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

MISSION & VISION

OUR MISSION
Serving taxpayers!

OUR VISION
Funding Arizona’s future through excellence in innovation, customer service and continuous improvement

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

- **$9.6 billion** State Agencies
- **$1.6 billion** Taxpayer Refunds
- **$2.8 billion** For Cities
- **$1.6 billion** For Counties

$15.6 Billion Revenue Distributed
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)

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
- Subchapter S Corporation
- Association
- Partnership
- Government
- Estate
- Trust
- Joint Venture
- Receivership

9* Description of Business: Describe merchandise sold or taxable activity.
- Licensees with business descriptions containing the following key words:

<table>
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<th>Cloud</th>
<th>Internet Services</th>
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<tbody>
<tr>
<td>Data Processing</td>
<td>SAAS</td>
</tr>
<tr>
<td>Digital</td>
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<tr>
<td>Download</td>
<td>Software Service</td>
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<td>Web Hosting</td>
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<tr>
<td>Electronic Video</td>
<td>eBook</td>
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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 does 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!