Estimating the "Fiscal Footprint" of Digital Goods, Software and other Electronic Items in Arizona

For: Ad Hoc Joint Committee on the Tax Treatment of Digital Goods and Services

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Arizona Department of Revenue

Agenda

- ADOR Mission, Vision, & High-level Summary
- Describe the challenges of estimating a digital goods "footprint"
- Explain the methodology under review
- Caveats and next steps

Mission & Vision

OUR MISSION

Serving taxpayers!

OUR VISION

Funding Arizona's future through excellence in innovation, customer service and continuous improvement

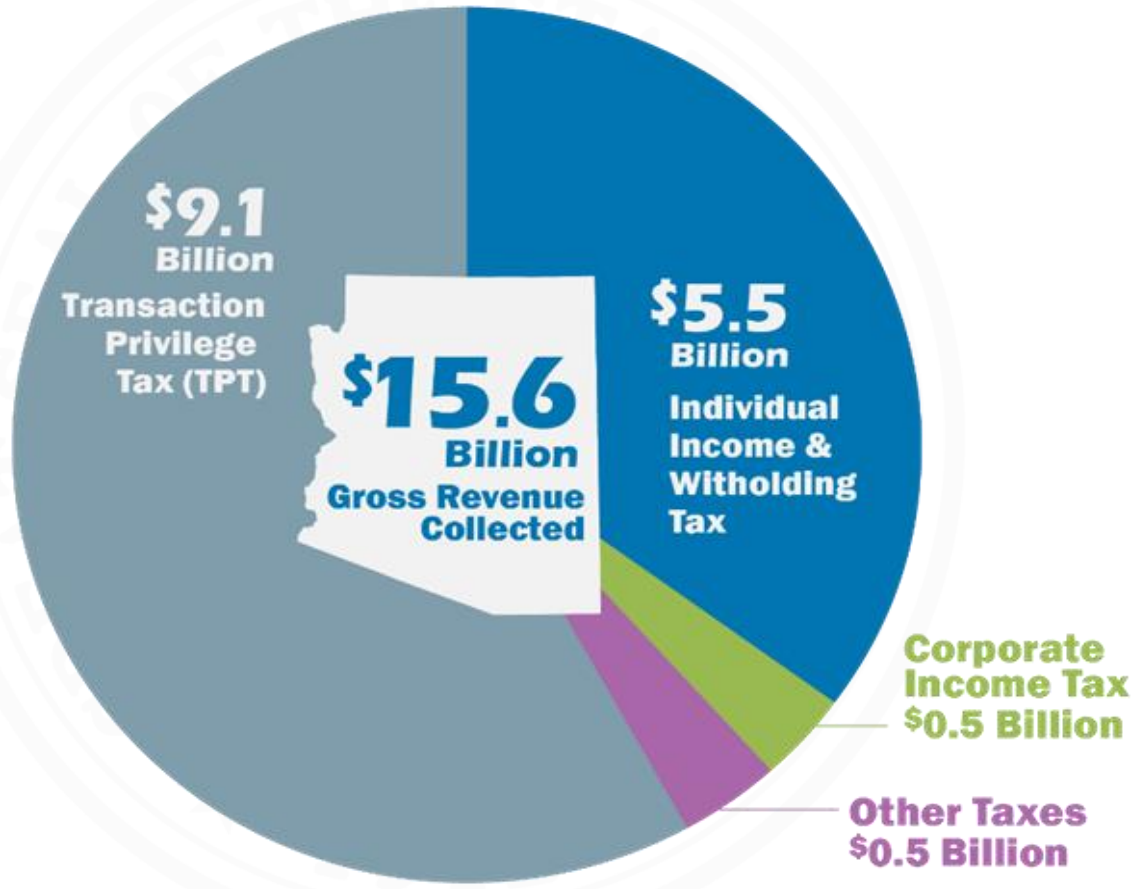
PURSUANT TO ARIZONA REVISED STATUTES (A.R.S.) TITLES 42 AND 43

FY18 ANNUAL OPERATING BUDGET

