



Legislative Fiscal Bureau

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February 17, 2020

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Assembly Bill 753/Senate Bill 706: Modification to the Tax Treatment of Tax-Option Corporations that Elect to Pay Tax at the Entity Level

Senate Bill 706 was introduced on January 24, 2020 and referred to the Senate Committee on Agriculture, Revenue, and Financial Institutions. That Committee held a public hearing on SB 706 on January 29, 2020. On February 5, 2020, that committee recommended the bill for passage by a vote of 6-3.

Assembly Bill 753, is an identical companion bill that was introduced on January 17, 2020, and referred to the Assembly Committee on Ways and Means. That Committee held a public hearing on AB 753 on January 23, 2020. On February 6, 2020, that Committee recommended passage of the bill by a vote of 12-0.

BACKGROUND

Treatment of Capital Gains

Under Wisconsin law, a capital gains exclusion under the individual income tax is provided for 60% of the capital gain from the sale of farm assets and 30% of the capital gain from the sale of other assets, provided those assets are held more than one year or are acquired from a decedent. Gains from assets held one year or less are fully taxed. The amount of capital losses that may be used to offset ordinary income is limited to \$500 annually, with the remainder carried over to future years. For comparison, under federal law, capital gains generally are fully taxable for federal purposes, and if capital losses exceed gains, then up to \$3,000 of the loss is allowed as a deduction against ordinary income, with the excess loss carried forward to be used in a later year.

State law treats partnerships and tax-option (S) corporations that elect to be taxed at the entity level differently. Under current law, partnerships electing to be taxed at the entity level compute their net income in the same manner as an individual. As a result, partnerships may claim the 30% and

60% long-term capital gains deduction under the entity-level tax. Likewise, an electing partnership is subject to the \$500 Wisconsin capital loss limitation.

By contrast, S corporations electing to pay tax at the entity level compute net income under the Internal Revenue Code (IRC). As discussed, the IRC does not provide for a 30% or 60% capital gains deduction for S corporations. Likewise, the net capital loss limitation of \$3,000 provided under the IRC applies, rather than the \$500 net capital loss limitation under Wisconsin law.

Quarterly Payments

Under current law, S corporations electing to pay tax at the entity level are required to make quarterly estimated payments in the same manner as C corporations. As a result, such S corporations are not required to pay interest on underpayments of estimated payments if their Wisconsin net income is less than \$250,000 for the current taxable year. Thus, these S corporations are not required to pay quarterly estimated payments prior to their final payment when filing their tax return. Also, two different sets of rules for determining the amount of the quarterly payments apply, depending on the amount of the S corporation's net income. In relevant part, if an S corporation has net income of less than \$250,000, then the amount of each quarterly installment payment is generally 25% of the lower of the following amounts: (a) 90% of the tax shown on the return for the taxable year or, if no return is filed, 90% of the tax for the taxable year; or (b) the tax shown on the return for the preceding year. S corporations having net incomes of more than \$250,000 may not use the second method in computing the installment amount.

By contrast, because partnerships electing to pay tax at the entity level are required to make estimated payments in the same manner as under the individual income tax, partnerships having net income of less than \$250,000 (but more than \$500) must pay 12% interest on any underpayment of estimated payments. Further, such partnerships make estimated payments in the manner consistent with C and S corporations having incomes of less than \$250,000.

SUMMARY OF THE BILLS

The bills would provide for similar treatment of S corporations and partnerships electing to be taxed at the entity level with regards to capital gains and quarterly payments of tax.

Similar to the treatment allowed under current law provided for partnerships electing to be taxed at the entity level, the bill would allow electing S corporations to exclude from tax: (a) 30% of the gains realized from the sale of assets held more than one year and the sale of all assets acquired from a decedent; and (b) 60% of the gains realized from the sale of farm assets held more than one year and the sale of all farm assets acquired from a decedent. Likewise, the bills would limit the excess capital loss deduction for electing S corporations from \$3,000 to \$500.

Similar to the treatment of partnerships, the bills would provide that the exemption to the requirement to pay interest on underpayments of estimated quarterly payments that is available to S corporations having net income of less than \$250,000 would not apply to S corporations electing to pay tax at the entity level. Finally, the bills would require S corporations to pay quarterly estimated

payments according to the standards applicable to taxpayers with net income of less than \$250,000 regardless of their net income, similar to the treatment of partnerships.

These changes would first apply to tax year 2020, assuming that the bill is enacted before November 30, 2020.

FISCAL EFFECT

According to the Department of Revenue, based on a review of tax year 2018 returns that made the election to pay tax at the entity level and assuming the bill would take effect for tax year 2020, the bills would decrease revenues by an estimated \$42,000 in 2019-20, \$171,000 in 2020-21, and \$185,000 in 2021-22. In addition, there would be a minimal decrease in SEG-Rev under the economic development surcharge.

Under s. 16.518(3) of the statutes, if actual tax collections exceed the amounts estimated in the state's biennial budget act, one-half of such excess is deposited into the budget stabilization fund. On January 23, 2020, this office prepared a memorandum projecting general fund tax revenues for the remainder of the 2019-21 biennium, and estimated that the amounts in the budget stabilization fund would total \$845.0 million at the end of 2019-20 and \$1,080.0 million at the end of 2020-21. Thus, the estimated effect of the bills on the budget stabilization fund would be a decrease in the estimated stabilization transfer of \$21,000 in 2019-20 and \$85,500 in 2020-21. As a result, these amounts would remain in the general fund.

Provided by: John Gentry