STATE OF WISCONSIN

REPORT OF THE JOINT SURVEY COMMITTEE ON TAX EXEMPTIONS

2005 ASSEMBLY BILL 100

[Introduced by Joint Committee on Finance by request Governor Jim Doyle.]

General Nature and Fiscal Effect of Tax Exemption Provisions in 2005 Assembly Bill 100

2005 Assembly Bill 100 is the 2005-07 Executive Budget Bill ("bill") proposed by the Governor and introduced by the Joint Committee on Finance at the request of the Governor. The bill contains a number of provisions which affect existing statutes or create new statutes relating to the exemption of property or persons from state or local taxes. This report addresses those provisions.

1. Internal Revenue Code Update

Wisconsin's individual and corporate tax provisions are primarily based on and referenced to definitions under the federal Internal Revenue Code (IRC). Changes made to the federal tax code are effective for Wisconsin purposes only after state law has been amended to incorporate the federal changes.

The bill updates state references to the IRC to reflect many federal law changes made during 2003 and 2004. According to the Legislative Fiscal Bureau (LFB), the IRC update provisions, including some provisions that may not relate to exemptions from taxation, would have the following affect:

> With exceptions, the bill would update state references to federal provisions enacted in 2003 and 2004 under the following federal laws: (a) the 2003 Jobs and Growth Tax Relief Reconciliation Act (JGTRRA); (b) the 2003 Military Family Tax Relief Act (MFTRA); (c) the 2003 Medicare Prescription Drug, Improvement, and Modernization Act (MPDIMA); (d) the Working Families Tax Relief Act (WFTRA); (e) the American Job Creation Act (AJCA); and (f) 2004 Public Law 108-476, relating to the YMCA retirement fund. AJCA repeals certain provisions under prior federal law related to foreign sales corporations (Public Law 106-519), which the state did not adopt for state tax purposes. However, the bill would include conformance to such provisions under Public Law 106-519, effective with tax year 2005, in order to facilitate the update to the current federal provisions under AJCA.
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> The bill would conform to all of the provisions under the federal laws described above with the exception of the following: (a) increases in federal alternative minimum tax exemptions for tax years 2003 and 2004 under JGTRRA [although the increase in the alternative minimum tax exemptions for tax year 2005 (under WFTRA) would be included]; (b) federal bonus depreciation and small business expensing provisions under JGTRRA and AJCA, which modified prior federal provisions that were

not adopted for state tax purposes; (c) health savings accounts (HSAs) in MPDIMA and provisions under WFTRA that would provide conformity between distributions from health savings accounts and Archer medical savings accounts; (d) the extension of expiring tax provisions that the state did not previously adopt, which augmented the deduction for donations of computer technology and equipment and provided immediate deductions of brownfield environmental remediation costs (under WFTRA); and (e) and federal provisions that would permit expensing of film and television production costs (under AJCA).

The bill would also include conformance of state statutes with the changes under two additional federal laws enacted in 2004 -- the 2004 Social Security Protection Act and the 2004 Pension Funding Equity Act. These two federal laws provided clarifications and technical corrections as well as adjusted rules relating to pension funds. While these provisions would not have a substantive effect on state tax law, the bill would adopt the federal changes to remain consistent with federal law.

The federal law provisions to which the state would conform, under the bill, would generally apply for Wisconsin purposes at the same time as they apply for federal purposes, with the following exceptions: (a) a deduction for travel expenses of members of the National Guard and Reserves under MPDIMA would be adopted prospectively for tax years beginning after December 31, 2004, rather than retroactively to tax year 2003, when the federal deduction took effect; (b) an extension of a deduction for classroom expenses of educators would be adopted prospectively, for tax year 2005, and not retroactively to tax year 2004, when the federal extension of the expiring provision took effect (under WFTRA); and (c) the provisions of Public Law 106-519, related to foreign sales corporations, would be adopted for tax years beginning on or after January 1, 2005, as described above.

In addition to updating state tax references to the IRC, the bill would clarify and correct certain provisions related to the standard deduction and to innocent spouse relief under the individual income tax. Under current law, the standard deduction for a person claimed as a dependent on another's return equals the lesser of: (a) the deduction for a single tax filer; or (b) \$800 (in 2005 – the amount is adjusted annually for inflation), but not more than the tax filer's earned income plus \$250. For nonresidents or part-year residents, if the deduction is the first amount, it is prorated by the ratio of Wisconsin adjusted gross income (WAGI) to federal adjusted gross income (FAGI); if the deduction is the second amount, it is not prorated. The bill would correct the statutes so that the standard deduction for nonresidents or part-year residents would be pro-rated by the ratio of WAGI to FAGI in all cases, effective with tax years beginning on or after January 1, 2005.

