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TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Senate Substitute Amendment LRB 0017/1 to January 2011 Special Session Senate Bill 7, and Assembly Substitute Amendment LRB 0015/1 to January 2011 Special Session Assembly Bill 7: Individual Income and Corporate Income and Franchise Taxes -- Exclusion for Income from New Employees

Senate Substitute Amendment LRB 0017/1 to 2011 Special Session Senate Bill 7, and Assembly Substitute Amendment LRB 0015/1 to 2011 Special Session Assembly Bill 7 are companion substitute amendments that would provide an income and franchise tax exclusion to a business for an increase in the number of employees employed by the business.

BACKGROUND

Under current law, a deduction is provided under the state individual income and corporate income/franchise taxes for salaries, wages, and other forms of remuneration to employees and officers of a business.

A deduction is provided for a reasonable salary allowance or other compensation for services actually rendered by employees. The form of compensation (fixed salary, percentage of gross or net income, commissions, and bonuses, contributions to pensions or profit sharing plans) or method of payment is not controlling as to deductibility. To be deductible, the compensation must be: (1) an ordinary and necessary expense; (2) reasonable in amount; (3) based on actual services rendered; and (4) actually paid or incurred. Amounts that are deducted from an employee's salary for payroll taxes (FICA) are deductible as part of the employee's wages. However, a publicly-held corporation cannot deduct compensation (remuneration) in excess of $1.0 million per tax year that is paid or accrued to certain executives.

An economic development tax credit can be claimed by businesses that conduct a job creation, capital investment, employee training, or corporate headquarters location or retention project. In general, jobs credits ranging from $3,000 to $10,000 per job created or retained can be claimed, depending upon the type and location of the project, and the wages paid to the employee. The credit is nonrefundable, but unused credit amounts can be carried forward up to 15 years offset future tax liabilities. In order to claim an economic development tax credit, a business must apply to the Department of Commerce for certification and allocation of the tax credits.

The enterprise zone program provides refundable tax credits, under the individual income and corporate income and franchise taxes, which can be claimed for eligible expenses for increased employment, retaining employees, employee training, capital investment, and purchases from Wisconsin vendors, for businesses in a zone. The enterprise zone jobs credit equals up to 7% of the wages of new employees in excess of $20,000 or $30,000, depending on measures of economic distress for the county in which a zone project is located. A tax credit of up to 7% is provided for increases in payroll for employees with wages in excess of $20,000 or $30,000, depending upon economic distress indicators, and only if the number of employees is the same or increased from the year in which the zone was created. A credit can also be claimed for retaining jobs, if the business makes a significant capital investment, and is an original equipment manufacturer, or has more than 500 full-time employees in an enterprise zone. The credit is refundable, so amounts not used to offset tax liability are paid to the business. Commerce is required to certify and allocate enterprise zone tax credits to a business if it meets certain criteria related to job creation, investment, wages and benefits paid, and purchases from Wisconsin businesses.

The refundable jobs tax credit may be claimed under the individual income and corporate income and franchise taxes and is equal to 10% of the wages paid to an eligible employee and/or the amount of costs incurred to undertake training activities. Specifically, the jobs tax credits equal 10% of wages of at least $20,000 or $30,000, but not more than $100,000, depending upon measures of economic distress for the county in which the business is located. Credit amounts in excess of the claimant's tax liability are refunded to the business. Commerce certifies and allocates credits to businesses. The maximum amount of tax credits that Commerce can allocate in a calendar year is $5 million. In addition, the total amount of credits that can be claimed for tax years beginning on or after January 1, 2010, and ending on June 30, 2013, is limited to $14,500,000. Tax credits certified by Commerce for tax years beginning after December 31, 2009 and before January 1, 2012, must be paid in tax years beginning after December 31, 2011. Commerce is also authorized to reallocate angel investment and early stage seed investment tax credits that are unused in any calendar year to persons eligible for the jobs tax credit, subject to 14-day passive review by the Joint Committee on Finance. These reallocated amounts are not subject to the $5 million limit on annual jobs tax credit claims. In December 2010, $3.1 million in unused early stage seed investment credits were reallocated to be used for jobs tax credits.

