STATE OF WISCONSIN

REPORT OF THE JOINT SURVEY COMMITTEE ON TAX EXEMPTIONS

2007 SENATE BILL 40

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

2007 Senate Bill 40 is the 2007-09 Executive Budget Bill ("bill") prepared 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.

General Nature and Fiscal Effect of Tax Exemption Provisions in 2007 Senate Bill 40

Income of Nonresidents and Part-Year Residents

The bill specifies that, for purposes of the individual income tax, amounts received by a nonresident under a covenant not to compete are taxable to the extent that the covenant was based on a Wisconsin-based activity. Such income is currently taxable for state residents. This provision would first apply to taxable years beginning on or after January 1, 2007.

In addition, the bill requires nonresidents and part-year residents to add back to federal adjusted gross income (AGI), for purposes of calculating Wisconsin AGI, certain items that are deductible under federal law and related to income that is not taxable by the state. This provision is intended to prevent nonresidents and part-year residents from receiving unintended state tax deductions relating to domestic production activities and certain attorney fees and court costs. These provisions would first apply to taxable years beginning on January 1 of the year in which the budget bill takes effect, except that if the bill's effective date is after July 31, the provisions would first apply to taxable years beginning on January 1 of the following year.

The LFB estimates that these provisions would have the effect of increasing individual income tax revenue by a minimal amount.

Oil Company Assessment

Generally, the bill creates, for the privilege of doing business in this state, an assessment on each motor vehicle fuel supplier at the rate of 2.5% of the supplier's gross receipts in each calendar quarter that are derived from the first sale in this state of motor vehicle fuel received by the supplier for sale in this state, for sale for export to this state, or for export to this state.

The bill does not include biodiesel fuel or ethanol blended with gasoline to create gasoline consisting of at least 85% ethanol in the calculation of a supplier's gross receipts. Additionally, the bill extends gasoline and diesel fuel exemptions to the state motor vehicle fuel excise tax for licensed exporters and for fuel sold for use by a federal agency to the proposed oil company assessment.

The LFB estimates the oil company assessment would increase revenues to the transportation fund by $116,710,000 in 2007-08 and $158,460,000 in 2008-09.

Health Insurance Deduction

Current law provides an individual income tax deduction for 100% of the amount paid by a person for a medical care insurance policy that covers the person and his or her spouse and dependents if the person's employer pays nothing toward the medical care insurance or if the person is self-employed. There is a similar deduction for approximately 33% of such amounts paid by a person who has no employer and no self-employment income. This percentage will increase to 100% for taxable years beginning after December 31, 2008.

This bill creates a phased-in individual income tax deduction for persons whose employers pay for a portion of their insurance. The deduction would be 10% of the amount paid by the employee in tax year 2008, 25% in 2009, 45% in 2010, and 100% in 2011, and thereafter. According to the LFB, the administration estimates that this provision would reduce individual income tax revenue by $11.8 million in 2008-09, $31.9 million in 2009-10, $62.0 million in 2010-11, and $149.0 million in 2111-12, and thereafter.

Tuition Deduction

Generally, current law provides a deduction from federal AGI for amounts paid by a claimant for tuition to attend certain higher education institutions located in this state or subject to the Minnesota-Wisconsin reciprocity agreement. Under current law, the maximum deduction amount is equal to twice the average amount charged by the Board of Regents of the University of Wisconsin (UW) System at four-year institutions for resident undergraduate tuition for the most recent fall semester. This amount is $4,844 for 2007.

The bill increases the maximum college tuition deduction amount to $6,000 per eligible student per year and provides that the deduction could be claimed for mandatory student fees as well as tuition. The changes would be effective for tax years beginning after December 31, 2006. According to the LFB, the administration estimates that these provisions would reduce state individual income tax revenues by $2.4 million in 2007-08 and $1.6 million in 2008-09.

Child and Dependent Care Deduction

This bill provides an individual income tax deduction for employment-related child or dependent care expenses that are allowable under the federal credit for child and dependent care expenses. The bill specifies the maximum amount that could be deducted in tax year 2008 as $750 if the taxpayer has one qualifying individual and $1,500 if the taxpayer has two or more qualifying individuals. The maximum deduction amounts would increase to $1,500 and $3,000 in 2009, $2,250 and $4,500 in 2010, and $3,000 and $6,000 in 2011 and thereafter. According to the LFB, the estimated fiscal effect would be a reduction in individual income tax revenues of $5.6 million in 2008-09 and would increase to $10.1 million in 2009-10, $13.5 million in 2010-11, and $15.9 million in 2111-12, and thereafter.

Internal Revenue Code Update

Generally, the bill updates statutory references to the federal Internal Revenue Code (IRC) to include changes to the IRC enacted in 2005 and through November 2006, with certain exceptions.