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The administration estimates that the IRC update under the bill would increase state tax revenues by $620,000 in 2005-06 and by $1,110,000 in 2006-07. The following table provides a list of the items that are projected to have an impact on state revenues, along with their estimated fiscal effects.

TABLE 1
Summary of Federal Law Changes with Substantive Fiscal Effects
(In Millions)

	2005-06	2006-07
Individual Income Tax		
Charitable contributions of patents and similar property	$2.30	$1.40
Charitable contributions of motor vehicles, boats, and airplanes	0.90	1.10
Treatment of partnership loss transfers and partnership basis adjustments	0.20	0.15
Alternative minimum tax relief for individuals	None	-0.05
Deduction for costs incurred in civil rights suits	-0.10	-0.10
Military death benefit exclusion	-0.20	Minimal
Exclusion of gain from sale of residence for uniformed personnel	-0.30	Minimal
Deduction for travel expenses by Guard and Reserve members	-0.50	-0.50
Extension of the teachers' expense deduction	None	-1.40
Individual Income Tax Total	$2.30	$0.60
Corporate and Business Taxes		
Reform tax treatment of leasing arrangements to tax-exempt entities	$3.30	$3.30
Consistent amortization period for start-up and organizational expenditures	0.30	1.20
Limitation of employer deduction for certain entertainment expenses	0.80	0.50
Treatment of nonqualified deferred compensation plans	0.65	0.15
Expanded disallowance of deduction for interest on convertible debt	0.40	0.25
Limitation on transfer or importation of built-in losses	0.30	0.30
Depreciation of sports franchises	0.30	0.20
Prevention of mismatching between deductions and income inclusions	0.25	0.20
Denial of installment sale treatment for all readily tradable debt	0.20	0.05
Depreciation of utility grading costs	0.10	0.10
Modification of straddle rules	0.10	0.07
Treatment of certain income of rural electric cooperatives	-0.06	0.00
Depreciation of certain motor racetrack facilities	-0.07	-0.06
Expand bank S corporation eligible shareholders to include IRAs	-0.10	-0.10
Increase the number of eligible S corporation shareholders to 100	-0.10	-0.15
Deduction for clean-fuel vehicles	-0.35	0.00
Method of accounting for naval shipbuilders	-0.20	-0.20
Modification of application of income forecast method of accounting	-0.20	-0.30
Election to expense qualified reforestation costs	-0.40	-0.15
Depreciation of certain leasehold improvement and restaurant property	-0.90	-0.55
Repeal exclusion for extraterritorial income	-6.00	-4.30
Corporate and Business Tax Total	-$1.68	$0.51
IRC Update Total	$0.62	$1.11

2. Increase of Individual Income Tax Deduction for College Tuition

Generally, current law provides a subtraction from federal adjusted gross income for up to $3,000 paid per year per student for tuition to attend a university, college, technical college, or certain other schools in Wisconsin or that are subject to the Minnesota Wisconsin reciprocity agreement. The bill increases the amount of the allowable subtraction from $3,000 per year per student to $5,100 or twice the average amount charged by the University of Wisconsin (UW) Board of Regents at four-year institutions for resident undergraduate tuition for the most recent fall semester, whichever is greater. The provisions would first apply to taxable years beginning on January 1 of the year in which the bill takes effect, except that if the bill takes effect after July 31, the provisions would first apply to taxable years beginning on January 1 of the following year. According to the LFB, the administration estimates that these provisions would reduce state individual income tax revenues by $4.9 million in 2005-06 and by $5.3 million in 2006-07.

3. Definition of Nonprofit Retailers and Increasing the Occasional Sale Thresholds

Generally under current law, the state imposes a sales tax on all retailers at the rate of 5% of the gross receipts of the sale, lease, or rental of tangible personal property in the sale of certain services. For sales tax purposes, a retailer includes a seller who sells any tangible personal property or taxable service. A retailer who is subject to the sales tax must obtain a seller's permit, collect the sales tax, and remit the collected tax to the Department of Revenue (DOR). The Wisconsin Supreme Court has held that a religious organization that sells tangible personal property is not a retailer subject to the sales tax if the sales are not mercantile in nature. The bill subjects a retailer to the sales tax regardless of whether the sale is mercantile in nature.

