 547/SB 267 would modify the statutory definition of taxable "tangible personal property" to specifically include the following types of prewritten computer software:

a. Computer software that is not designed and developed by the author or creator of the software according to a specific purchaser's specifications.

b. Computer software upgrades that are not designed and developed by the author or creator of the software according to a specific purchaser's specifications.

c. Computer software that is designed and developed by the author or creator of the software according to a specific purchaser's specifications and that is sold to another purchaser.

d. Any combination of computer software under (a) to (c), including any combination with any portion of such software.

e. Computer software as described above and any portion of such software, that is modified or enhanced by any degree to a specific purchaser's specifications, except such modification or enhancement that is reasonably and separately indicated on an invoice, or other statement of the price, provided to the purchaser.

"Computer software" would mean a set of coded instructions designed to cause a computer or automatic data processing equipment to perform a task. "Computer" would mean an electronic device that accepts information in digital or similar form and that manipulates such information to achieve a result based on a sequence of instructions.

As under current law, sales of custom computer programs that do not meet the definition of "prewritten computer software" outlined above would be exempt from tax.

The proposed statutory definitions are consistent with definitions required by the Agreement, and DOR indicates that the new definitions would be interpreted as identical to the current provisions of the administrative rule for most transactions. However, the Department has identified two situations where the tax would be imposed differently under AB 547/SB 267.

The first situation involves cases where one vendor sells taxable prewritten software to another vendor who, in turn, sells the prewritten software, along with modifications programmed by the second vendor, to the end-user. Under current law, the initial sale of the software from the first vendor to the second vendor would be taxable, and the subsequent sale of the modified software would not be subject to tax. Under AB 547/SB 267, the first sale of the software would be exempt as a sale for resale, but the tax would be imposed on the prewritten software, less any separately-stated charges for program modifications, in the second sale to the end-user. The

charges for the modifications would not be taxed under either current law or the bills.

The second situation involves cases where, in a single transaction, a vendor has developed prewritten software that must be modified by the vendor for use by the final customer. Under current law, the entire amount of the sale to the customer would be exempt. Under AB 547/SB 267, the tax would be imposed on the proceeds of the final sale, less any separately-stated charges for programmed modifications. As in the first example, the charges for the modifications to the software would not be taxed under either current law or AB 547/SB 267.

ANIMAL MEDICINE

According to DOR, the new definition of "drug" under AB 547/SB 267 (described below) would change how animal foods that may be considered medicines under current law sold by veterinarians are taxed. Under present law, veterinarians pay the sales tax on their purchases of animal food that would meet the definition of "medicine" (because it prevents disease, for example), and the tax is not imposed when the food is sold to the customer. Under AB 547/SB 267, the purchase of animal food sold by the veterinarian apart from the provision of veterinary services would be an exempt sale for resale and the final sale to the customer would be taxable, unless the customer could claim an exemption (because the food is for farm livestock, for example).

DEFINITIONS OF "GROSS RECEIPTS," "SALES PRICE," AND "PURCHASE PRICE"

Current law includes a detailed definition of "gross receipts", which is referenced in the statutes imposing the sales tax, the statutory exemptions, and other provisions. Current law also includes a similar definition of "sales price", which is referenced in the use tax statutes.

AB 547/SB 267 would repeal the definition of "gross receipts" and, instead, refer to a new definition of "sales price" in the language imposing the sales tax and in the exemption statutes. The bills would also create a definition for the term "purchase price", which would be identical to the new definition of "sales price." The term "purchase price" would be used in the use tax statutes. The new definitions would be consistent with the SSUT Agreement. The bills would also move certain provisions that are incorporated in the existing definitions of "gross receipts" and "sales price" to the section of the statutes relating to sales tax return adjustments and to other areas of the statutes.

Although the bills contain numerous statutory modifications relating to these definitions, the Department of Revenue indicates that most of the new provisions would be consistent with the current statutes, rules, and administrative practice. However, these definitional provisions would make one substantive change relating to bundled property, which is discussed below.