The LFB describes the effect of the bill as follows:

> Under current law, state tax references generally refer to the IRC in effect as of December 31, 2004. Provisions not previously adopted related to amortization and accelerated depreciation and expensing would not be adopted, with the exception of certain provisions related to capital investment expense deductions for persons actively engaged in farming. The bill would also modify current law to base filing deadlines for extensions for corporate taxfilers on federal requirements and to conform to federal law regarding electronic reporting of withholding statements. The IRC update provisions would generally apply for Wisconsin purposes at the same time as they apply for federal purposes.

The LFB estimates the fiscal effect of these provisions would be to reduce state income and franchise tax revenues by $9.8 million in 2007-08 and $3.8 million in 2008-09. The LFB also notes that the IRC update would affect taxes that would normally be paid during the 2006-07 fiscal year. The Department of Revenue estimates that these provisions would reduce state income and franchise tax revenues by $3.0 million. The LFB describes the fiscal effect of the Internal Revenue Code update in the following table:

TABLE 1

Summary of Federal Law Changes Included in SB 40 with Substantive Fiscal Effects (In Millions)

	2007-08	2008-09
Individual Income Tax		
Qualified disaster mitigation payments	Minimal	-$0.05
Inflation indexing of certain income limits for individual retirement accounts (IRAs)	-$0.52	-0.70
Rollover by nonspouse beneficiaries of certain retirement plan distributions	-0.30	-0.26
Tax-free pension distributions for health care and long-term care insurance for public safety officers	-3.18	-1.97
Required condition for charitable contributions of clothing and household goods	0.30	0.36
Tax-free IRA distributions for charitable giving	-2.24	-0.37
Alternative minimum tax	-1.00	0.00
S-corporation basis adjustment for charitable giving	-0.56	Minimal
Individual Income Tax Total	-$7.50	-$2.99
Corporate and Business Taxes		
Treatment of certain income of electric cooperatives	-$0.05	-$0.06
Energy efficiency commercial buildings property deduction	-0.58	0.00
Extend replacement period for nonrecognition of gain	-0.43	Minimal
Enhanced deductions for contributions of food inventories to individuals	-0.94	-0.64
Excess pension assets for future medical benefits	-0.06	-0.05
Allowance for medical benefit reserve	-0.05	-0.07
Enhanced deduction for food	-0.15	-0.00
Corporate and Business Tax Total	-$2.26	-$0.82
IRC Update Total	-$9.8	-$3.8

Exclusion for Veterans Service Organizations--Income and Property Tax

Effective with property assessed as of January 1, 2007, the bill provides a property tax exemption for real property owned by a veterans service organization that is chartered under federal law, if the property is necessary for the location and convenience of buildings. Currently, there are 45 congressionally-chartered veterans service organizations.

The bill also provides an exemption from corporate income and franchise tax for veterans service organizations that are chartered under federal law. The LFB estimates the fiscal effect of this provision to be minimal.

Sales Tax Exemptions for Biotechnology

The bill creates sales and use tax exemptions for animals, machines, and other types of tangible personal property purchased by biotechnology businesses if the items are used exclusively and directly in biotechnology research or businesses raising laboratory animals that are sold to biotechnology businesses for use in research. These provisions would take effect on the first day after the second month beginning after publication of the bill. According to the LFB, the estimated fiscal effect would be a reduction in sales and use tax revenues of $3.3 million in 2007-08, assuming a July 2007 publication date, and $4.5 million in 2008-09.

Streamlined Sales and Use Tax

The bill modifies state sales and use tax laws to conform to the provisions of the multi-state Streamlined Sales and Use Tax Agreement (SSUTA). Generally, the agreement requires states to use uniform definitions in establishing their tax bases. According to the LFB, the modifications to the current sales and use tax base include the following:

- 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.

- The bill 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.

- The bill 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.

- The bill 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 bill would generally impose the tax on the entire sales price of products comprised of exempt items that are bundled with taxable items by the seller. However, if the retailer can identify, by reasonable and verifiable standards from the retailer's books and records, the portion of the price that is attributable to nontaxable products, that portion of the sales price would not be taxable. Currently, the seller is not required to pay tax on the value of the nontaxable items. Certain exceptions would apply to the general treatment of bundled transactions, such as an exception for transactions in which the value of the taxable products is no greater than 10% of the value of all the bundled products. The bill would also exclude from treatment as bundled transactions certain goods packaged and sold together containing food and food ingredients, drugs, durable medical equipment, mobility enhancing equipment, prosthetic devices, or medical supplies if the value of the nontaxable items is at least 50% of the value of all of the tangible personal property included (in what would otherwise be a taxable, bundled transaction). In such cases, the entire bundle of goods would be exempt from tax. This treatment is similar to the treatment of certain combinations of nontaxable food, food products, and beverages with taxable items under current law.

