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January 18, 2011

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: January 2011 Special Session Assembly Bill 7 and Special Session Senate Bill 7: Individual Income and Corporate Income/Franchise Taxes -- Small Business Tax Credit

January Special Session Assembly Bill 7 and Senate Bill 7 are companion bills that would provide a tax credit for certain small businesses. SS AB 7 was introduced on January 11, 2011, and referred to the Assembly Committee on Jobs, Economy and Small Business. On January 13, 2011, SS AB 7 was recommended for passage by a vote of 9 to 6. SS SB 7 was introduced on January 11, 2011, and referred to the Senate Committee on Workforce Development, Small Business and Tourism. On January, 13, 2011, Senate Amendment 1 to SS SB 7 was adopted, and the bill, as amended, was recommended for passage by a vote of 5 to 0.

BACKGROUND

In general, a corporation determines state corporate income/franchise tax liability by computing gross or total income, subtracting deductions, apportioning the net income to the state (if necessary), adjusting for nonapportionable income and net operating losses (if applicable), applying the 7.9% state tax rate, and subtracting tax credits. Corporations that operate entirely in Wisconsin do not apportion net income. However, if the corporation is a member of a combined group of corporations, an individual corporation's income/franchise tax liability is based on the group's combined income computed in a combined report that must be completed by each such group.

In contrast to the income tax treatment of C corporations, income of pass-through entities is not subject to tax at the level of the business entity but is "passed through" to be taxed to the members or shareholders. Wisconsin income allocable to shareholders, partners, members, or beneficiaries of pass-through entities is subject to Wisconsin's individual income tax. Pass-through entities are partnerships, limited liability companies (LLCs), tax-option corporations (S corporations), estates, and trusts that are treated as pass-through entities for federal tax purposes.

SUMMARY OF PROPOSAL

The bills would create a small business tax credit, under the state individual income and corporate income/franchise taxes, for tax years beginning after December 31, 2010. The credit would equal the following percentage of the claimant's gross tax liability in the tax year for which the claimant filed a return:

a. Fifteen percent, if the gross receipts from all activities of the claimant's business in the tax year were $250,000 or less.

b. A percentage equal to 15, minus the product of 0.00006 multiplied by the amount of gross receipts from all activities of the claimant's business for the tax year that exceed $250,000, if the gross receipts from all activities of the claimant's business were greater than $250,000, but less than $500,000. For example, a claimant with gross receipts of $350,000 could claim a credit of 9% (15 - 6 [$100,000 x 0.00006]). The credit would phase out at $500,000 of gross receipts.

c. No credit could be claimed if the claimant's gross receipts from all activities of the business for the tax year were $500,000 or more.

Unused credit amounts could be carried forward up to 15 years to offset future tax liabilities.

Partnerships, LLCs, and tax-option corporations could not claim the small business tax credit. However, a partnership, LLC, or tax-option corporation would be required to compute the rate of credit that each of its partners, members, or shareholders could claim, and provide that information to them.

Small business tax credit claimants would be required to file for the credit on a form prepared by the Department of Revenue (DOR) and submit any documentation DOR requires to administer the credit. DOR would administer the small business tax credit, and current law provisions related to timely claims, change of business ownership, and ineligible claimants would apply.

"Gross receipts from all activities" would mean gross receipts, gross sales, gross dividends, gross interest income, gross rents, gross royalties, the gross sales price from the disposition of capital assets and business assets, gross receipts passed through from other entities, and all other receipts that are included in gross income before apportionment for Wisconsin franchise or income tax purposes.

The bills 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 bills.

SUMMARY OF SENATE AMENDMENT 1

SA 1 to SS SB 7 would specify that the small business tax credit would equal a percentage of the claimant's gross tax liability from business activities, rather than a percentage of gross tax liability.

FISCAL EFFECT

As noted, the bills would create a small business tax credit, under the state individual income and corporate income and franchise taxes, equal to a specified percentage business gross receipts, for businesses with under $500,000 in gross receipts. The Department of Revenue indicates that the credit would reduce state income and franchise taxes by an estimated $38.3 million in 2011-12 and $40.9 million in 2012-13.

Under the bills, the proposed small business tax credit would be equal to a percentage of the claimant's gross tax liability. Gross tax liability is the amount of tax due before consideration of other tax credits. Based on information from the administration, this does not conform to their intent. The intent was to have the new credit equal to a percentage of the claimant's net tax liability after considering all other credits. The fiscal effects reported above assume that the bills would be amended to conform to the administration's intent. The Department of Revenue is also working on other recommended technical modifications to the bill draft.

SA 1 to SS SB 7 would have no fiscal effect.

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