BUNDLED PROPERTY

Under current law, if exempt tangible personal property is bundled with taxable property by a seller and sold as a single product or piece of merchandise (such as a fruit basket that includes candy, or a cheese tray that includes a cutting board and knife), the seller is not required to pay tax on the value of the nontaxable items. Under AB 547/SB 267, the tax would be imposed on the entire sales price. [It should be noted that DOR believes that retailers may already be collecting and paying the tax on the entire sales price for such items because their cash registers do not allow for separation of a single item.]

DEFINITION OF "LEASE OR RENTAL"

Under current law, the state and local sales taxes are imposed on the privilege of selling, leasing, or renting tangible personal property and selling, performing, or furnishing taxable services. The current definition of "lease" includes rental, hire, and license. AB 547/SB 267 would repeal this definition and, instead, create a more detailed definition of "lease or rental" that conforms to the requirements of the SSUT Agreement.

Under AB 547/SB 267, "lease or rental" would mean any transfer of possession or control of tangible personal property for a fixed or indeterminate term and for consideration, including: (a) a transfer that includes future options to purchase or extend; and (b) agreements related to the transfer of possession or control of motor vehicles or trailers, if the amount of any consideration may be increased or decreased by reference to the amount realized on the sale or other disposition of such motor vehicles or trailers, consistent with federal provisions regarding the taxation of motor vehicle operating leases [section 7701 (h) (1) of the Internal Revenue Code].

Such transfers would be considered a lease or rental, regardless of whether the transfer is considered a lease or rental under generally accepted accounting principles, or any provision of federal or local law, or any other provision of state law.

"Lease or rental" would not include any of the following: (a) a transfer of possession or control of tangible personal property under a security agreement or deferred payment plan, if such agreement or plan requires transferring title to the tangible personal property after making all required payments; (b) a transfer of possession or control of tangible personal property under any agreement that requires transferring title to the tangible personal property after making all required payments and after paying an option price that does not exceed the greater of $100 or 1% of the total amount of the required payments; or (c) providing tangible personal property along with an operator, if the operator is necessary for the tangible personal property to perform in the manner for which it is designed and if the operator does more than maintain, inspect, or set up the tangible personal property.

These types of transfers would not be considered a lease or rental, regardless of whether such transfer is considered a lease or rental under generally accepted accounting principles, or any

provision of federal or local law, or any other provision of state law.

Equipment Provided with an Operator. According to the Department of Revenue, the most significant change under the new leasing provisions would be for transactions involving the use of equipment that is provided with an operator, such as cranes and other construction equipment.

Under current administrative rules, which are based on case law, the determination of whether such transactions are services (which may or may not be taxable) or leases of tangible personal property (which generally are taxable) depends upon how much control the lessor has over the operator's work and whether the customer or the lessor is responsible for satisfactory completion of the work. Specifically, under the current rule, a person who uses his or her own equipment to perform a job and who assumes responsibility for its satisfactory completion is considered to be performing a service. In contrast, if equipment is furnished with an operator to perform a job and the customer supervises and is responsible for the satisfactory completion of the work, the transaction is considered a lease of the equipment. If the transaction is a lease and it is customary or mandatory that the lessee accept an operator with leased equipment, the entire charge is subject to the tax. However, the operator's services are not taxable if billed separately and if a lessor customarily gives a lessee the option of taking the equipment without the operator.

Under AB 547/SB 267, any time tangible personal property is provided along with an operator the transaction would be considered a service rather than a lease as long as: (a) the operator is necessary for the property to perform in the manner for which it is designed; and (b) the operator does more than maintain, inspect, or set up the tangible personal property. The amount of control maintained by the lessor and the degree of responsibility for completion of the work assumed by the lessor or customer would no longer be considered in determining whether such transactions are leases or services.

Licensing Transactions. Because the SSUT definition of lease is silent as to licenses, the bills would specifically impose state and local sales taxes on the privilege of licensing tangible personal property and taxable services. These changes would ensure that the definition of "lease" conforms to the SSUT Agreement and that the licensing of computer software would remain taxable. According to DOR, these would not be substantive changes to current law.