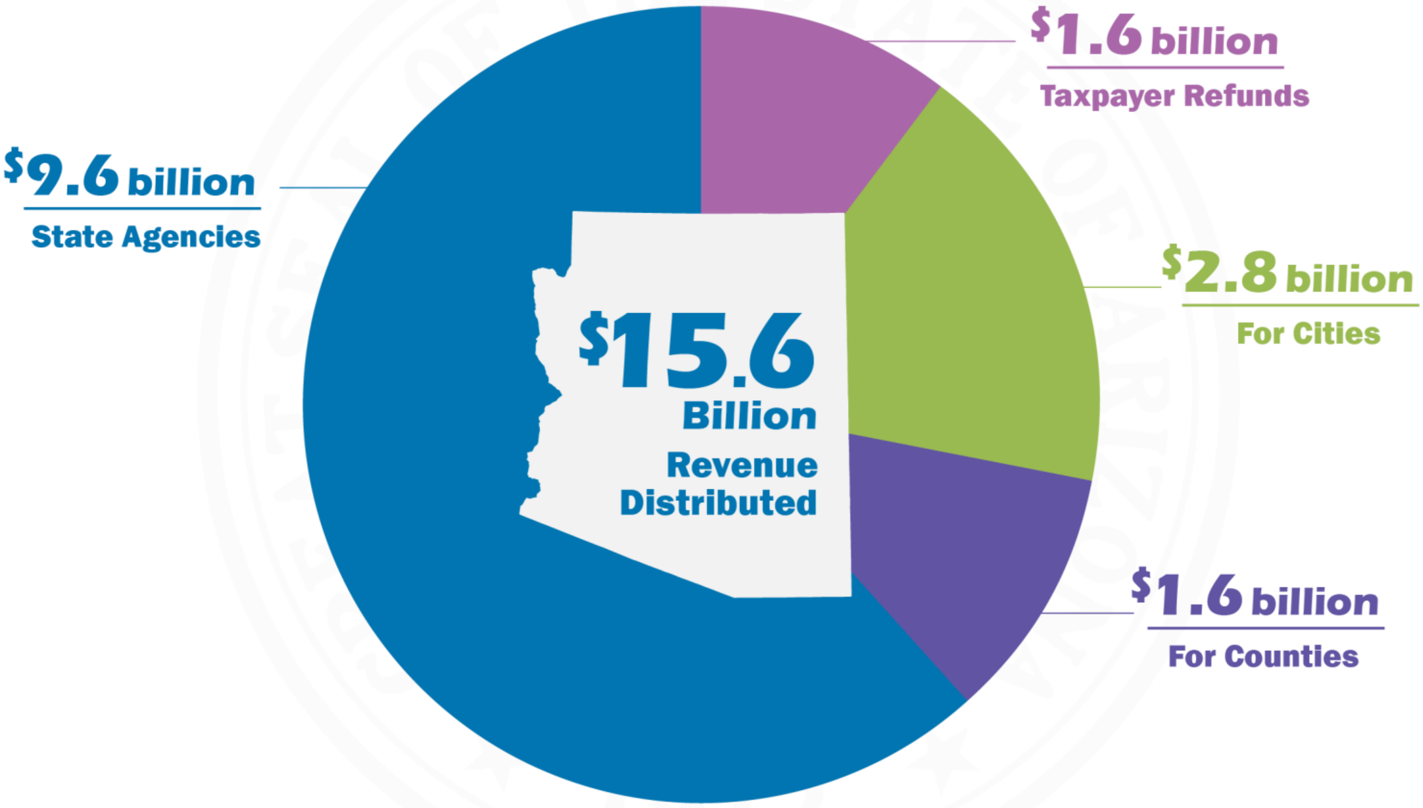
$90.7 MILLION

535 Employees

Revenue collections exceeded $15 billion in FY 2017



Revenue distributions primarily fund State operations, cities/towns, & counties



ADOR's multi-faceted operations touch every part of Arizona - FY17 Highlights

- **Nearly 5.9M Tax Returns Processed**
  - 1.7M+ Transaction Privilege Tax
  - 193,000+ corporate returns
  - 3.3M individual income tax returns
  - 2.1M individual income tax refunds
- **$25.9 million in Individual Income Tax Fraud Stopped**
- **40,000+ new TPT licenses issued**
- **$57 million in Unclaimed Property Returned**
- **Property Tax Unit valued 963 Centrally Valued Properties & Trained more than 100 Certified County Appraisers**

