



## Legislative Fiscal Bureau

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Joint Committee on Finance

Paper #330

### **Impose Sales and Use Tax on Digital Products (General Fund Taxes -- General Sales and Use Tax)**

#### *Bill Agency*

[LFB 2007-09 Budget Summary: Page 171, #1]

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#### **CURRENT LAW**

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 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.

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 book would be subject to the tax). However, current law makes the following exceptions to this general approach:

- 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.
- b. Taking photographs, reproducing them in a digital format, and delivering them electronically is a taxable service.
- 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.

## **GOVERNOR**

Impose the state's 5% sales and use 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. 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.

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.

The bill would create the following definitions related to digital goods:

a. "Specified digital goods" would mean digital audio works, digital audiovisual works, and digital books.

b. "Additional digital goods" would mean video greeting cards sent by email, finished artwork, periodicals, and video and electronic games. The bill would specify that, for sales and use tax purposes, the treatment of a digital code (as defined below) would be the same as that of any specified digital goods or additional digital goods to which the digital code relates.

c. "Digital audio works" would mean works that result from the fixation of a series of musical, spoken, or other sounds that are transferred electronically, including prerecorded or live music, prerecorded or live readings of books or other written materials, prerecorded or live speeches, or ringtones, but not including audio greeting cards sent by email. [Audio greeting cards would not be subject to tax under the proposal.]

d. "Digital audiovisual works" would mean a series of related images that, when shown in succession, impart an impression of motion, along with accompanying sounds, if any, that are transferred electronically. "Digital audiovisual works" would include motion pictures, musical videos, news programs, and live events.

e. "Digital books" would mean works that are generally recognized as books and are transferred electronically. "Digital books" would include novels, nonfiction works, and short stories, but would not include newspapers, periodicals, chat room discussions, or blogs.

f. "Digital code" would mean a code that provides the person who holds the code a right to obtain an additional digital good, a digital audiovisual work, digital audio work, or

digital book and that may be obtained by any means, including tangible forms and email, regardless of whether the code is designated as song code, video code, or book code. "Digital code" would include codes used to access or obtain any specified digital goods, or any additional digital goods that have been previously purchased, and promotion cards or codes that are purchased by a retailer or other business entity for use by the retailer's or entity's customers. "Digital code" would not include the following: (i) a code that represents any redeemable card, gift card, or gift certificate that entitles the holder of such card or certificate to select any specified digital goods or additional digital goods at the cash value indicated by the card or certificate; or (ii) digital cash that represents a monetary value that a customer may use to pay for a future purchase.

g. "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 such items are reproduced: drawings, paintings, designs, photographs, lettering, paste-ups, mechanicals, assemblies, charts, graphs, and illustrative materials.

h. "Ringtones" would mean digitized sound files that are downloaded onto a device and that may be used to alert the customer with regard to a communication. "Ringtones" would include MP3 or musical tones, polyphonic tones, and synthetic music mobile application format tones, but would not include ring-back tones.

i. "Transferred electronically" would mean accessed or obtained by the purchaser by means other than tangible storage media.

The provisions described above would take effect on January 1, 2008. The administration has estimated that these provisions would result in increased state sales and use tax revenues of \$2.6 million in 2007-08 and \$3.7 million in 2008-09, for a total increase of \$6.3 million in the 2007-09 biennium. It should be noted, however, that the estimate for the first year is based on the provisions taking effect September 1, 2007, whereas the bill would provide an effective date of January 1, 2008. Based on the administration's estimates and the January 1, 2008, effective date, the estimated revenue in 2007-08 would be \$1.1 million lower than the estimate included in the bill.

## **DISCUSSION POINTS**

1. In recent years, the United States Census Bureau has issued quarterly and annual reports providing estimates of e-commerce and total retail sales in the U.S. In the most recent reports available, national e-commerce sales for 2006 were estimated at \$108.7 billion, which represents an increase of 23.5% over 2005. Total retail sales were estimated to have increased 5.8% for the same period.

2. A Census Bureau report comparing estimates of quarterly U.S. retail e-commerce sales as a percent of total quarterly retail sales from the 4<sup>th</sup> quarter of 1999 through the 4<sup>th</sup> quarter of

2006 attributes a steadily increasing proportion of all retail sales to e-commerce; whereas an estimated 0.6% of all U.S. retail sales in the 4<sup>th</sup> quarter of 1999 were from e-commerce, that percentage had risen to 3.0% in the 4<sup>th</sup> quarter of 2006.

3. A portion of e-commerce retail sales consists of electronic products that have previously been sold primarily as tangible personal products. These products include, for example, music, movies, on-line video and other games, books, periodicals, finished artwork, and video greeting cards. Such products are subject to the state's sales and use tax when sold in tangible form. However, with the exceptions described above under "Current Law," the state does not currently impose sales and use taxes on intangible products. As technology continues to evolve, it is expected that the sales volume of electronic versions of such items will increase, leading to erosion of the sales tax base and disadvantaging Wisconsin brick and mortar retailers (whose sales of the tangible versions of such products are subject to the sales tax).

4. In addition to e-commerce involving retail sales of electronic products that have previously been sold primarily as tangible personal products, new product development in response to technological advances has led to sales of digital goods that are primarily available in digital form, such as ringtones (digitized sound files used with devices such as cellular phones to alert the customer of a communication). Broadcast Music, Inc. projected total U.S. ringtone sales in 2006 surpassing \$600 million, which would represent 20% growth over estimated sales in 2005. If such products were sold in tangible form (such as on a compact disc), they would be subject to the state's sales and use tax. However, as a digital product purchased through the Internet, such items are not subject to taxation by the state.