Bargain Purchase Option Leases. AB 547/SB 267 would specify that "lease or rental" would not include transfers of possession or control of tangible personal property under agreements that require transferring title to the property after making all required payments and after paying an option price that does not exceed the greater of $100 or 1% of the total amount of the required payments (bargain purchase option leases). Instead, such transactions would be considered sales of property. Currently, the determination of whether such transactions are leases or sales is made based on federal guidelines set forth in an IRS Revenue Ruling. The federal guidelines consider a number of factors regarding the transaction, such as the lessor's investment in the property, lease term and renewal options, and whether the lessee has the option to purchase the property at less than market value. The proposed modification under AB 547/SB 267 would

streamline such determinations and would not affect the amount of tax owed on such transactions. However, the timing of when the tax is due would be affected in certain cases if a transaction is deemed to be a sale rather than a lease or vice-versa.

The remaining provisions would be consistent with DOR's current practice regarding the taxation of leases and rentals.

DEFINITION OF "RETAIL SALE"

AB 547/SB 267 would define "retail sale" or "sale at retail" to mean any sale, lease, or rental for any purpose other than resale, sublease, or subrent. This modification was required in order to conform to the SSUT Agreement, and is considered to be non-substantive by the Department.

DEFINITION OF "SALE" AND SIMILAR TERMS

Under current law, the general definition of the terms "sale," "sale, lease or rental," "retail sale," "sale at retail," or equivalent terms includes any one or all of the following: the transfer of the ownership of, title to, possession of, or enjoyment of tangible personal property or services for use or consumption but not for resale as tangible personal property or services. Under AB 547/SB 267, this general definition would be retained but would only apply to the term "sale." This would not be a substantive change.

The current definition of "sale" also incorporates a number of specific provisions regarding the taxation of drop-shipments, certain leases where possession is granted by the lessor to the lessee or another person at the direction of the lessee, auction sales, sales to contractors, and other transactions. AB 547/SB 267 would make a substantive change regarding drop-shipments, which is described below. The other provisions would be moved from the definition of sale to other sections of the statutes or modified slightly in order to conform to the SSUT Agreement. DOR indicates that these would not be substantive changes to current law.

DEFINITION OF "SALE FOR RESALE" AND SIMILAR TERMS

AB 547/SB 267 would specify that "sales, lease, or rental for resale, sublease, or subrent" includes transfers of tangible personal property to a service provider that the service provider transfers in conjunction with, but not incidental to, the selling, performing, or furnishing of any service, and transfers of tangible personal property to a service provider that the service provider physically transfers in conjunction with the selling, performing, or furnishing of photographic, repair, fabricating and printing, and landscaping services. This provision would not apply to sales to contractors engaged in real property construction.

"Sales, lease, or rental for resale, sublease, or subrent" would not include any of the

following: (a) the sale of building materials, supplies, and equipment to owners, contractors, subcontractors, or builders for use in real property construction activities or the alteration, repair, or improvement of real property, regardless of the quantity of such materials, supplies, and equipment sold; (b) any sale of tangible personal property to a purchaser even though such property may be used or consumed by some other person to whom such purchaser transfers the tangible personal property without valuable consideration, such as gifts, and advertising specialties distributed gratis apart from the sale of other tangible personal property or service; (c) transfers of tangible personal property to a service provider that the service provider transfers in conjunction with the selling, performing, or furnishing of any service, if the tangible personal property is incidental to the service, unless the service provider is selling, performing, or furnishing photographic, repair, fabricating and printing, and landscaping service; and (d) sales of tangible personal property to a contractor or subcontractor for use in the performance of contracts with the U.S. or its instrumentalities for the construction of improvements on or to real property.

According to DOR, these provisions would be consistent with the current statutes and administrative practice.

DROP-SHIPMENTS

A Wisconsin "drop-shipment" occurs when a purchaser located in Wisconsin orders an item from an out-of-state retailer not registered to collect Wisconsin sales or use tax and the product is delivered to the customer directly from a Wisconsin manufacturer, without the retailer taking possession. Under current law (through the definition of taxable "sale"), the Wisconsin manufacturer is required to collect the sales tax from the purchaser on such transactions. Specifically, under current law, taxable sales include the delivery in this state of property by an owner or former owner thereof or by a factor, or agent of such owner, former owner or factor, if the delivery is to a consumer or person for redelivery to a consumer, pursuant to a retail sale made by a retailer not engaged in business in this state. The person making the delivery must include the retail selling price of the property in that person's gross receipts and pay the sales tax on those receipts.