Difficulties of estimating the "digital goods" footprint w.r.t. TPT

Challenges to estimation

- **Institutional**
  - JLBC staff, rather than ADOR, normally provides estimates
  - Reputation – ADOR legacy that current administration is working to overcome
- **"Optics"**
  - Too high a number stifles a healthy policy discussion
  - Too low or no number creates a perception that there is no fiscal consequence for a policy exercise
- **Methodological**
  - Structure of TPT limits estimation techniques / options
  - Rapid technological innovation means "scope" of digital goods question is constantly changing, broadening, and deepening

Arizona Transaction Privilege Tax (TPT) Primer

- **Tax on the privilege of conducting business in Arizona**
  - Seller or vendor taxable
  - Seller may pass economic expense to purchaser
- **Generally all of a business' gross income within one or more of 16 business classifications is taxable unless specific exemption or deduction exists**
- **Exemptions or deductions only available for the specific classification under which the deduction is provided**
  - Deduction under one classification does not apply under another classification unless specifically provided
- **Tax Statutes are construed strictly against a party who claims an exemption**

Why is it so challenging to estimate a "digital goods" footprint?

- The structure of TPT makes estimating revenue changes extremely challenging because:
  - Tax imposed on Gross Income, not on individual transactions
  - Difficult to determine where digital goods fit into the "basket of goods" purchased by a representative consumer
  - Unclear who the major taxpayers are & taxpayer confidentiality concerns arise when trying to identify them
  - Information asymmetry between potential beneficiaries of tax law changes & estimators of revenue impacts

Proposed methodology entails taxpayer self-identification on TPT license application

ARIZONA JOINT TAX APPLICATION (JT-1)

Customer Care and Outreach
ARIZONA DEPARTMENT OF REVENUE
PO BOX 29032
Phoenix, AZ 85038-9032

IMPORTANT! Incomplete applications WILL NOT BE PROCESSED.

- Please read form instructions while completing the application. Additional information and forms available at www.azdor.gov
- Required information is designated with an asterisk (*).
- Return completed application AND applicable license fee(s) to address shown at left.
- For licensing questions regarding transaction privilege tax, call Customer Care and Outreach: (602) 255-3381

You can register, file and pay for this application online at www.AZTaxes.gov. It is fast and secure.

SECTION A: Business Information

1* Federal Employer Identification Number or Social Security Number, *required if sole proprietor with no employees*

2* License Type – *Check all that apply:*

- ☐ Transaction Privilege Tax (TPT)
- ☐ Withholding/Unemployment Tax (*if hiring employees*)
- ☐ Use Tax
- ☐ TPT for Cities ONLY

3* Type of Organization/Ownership – *Tax exempt organizations must attach a copy of the Internal Revenue Service's letter of determination.*

- ☐ Individual/Sole Proprietorship
- ☐ Corporation
  State of Inc.
- ☐ Subchapter S Corporation
- ☐ Association
- ☐ Partnership
- ☐ Government
- ☐ Estate
- ☐ Trust
- ☐ Joint Venture
- ☐ Receivership

9* Description of Business: *Describe merchandise sold or taxable activity.*

Search terms

- **Licensees with business descriptions containing the following key words:**

Cloud	Internet Services
Data Processing	SAAS
Digital	Software Publish
Download	Software Service
Electronic Books	Web Hosting
Electronic Video	eBook

Running the search terms through the tax system

- A query is then performed to identify the amount of TPT paid by licensees and distributed to the State, Counties and Municipalities.

- A manual review of the query results can be performed to remove licensees that had business descriptions that did not fall within the study scope.

- Duplicate Account IDs are removed.

Why the estimate could be lower than what the methodology indicates

- **Self-identification can be aspirational and unrepresentative of the taxpayer's gross receipts**

- **A mixture of taxable digital goods and non-taxable digital goods could exist within the taxpayer's gross receipts**

Why the estimate could be higher

- Taxpayer may not self-identify primarily as a seller of digital goods, but a significant part of its business <u>does</u> entail selling/renting digital goods
- Methodology omits businesses currently not licensed and reporting on sales/rentals of digital goods
- Methodology omits businesses currently licensed but miss-reporting on gross receipts arising from sales/rentals of digital goods

Recommendations

- Consider, as part of this committee, creating a "Digital Goods" business classification within TPT that requires businesses within that line of business to report on its gross receipts

- Eliminate, prospectively, any TPT exemptions that have gone unused for a number of years to reduce taxpayer confusion

THANK YOU!