



Legislative Fiscal Bureau

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Joint Committee on Finance

Paper #110

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

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

CURRENT LAW

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

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

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

GOVERNOR

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

DISCUSSION POINTS

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

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

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

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

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

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

ALTERNATIVES TO BILL

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

<u>Alternative 1</u>	<u>GPR</u>
2001-03 REVENUE (Change to Bill)	- \$500,000

2. Maintain current law.

<u>Alternative 2</u>	<u>GPR</u>
2001-03 REVENUE (Change to Bill)	- \$52,000,000

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