SUMMARY OF SUBSTITUTE AMENDMENTS

Senate Substitute Amendment LRB 0017/1 to Special Session Senate Bill 7 and Assembly Substitute Amendment LRB 0015/1 to Special Session Assembly Bill 7 would provide an exclusion (subtraction) from income, under the individual income and corporate income and franchise taxes, for the increase in the number of full-time employees employed by a business in the state. Specifically, an exclusion from income would be provided equal to: (a) $4,000, multiplied by the increase in the number of full-time equivalent (FTE) employees employed by the business in Wisconsin for a business with gross receipts of $5,000,000 or less; and (b) $2,000 multiplied by the increase in the number of FTE employees employed by the business in Wisconsin for a business with gross receipts greater than $5,000,000. The increase in employment would be determined by subtracting the average FTE employee count from the preceding year from the average employee count for the tax for which the exclusion is claimed. The employee counts would be based on the taxpayer's unemployment insurance (UI) quarterly wage reports or other information as required by the Department of Revenue. The exclusion could first be claimed for tax years beginning on or after January 1, 2011.

A taxpayer could not claim the exclusion from income provided under the substitute amendments and the relocated business tax credit that would be created under Senate Substitute Amendment 2 to Special Session Senate Bill 3 and Assembly Substitute Amendment 2 to Special Session Assembly Bill 3. The Department of Revenue would be required to promulgate rules regarding the new deduction.

The substitute amendments also include a nonstatutory provision specifying that the general fund statutory reserve requirement ($65 million in 2010-11, and the 2011-13 biennium) does not apply to the action of the Legislature in enacting the substitute amendments.

FISCAL EFFECT

As noted, SSA LRB 0017/1 to SS SB 7 and ASA LRB 0015/1 to SS AB 7 would provide a $4,000 per employee exclusion from income for increased employment for businesses with $5,000,000 or less of gross receipts and a $2,000 per employee exclusion from income for increased employment for businesses with gross receipts in excess of $5,000,000. Based on data developed by the Department of Revenue from the data warehouse and aggregate corporate income/franchise tax statistics, and from federal Internal Revenue Service data from corporate income tax returns and data from Bureau of Labor Standards Employment Dynamics Statistics, the exclusion would decrease state income and franchise tax revenues by an estimated $33,500,000 in 2011-12, and annually thereafter.

The tax benefit of an exclusion, subtraction, or deduction from income is equal to the exclusion, subtraction, or deduction amount multiplied by the taxpayer's marginal tax rate. For corporations, the state tax rate is 7.9%. For sole proprietors, partners, members of limited liability companies (LLCs), and shareholders of tax-option corporations who file and pay taxes under the individual income tax, the marginal tax rates range from 4.6% to 7.75%. Therefore, the state tax benefit of a $4,000 exclusion would be $316 for a corporate filer, and would range from $184 to $310 for business owners who file under the individual income tax. The tax benefit of a $2,000 exclusion would be $158 for a corporate filer, and would range from $92 to $155 for business owners who file under the individual income tax.

In addition, state income and franchise taxes are deductible for federal income tax purposes. Consequently, a decrease in the taxpayer's state income or franchise tax would be partially offset by increased federal income taxes. Federal corporate income tax rates range from 15% to 35%, and federal individual income tax rates range from 10% to 35%. As an example, consider a corporate taxpayer that is taxed at the 15% federal tax bracket, and receives a reduction of $316 in state income/franchise taxes. For this taxpayer, a reduction in state taxes of $316 would result in an increased federal tax liability of $47 (.15 x $316), so that the net increase in the taxpayer's after-tax income would be $269. If the same taxpayer was taxed at the 35% federal tax bracket, the offsetting federal tax increase would be $111, and the net increase in after-tax income would be $205. Similar results would occur for business owners who file under the individual income tax.

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