AB 547/SB 267 would repeal these current provisions. As a result, Wisconsin manufacturers would no longer be liable for the sales tax on drop-shipments to Wisconsin purchasers. The manufacturer could accept an exemption certificate claiming resale from the unregistered seller. Instead, the purchaser would be liable for use tax.

EXEMPTIONS FOR FOOD AND BEVERAGES

Current Law

General Exemption for Off-Premises Consumption. Under current law, an exemption is provided for food, food products, and beverages for off-premises human consumption. "Food," "food products," and "beverages" include, by way of illustration and not of limitation, items

commonly thought of as food (such as milk, meat, poultry, fish, fruit, fruit juices, vegetables, and condiments) and the following: (a) bottled water that is for human consumption and that is not carbonated or sweetened or flavored; (b) coffee, coffee substitutes, tea, and cocoa; (c) spices and flavoring; and (d) dietary foods and health supplements.

"Food," "food products," and "beverages" do not include: (a) medicines, tonics, vitamins, and medicinal preparations in any form; (b) fermented malt beverages (beer) and intoxicating liquors; or (c) soda water beverages, bases, concentrates, and powders intended to be reconstituted by consumers to produce soft drinks, and fruit drinks and ades not defined as fruit juices.

Taxable Food Sales. Sales of meals, food, food products, and beverages for direct consumption on the premises are generally taxable. In addition, sales of the following items for off-premises consumption are taxable: (a) meals and sandwiches, whether heated or not; (b) heated food or heated beverages; (c) soda fountain items such as sundaes, milk shakes, malts, ice cream cones, and sodas; and (d) candy, chewing gum, lozenges, popcorn, and confections.

For purposes of this provision, "meal" includes, but is not limited to, a diversified selection of food, food products, or beverages that are customarily consumed as a breakfast, lunch, or dinner, that may not easily be consumed without an article of tableware and that may not conveniently be consumed while standing or walking; except that "meal" does not include frozen items that are sold to a consumer, items that are customarily heated or cooked after the retail sale and before they are consumed, or a diversified selection of food, food products, and beverages that is packaged together by a person other than the retailer before the sale to the consumer. Current law also includes a definition of "sandwich."

For on-premises sales, taxable gross receipts include cover, minimum, entertainment, service, or other charges made to patrons or customers.

Other Non-Taxable Food Sales. The following sales of food and beverages are also exempt from tax:

a. Meals, food, food products, or beverages sold by, and served at, hospitals, sanatoriums, nursing homes, retirement homes, community-based residential facilities, or registered day care centers.

b. Meals, food, food products, or beverages sold to the elderly or handicapped by persons providing "mobile meals on wheels."

c. Otherwise taxable food and beverage items, or disposable products that are transferred with such items, that are provided by a restaurant to the restaurant's employee during the employee's work hours.

d. Meals, food, food products, or beverages, furnished in accordance with any contract or agreement or paid for to such institution through the use of an account of such institution, by a

public or private institution of higher education to an undergraduate student, a graduate student, or a student enrolled in a professional school if the student is enrolled for credit at that institution and if the goods are consumed by that student and meals, food, food products, or beverages furnished to a National Football League team under a contract or agreement.

e. Food, food products, or beverages and other goods that are packaged together by a person other than a retailer before the sale to the final consumer if 50% or more of the sales price of the package is attributable to goods that are exempt.

For purposes of these provisions "premises" is construed broadly, and, by way of illustration but not limitation, includes the lobby, aisles, and auditorium of a theater or the seating, aisles, and parking area of an arena, rink, or stadium or the parking area of a drive-in or outdoor theater. The premises of a caterer with respect to catered meals or beverages is the place where served. Sales from a vending machine are considered sales for off-premises consumption.