Generally under current law, a nonprofit organization that sells tangible personal property or services is required to have a seller's permit if it sells property or services on more than 20 days during the year and the gross receipts from such sales exceed $15,000. The bill increases this amount to $25,000. Finally, under current law, the sales of tangible personal property are taxable services made by a nonprofit organization at an event involving entertainment are subject to the sales tax and the use tax if the organization's payment for the entertainment exceeds $300. The bill increases this amount to $500.

These provisions would take effect on January 1, 2006.

The LFB provides the following with respect to the fiscal ramifications of the above provisions:

> According to the department [of Revenue], removing a mercantile standard from the definition of a retailer would result in additional sales tax being collected by retailers currently not collecting sales tax on certain transactions. However, increasing the occasional sales exemption standards would reduce the amount of sales tax collected by nonprofit organizations. While it is not possible to measure the impact from either of the proposed modifications, the department anticipates that the overall fiscal impact would be minimal revenue increase.

4. Sales and Use Tax on Electronic Versions of Certain Personal Property

Generally, the bill imposes the sales tax and the use tax on audiovisual works, finished artwork, literary works, and audio works that are delivered electronically to a purchaser.

The LFB describes the effect of the bill as follows:

> Under current law, the 5% state sales and use tax is generally imposed on the gross receipts from the sale and rental of tangible personal property. In addition, the sales and use tax is specifically imposed on the sale and use of selected services. There is no imposition of tax on sales of real property or intangible property, unless the item would fall within one of the services that are subject to Wisconsin sales tax.
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> With some exceptions, items transferred in electronic form through the internet are not taxable, even if the item would be taxable if transferred in tangible form (for example, a novel purchased via the internet in digital format and then printed would not be subject to the tax, whereas the same novel purchased as a paperback book would be subject to the tax). However, current law makes the following exceptions to this general approach:
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> a. Computer software, excluding custom software, is defined by state law to be tangible personal property for purposes of the sales and use tax, without regard to the form in which it is transferred.
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> b. Taking photographs, reproducing them in a digital format and delivering them electronically is a taxable service.
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> c. Pay-per-view movies, movie channels, and similar means of viewing motion pictures are cable television services that are specifically subject to tax. However, movies downloaded via the internet may not meet Wisconsin's current definition of cable television service, which requires amplification of the program.
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> As described above, current law generally imposes the sales and use tax on tangible personal property, and specifically imposes the tax on selected services. The bill would create new provisions specifically imposing the sales and use tax on four types of electronic products, including audio works, audiovisual works, finished artwork, and literary works. The bill would define these electronic products as follows:
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> a. "Audio works" would mean works that result from the fixation of a series of musical, spoken, or other sounds, including prerecorded or live music, prerecorded or live readings of books or other written materials, prerecorded or live speeches, and digitized sound files that are downloaded to a telephone handset. "Audio works" would not include broadcast radio services or sounds accompanying an audiovisual work.

b. "Audiovisual works" would mean a series of related images that, when shown in succession, impart an impression of motion, together with sound, including motion pictures, musical videos, and live events. "Audiovisual works" would not include broadcast television services or cable television system services.

c. "Finished artwork" would mean the final art used for actual reproduction by photomechanical or other processes or for display purposes. "Finished artwork" would also include all of the following items, regardless of whether the items are reproduced: drawings; paintings; designs; photographs; lettering; paste-ups; mechanicals; assemblies; charts; graphs; and illustrative materials.

d. "Literary works" would mean works, not including audiovisual works, audio works, and computer software, that are expressed in words, numbers or other verbal or numerical symbols or indicia, including books and periodicals.

The bill would modify certain provisions under current law as they relate to the incidental transfer of tangible personal property with a service and the separate sale of such items apart from selected services. The bill would provide that transfers of the electronic products described above with a service would be treated consistently with the treatment of transfers of tangible personal property with a service under current law. In addition, the bill would provide an exemption from the sales and use tax for any of the electronic products described above that would be exempt from tax if transferred in a tangible form.

The LFB estimates increased sales tax revenues of $1.3 million in 2005-06, assuming an effective date of August 1, 2005, and $1.9 million in 2006-07.