- Under the bill, 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 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.

- The bill would define a "prepaid wireless calling service" as a telecommunications service that provides the right to utilize mobile wireless service as well as other nontelecommunications services, including the download of digital products delivered electronically, content, and ancillary services, and that is paid for prior to use and sold in predetermined dollar units whereby the number of units

> declines with use in a known amount. Based on this definition, if an otherwise nontaxable nontelecommunications service were purchased through a prepaid wireless calling service and sourced to this state under the sourcing rules, then the service would be subject to the tax imposed on a prepaid wireless calling service.

According to the LFB:

> The administration estimates that the modifications in product definitions to comply with the SSUTA would result in a reduction in state sales tax revenues of $1,900,000 in 2007-08 and $3,500,000 in 2008-09. However, the administration also estimates that sales tax revenues would increase by $3,200,000 in 2007-08 and $7,000,000 in 2008-09 as a result of voluntary collections, including those volunteering in order to take advantage of the amnesty provisions. The net effect of these provisions would be an increase in state sales tax revenues of $1,300,000 in 2006-07 and $3,500,000 in 2008-09.

Sales Tax Exemption for Catalogs

Under current law, there are two provisions related to the sales tax as it applies to catalogs. Under the first, the statutes specifically impose the tax on gross receipts from the service of producing, fabricating, processing, printing, or imprinting of tangible personal property for consumers who furnish the materials. However, an exception is provided if the tangible personal property will subsequently be transported and used solely outside this state by the consumer for advertising purposes. Under the second, a sales tax exemption is provided for the gross receipts from the storage of printed material designed to advertise and promote the sale of merchandise or to advertise the services of individual business firms, if such printed material is purchased and stored for the purpose of subsequently transporting the material outside the state by the purchaser for use solely outside the state.

Under the bill, all purchases of catalogs, and printing services that create catalogs, would be exempt from the sales tax. Envelopes in which catalogs are mailed also would be exempt. These provisions would take effect on April 1, 2009. The LFB estimates the fiscal effect of this provision to be a reduction in sales tax revenue of $600,000 in 2008-09. The fiscal effect would increase to $2.4 million annually in 2009-10, and thereafter.

Sales Tax Exemption for Veterans Home Exchanges

The bill creates a sales and use tax exemption for goods and services sold by veterans home exchanges, effective on the first day of the second month beginning after publication of the budget bill. The LFB estimates the fiscal effect of this provision to be minimal.

Sales Tax Exemption for Motion Picture Film and Tape

The bill modifies the current sales tax exemption for motion picture film or tape and related advertising materials sold, leased, or rented to movie theaters or radio or television stations to specify that the exemption also applies to motion pictures or radio or television programs for listening, viewing, or broadcast. This provision, which would take effect on the effective date of the budget bill, is intended to clarify current law and is estimated to have no fiscal effect.

Sales and Use Tax on Digital Goods

Generally, the bill imposes sales and use tax on certain digital products that would be subject to the tax if furnished in tangible form.

The LFB describes the effect of the bill as follows:

> 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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> The bill would impose the 5% sales tax on the privilege of selling, licensing, leasing, or renting specified digital goods or additional digital goods at retail, regardless of whether the purchaser has the right to permanently use such goods or whether the purchaser's right to access or retain such goods is not permanent.
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> The bill would also impose the 5% use tax on the storage, use, or other consumption of specified digital goods or additional digital goods purchased from any retailer, regardless of whether the purchaser has the right to permanently use such goods or whether the purchaser's right to access or retain such goods is not permanent.
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> The bill would, however, provide an exemption from tax for specified digital goods or additional digital goods that are transferred electronically to the purchaser, if the sale of and the storage, use, or other consumption of such goods sold in a tangible form is exempt from tax.

Based on the provisions taking effect January 1, 2008, and certain estimates for compliance, the LFB estimates that these provisions would increase sales and use tax revenues of $1,500,000 in 2007-08 and $3,700,000 in 2008-09.

Legality Involved

Generally, there are no questions of legality involved in the provisions of the bill described in this report. However, a constitutional concern may exist with regard to the provisions of the bill relating to the oil company assessment. Generally, the concern relates to the constitutionality of the "anti-pass-through" portion of the oil company assessment. [See Legislative Fiscal Bureau (LFB) Budget Paper #761, May 31, 2007.]

Public Policy Involved

The Joint Survey Committee on Tax Exemptions makes no recommendation regarding the public policy of 2007 Senate Bill 40.