Provisions of AB 547/SB 267

The bills would repeal all of the existing provisions regarding sales of food and, instead, create new exemptions for:

a. Food and food ingredients, except candy, soft drinks, dietary supplements, and prepared food. "Food and food ingredient" would mean a substance in liquid, concentrated, solid, frozen, dried, or dehydrated form, that is sold for ingestion, or for chewing, by humans and that is ingested or chewed for its taste or nutritional value. "Food and food ingredient" would not include alcohol beverages or tobacco. AB 547/SB 267 also include definitions for "candy," "soft drinks," "dietary supplements," "prepared food," "alcohol beverages," and "tobacco," which are outlined below. These definitions are consistent with the Agreement.

b. Food and food ingredients, except soft drinks, sold by hospitals, sanatoriums, nursing homes, retirement homes, community–based residential facilities, or registered day care centers, including prepared food that is sold to the elderly or handicapped by persons providing mobile meals on wheels.

c. Food and food ingredients furnished in accordance with any contract or agreement or paid for to such institution through the use of an account of such institution, by a public or private institution of higher education to any of the following: (1) an undergraduate student, a graduate student, or a student enrolled in a professional school if the student is enrolled for credit at the public or private institution of higher education and if the food and food ingredients are consumed by the student; or (2) a National Football League team.

Similar to current law, AB 547/SB 267 would also provide an exemption for candy, soft drinks, dietary supplements, and prepared foods, and disposable products that are transferred with such items, furnished by a restaurant to the restaurant's employee during the employee's work hours. However, the bills would limit this exemption to only include such items that are furnished

for no consideration (as opposed to sold) by restaurants to their employees.

"Prepared food" would mean: (a) food and food ingredients sold in a heated state; (b) food and food ingredients heated by the retailer (except as provided below); (c) food and food ingredients sold with eating utensils that are provided by the retailer including plates, knives, forks, spoons, glasses, cups, napkins, and straws ("plate" would not include a container or packaging used to transport food and food ingredients); and (d) except as provided below, two or more food ingredients mixed or combined by a retailer for sale as a single item.

"Prepared food" would not include the following items, unless they are provided with utensils: (a) two or more food ingredients mixed or combined by a retailer for sale as a single item, if the retailer's primary classification in the 1997 North American Industry Classification System is manufacturing under sectors 31 to 33, not including bakeries and tortilla manufacturing under industry group number 3118; (b) two or more food ingredients mixed or combined by a retailer for sale as a single item, sold unheated, and sold by volume or weight; (c) bakery items made by a retailer, including breads, rolls, pastries, buns, biscuits, bagels, croissants, donuts, danish, cakes, tortes, pies, tarts, muffins, bars, cookies, and tortillas; (d) food and food ingredients that are only sliced, repackaged, or pasteurized by a retailer; or (e) eggs, fish, meat, and poultry, and foods containing any of them in raw form, that require cooking by the consumer, as recommended by the FDA to prevent food–borne illnesses.

"Candy" would mean a preparation of sugar, honey, or other natural or artificial sweetener combined with chocolate, fruit, nuts, or other ingredients or flavorings in the form of bars, drops, or pieces. "Candy" would not include a preparation that contains flour or that requires refrigeration.

"Dietary supplement" would mean a product, other than tobacco, that is intended to supplement a person's diet, if all of the following apply:

a. The product contains any of the following ingredients or any combination of any of the following ingredients: (1) a vitamin; (2) a mineral; (3) an herb or other botanical; (4) an amino acid; (5) a dietary substance that is intended for human consumption to supplement the diet by increasing total dietary intake; or (6) a concentrate, metabolite, constituent, or extract.

b. The product is intended for ingestion in tablet, capsule, powder, soft–gel, gel–cap, or liquid form, or, if not intended for ingestion in such forms, is not represented as conventional food and is not represented for use as the sole item of a meal or diet.

c. The product is required to be labeled as a dietary supplement under federal regulations [21 CFR 101.36].

"Soft drink" would mean a beverage that contains less than 0.5% of alcohol and that contains natural or artificial sweeteners. "Soft drink" would not include a beverage that contains milk or milk products; soy, rice, or similar milk substitutes; or more than 50% vegetable or fruit juice by volume.

"Alcohol beverage" would mean a beverage that is suitable for human consumption and that contains 0.5% or more of alcohol by volume.

"Tobacco" would mean cigarettes, cigars, chewing tobacco, pipe tobacco, and any other item that contains tobacco.