5. Streamlined Sales and Use Tax Agreement

The bill makes various changes to the state sales and use tax statutes to assist the state in conforming to the terms of the multi-state streamlined sales and use tax agreement. The agreement is intended to simplify and modernize sales and use tax administration for states that enter into the agreement and to encourage out-of-state retailers to collect and remit sales and use taxes voluntarily. Under current law and constitutional principles, Wisconsin may not compel an out-of-state retailer who sells goods or services to customers in this state to collect sales or use tax imposed on such sales if the retailer has no physical presence in this state.

States that wish to enter into the agreement must adopt uniform definitions related to the administration of sales and use taxes. Although a state retains the ability to determine the taxability of various goods and services, it must do so using the uniform definitions. Among other things, the bill adopts these various uniform definitions. Mostly because the use of these uniform definitions, various items will have your taxable nature changed. Some items that are currently exempt from tax will become taxable and some items that are currently taxable will become exempt by the adoption of these definitions. These provisions would be effective on October 1, 2005.

The LFB estimates the major fiscal ramifications of the tax exemption provisions of the streamline sales tax agreement as follows:

> **Pre-Written Software.** Certain currently exempt sales of pre-written computer software that is customized for a specific purchaser would become taxable. This provision is estimated to result in a minimal increase in tax revenues.
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> **Bundled Items.** The sales tax would be imposed on the entire sales price of products comprised of exempt items that are bundled with taxable items by the seller. Currently, the seller is not required to pay tax on the value of the nontaxable items. The fiscal effect of this modification is also estimated to be a minimal revenue increase.
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> **Property Provided with an Operator.** Under the bill, if tangible personal property 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 represent a property lease 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. For individual taxpayers, this modification could result in a larger or smaller tax liability than current law, depending upon the specific circumstances of the transaction. The net fiscal effect is estimated to be minimal.
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> **Food and Beverages.** ...certain food sales that are now exempt would become taxable and certain sales that are now taxable would become exempt. In addition, the treatment of pet food sold by veterinarians would be modified. In total, these modifications are estimated to decrease state tax revenues by $2,750,000 in 2005-06 and by $3,230,000 in 2006-07. In addition, county and stadium sales tax revenues are estimated to decrease by $210,000 in 2005-06 and by $250,000 in 2006-07. The largest revenue impacts relate to the treatment of: (a) ready-to-drink tea ($2,100,000 in 2005-06 and $3,390,000 in 2006-07); (b) frozen novelties (-$1,770,000 in 2005-06 and -$2,500,000 in 2006-07); (c) fruit drinks with 50% to 99% juice (-$760,000 in 2005-06 and -$1,030,000 in 2006-07); (d) popcorn (-$1,070,000 in 2005-06 and -$1,450,000 in 2006-07); (e) chocolate chips and baking chocolate ($890,000 in 2005-06 and $1,240,000 in 2006-07); and (f) packaged ice (-$780,000 in 2005-06 and -$1,060,000 in 2006-07). Exposition district tax revenues would increase by an estimated $250,000 in each year.

Medical Equipment; Antiembolism Elastic Hose. The bill would expand the types of medical equipment that are exempt from tax. In addition, 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, and the existing exemption for antiembolism elastic hose would be repealed. The additional exemptions for durable medical equipment are estimated to decrease state sales tax collections by $2,210,000 in 2005-06 and by $3,090,000 in 2006-07 and reduce county and stadium sales tax collections by $170,000 in 2004-05 and by $240,000 in 2006-07. The other modifications would have a minimal fiscal effect.

Cloth Diapers. The current exemption for cloth diapers would be eliminated. The estimated fiscal effect is an increase in state revenues of $30,000 in 2005-06 and $50,000 in 2006-07 and a minimal increase in local revenues in each year.

Catalogs and other Property Delivered to Wisconsin Residents. Purchases of items 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. Currently, such sales are not subject to the sales or use tax if the printer is located out-of-state and does not have nexus with Wisconsin. This provision would increase state sales taxes by an estimated $950,000 in 2005-06 and $1,300,000 in 2006-07 and increase county and stadium taxes by $74,000 in 2005-06 and $100,000 in 2006-07.

Legality Involved

There are no questions of legality involved.

Public Policy Involved

The Joint Survey Committee on Tax Exemptions finds that there is questionable public policy concerning tax exemptions in both Assembly Bill 100 and in the version of the bill recommended by the Joint Committee on Finance.