5. Under the proposal, a vendor of the electronic products that would become subject to the state sales and use tax would have to collect the tax at the time of the sale if the vendor had sufficient nexus (physical presence) with the state or had voluntarily agreed to collect the tax. For sales of such products into the state by a seller who does not have nexus and has not voluntarily agreed to collect the tax, the state use tax would apply. However, collecting the use tax from individual purchasers presents a difficult enforcement issue.

6. Digital music is one of the intangible products that would become taxable under the proposal. A primary vendor of music in digital form is the iTunes Music Store. According to the Music Store's website, invoices for downloads of music currently include local taxes on music downloads by residents of the following states: Alabama, Arizona, Colorado, Washington D.C., Hawaii, Idaho, Indiana, Louisiana, Maine, New Mexico, South Dakota, Texas, Utah, Washington, and West Virginia.

7. According to a survey of other states by the Department of Revenue (DOR), which was conducted in March, 2005, Iowa, Kentucky, and New Jersey, also impose the sales tax on digital versions of music. Based on information from that survey and the iTunes Music Store website, it appears that approximately one-third of the 45 states plus the District of Columbia that impose a state sales tax also impose the tax on digital versions of music. In a digital goods survey by the Streamlined Sales and Use Tax Project (SSTP) in October, 2004, 12 of 27 responding states

reported that the state's sales and use tax is generally levied on products delivered electronically (the question excluded pre-written computer software, which is treated as a separate item by many states).

8. The administration has estimated that the proposed sales tax on specified and additional digital goods would result in increased state sales and use tax collections of \$2.6 million in 2007-08 and \$3.7 million in 2008-09. The estimates are based on various industry and media reports, and assume annual growth in sales of goods that would become taxable under the proposal of 20%. The administration's estimates are consistent with general growth in e-commerce in recent years as reported by the U.S. Census Bureau. Based on these projections, the administration estimates that county and stadium district tax collections would increase by approximately \$200,000 in 2007-08 and \$300,000 in 2008-09.

9. The estimated fiscal effect included in the bill assumes a 90% compliance rate, which is within the range of compliance rates that DOR typically uses in estimating the effect of sales tax proposals. However, unlike most sales tax proposals, this proposal is specific to sales of products that are likely to be sold by remote sellers, rather than in brick and mortar stores. As described above, sellers of digital products that would become taxable under the proposal would not be required to collect the tax if they do not have nexus with Wisconsin or have not voluntarily agreed to collect the tax.

10. Other than the iTunes Music Store, no data has been found suggesting that sellers of the digital products described above would be likely to collect Wisconsin sales and use taxes based on having nexus with the state or voluntarily agreeing to collect the tax for the state. Given the expectation that an unusually high proportion of such sales would be made from remote vendors, it seems unlikely that the compliance rate would be the same as that generally observed with respect to tangible products. However, it is not possible to predict with precision the actual compliance rates that would occur if the proposal were enacted into law.

11. The administration's estimate of 90% compliance for music sold in digital form seems reasonable, given that a major seller currently collects sales tax on its sales into states that impose a tax. For other digital sales, a more conservative approach would be to assume a lower compliance rate, such as 50%. Under this approach, it is estimated that sales tax revenues under the proposal would be increased by \$1.0 million in 2007-08 and by \$2.4 million in 2008-09, compared to current law. Compared to the bill, these estimates are lower by \$1.6 million in 2007-08 and \$1.3 million in 2008-09, for a total of \$2.9 million for the 2007-09 biennium. The larger difference in the first year reflects the fact that the first-year estimate in the bill assumed that the provisions would first apply on September 1, 2007, rather than on January 1, 2008, as the bill would provide. Under these assumptions, estimated county and stadium district tax collections would also be slightly lower than the figures referred to above.

12. The administration has identified a number of corrections to be made to the bill's provisions imposing the sales and use tax on specified digital goods and additional digital goods. These corrections are technical in nature and should be made for internal consistency within the

proposal.

### ALTERNATIVES TO BILL

1. Approve the Governor's proposal, including the technical corrections requested by the administration. However, reduce the estimated sales and use tax revenues to reflect a more conservative estimate of likely compliance rates of 50% for all sales of digital products other than music and to reflect the effective date provided under the bill of January 1, 2008. Compared to current law, this alternative would increase state sales and use tax revenues by an estimated \$1.0 million in 2007-08 and \$2.4 million in 2008-09. Compared to the estimates in the bill, this alternative would reduce sales and use tax revenues by \$1.6 million in 2007-08 and \$1.3 million in 2008-09.

<b>ALT 1</b>	<b>Change to Bill Revenue</b>	<b>Change to Base Revenue</b>
GPR-REV	-\$2,900,000	\$3,400,000

2. Delete provision. Compared to the bill, this alternative would reduce estimated sales and use tax revenue by \$2.6 million in 2007-08 and \$3.7 million in 2008-09, for a total of \$6.3 million in the 2007-09 biennium.

<b>ALT 2</b>	<b>Change to Bill Revenue</b>	<b>Change to Base Revenue</b>
GPR-REV	-\$6,300,000	\$0

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