Net Impact of AB 547/SB 267

With the above modifications, most sales of food would be treated the same as under current law. Most sales of food for off-premises consumption would remain exempt; restaurant meals, alcohol, tobacco, and soda would continue to be taxable; and the current exemptions for institutional sales of meals and food (including "meals on wheels") would be retained. However, as noted, the exemption for food and disposable utensils that are provided by restaurants to their employees would apply only if such items were furnished for no consideration. Also, exempt food or beverages and other taxable goods that are packaged together by a person other than a retailer before the sale to the final consumer ("lunchables" for example) would always be exempt. Currently, these products are exempt only if 50% or more of the sales price of the package is attributable to goods that are exempt.

In addition to these changes, the Department of Revenue has identified a number of other types of food products that would be taxed differently under the new provisions. For example, chocolate chips and marshmallows, which are currently exempt, would be taxable under AB 547/SB 267, while unpopped popcorn, which is currently taxable, would be exempt. Attachment 1 presents a list of food items whose tax treatment would be modified under the bills.

EXEMPTION FOR PRESCRIPTION DRUGS

Under current law, a sales and use tax exemption is provided for medicines that are any of the following: (a) prescribed for the treatment of a human being by a person authorized to prescribe the medicines, and dispensed on prescription filled by a registered pharmacist in accordance with law; (b) furnished by a licensed physician, surgeon, podiatrist, or dentist to a patient for treatment of the patient; (c) furnished by a hospital for treatment of any person pursuant to the order of a licensed physician, surgeon, podiatrist, or dentist; (d) sold to a licensed physician, surgeon, podiatrist, dentist, or hospital for the treatment of a human being; (e) sold to this state or any political subdivision or municipal corporation thereof, for use in the treatment of a human being; (f) furnished for the treatment of a human being by a medical facility or clinic maintained by this state or any political subdivision or municipal corporation thereof; or (g) furnished without charge to a physician, surgeon, nurse anesthetist, advanced practice nurse, osteopath, or to any licensed dentist, podiatrist, or optometrist if the medicine may not be dispensed without a prescription.

AB 547/SB 267 would replace the word "medicine" with "drug" in the statute relating to this exemption and clarify that such drugs must be for a human being.

Under the current exemption statutes, "medicines," means any substance or preparation that is intended for use by external or internal application to the human body in the diagnosis, cure, mitigation, treatment, or prevention of disease and that is commonly recognized as a substance or preparation intended for such use; but "medicines" do not include any of the following: (a) any auditory, prosthetic, ophthalmic, or ocular device or appliance; (b) articles that are in the nature of splints, bandages, pads, compresses, supports, dressings, instruments, apparatus, contrivances, appliances, devices, or other mechanical, electronic, optical, or physical equipment or articles, or the component parts or accessories thereof; or (c) any alcohol beverage the manufacture, sale, purchase, possession, or transportation of which is licensed or regulated under the laws of this state.

AB 547/SB 267 would repeal this definition. Instead, consistent with the SSUT Agreement, "drug" would be defined as a compound, substance, or preparation, or any component of them, other than food and food ingredients, dietary supplements, or alcoholic beverages, to which any of the following applies:

a. It is listed in the US Pharmacopoeia, Homeopathic Pharmacopoeia of the US, or National Formulary, or any supplement to any of them.

b. It is intended for use in diagnosing, curing, mitigating, treating, or preventing a disease.

c. It is intended to affect a function or structure of the body.

AB 547/SB 267 would also create a definition of "prescription", which would mean an order, formula, or recipe that is issued by any oral, written, electronic, or other means of transmission and by a person who is authorized by the laws of this state to issue such an order, formula, or recipe. The definitions of "food and food ingredients," "dietary supplements," and "alcoholic beverages" are included in the previous section regarding the taxation of food.

The bills would also create a new exemption for bandages, dressings, syringes, and similar items that are bundled together with exempt drugs for sale by the seller as a single product or piece of merchandise. This exemption would also apply only to items used on human beings.

The Department indicates that the new definition of "medicine" is consistent with how it interprets the current statute regarding this exemption. The new exemption for bandages and similar items that are bundled together with exempt drugs would be consistent with the Department's current practice in administering the exemption for medicine, although there is no statute or rule regarding these items under present law. The proposed definitions of "dietary supplement" and "prescription" are consistent with the Agreement.

MEDICAL EQUIPMENT EXEMPTION

Current law provides an exemption for the following property, including parts and