Legislative Fiscal Bureau

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Internal Revenue Code Update
(General Fund Taxes)

[LFB Summary of the Governor's Budget Reform Bill: Page 46, #1]

CURRENT LAW

State tax provisions are generally referenced to definitions under federal law. With limited exceptions, changes to federal law take effect for state purposes only after action by the Legislature. Generally, the Legislature reviews the previous year's federal law changes each year to update state references to the Internal Revenue Code (IRC). With exceptions, current state tax provisions reference the code in effect as of December 31, 1999.

GOVERNOR

Update state tax references to the IRC to conform to federal law changes enacted through December 31, 2001, with one exception. Provide that the changes would apply for Wisconsin purposes at the same time as for federal purposes. Estimate the fiscal effect of adopting the provisions as a reduction in general fund tax revenues of $8.55 million in 2001-02 and $24.35 million in 2002-03, for a total reduction of $32.90 million for the 2001-03 biennium.

Most of the changes to federal law that affect the IRC were enacted under the following four federal acts: (a) the Foreign Sales Corporation Repeal and Extraterritorial Income Exclusion Act of 2000; (b) the Community Renewal Tax Relief Act, which was incorporated into the Consolidated Appropriations Act of 2000; (c) the Installment Tax Correction Act of 2000; and (d) the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), which was the major federal tax legislation signed into law on June 7, 2001.

The excluded federal provision is an individual income tax deduction for payments made for higher education expenses in taxable years 2002 through 2005. The federal deduction is similar to (although broader than) a current state deduction for tuition expenses at higher education institutions in Wisconsin and in Minnesota under the Minnesota-Wisconsin reciprocity agreement.

The majority of items under the proposed IRC update are estimated to have a minimal or no fiscal effect. The following table provides a summary of the items that are estimated to have an impact on state revenues in the 2001-03 biennium.

Summary of Federal Law Changes with Substantive Fiscal Effects

	2001-02	2002-03
Individual Income Tax		
Expansion of Employer Adoption Assistance Exclusion	-$50,000	-$200,000
Increased Contributions to IRAs	-2,250,000	-5,950,000
Increase in Alternative Minimum Tax Exemption	Minimal	-200,000
Educational Assistance Programs	-2,700,000	-4,650,000
Education IRAs	-1,050,000	-2,250,000
Student Loan Interest Deduction	-900,000	-1,550,000
Individual Total	-$6,950,000	-$14,800,000
Corporate and Business Taxes		
Environmental Remediation Costs	Minimal	-$1,250,000
Corporate Donations of Computer Technology	Minimal	-1,100,000
Duplication or Acceleration of Loss Through Assumption of Certain Liabilities	Minimal	200,000
Foreign Sales Corporations	Minimal	-2,800,000
Corporate and Business Total	Minimal	-$4,950,000
Pension Provisions		
Increase in Contribution Limits	-$400,000	-$1,500,000
Benefit Limits Under Qualified Plans	-100,000	-250,000
Catch-Up Contributions	-500,000	-1,200,000
Increases in Defined Contribution Plan Limit	-200,000	-400,000
Repeal of Coordination Requirements for Section 457 Plan Limits	-50,000	-150,000
Increase in Employer Deduction Limits	Minimal	-100,000
Exclusion of Elective Deferrals in Determination of Deduction Limits	-200,000	-400,000
Treatment of Contributions to a Multi-Employer Plan	Minimal	-50,000
Repeal of the 160% Current Liability Funding Limit	-50,000	-100,000
Plan Loans for Small Business Owners	-100,000	-150,000
Rollovers to and from Governmental Plans and Tax-Sheltered Annuities	100,000	Minimal
Reinvestment of ESOP Dividends	-100,000	-250,000
Modification of Top-Heavy Rules	Minimal	-50,000
Pension Provisions Total	-$1,600,000	-$4,600,000
IRC Update Total*	-$8,550,000	-$24,350,000

*The estimated fiscal effect for 2002-03 under the bill was shown as -$24.45 million, rather than the -$24.35 million shown above, due to the inadvertent inclusion of an unrelated federal provision. However, it is the administration's intent to include the provisions and estimates shown above.

DISCUSSION POINTS

1. State references to federal law generally provide greater simplicity for taxpayers in preparing returns and reduce the administrative burden and cost for both taxpayers and the Department of Revenue (DOR) in assuring compliance with tax laws. The IRC references are used to determine which items of income are subject to taxation prior to specific state modifications. The state uses separate tax rates and brackets and separate provisions regarding standard deductions, itemized deductions and tax credits.

2. Under the bill, the IRC update provisions would apply for Wisconsin purposes at the same time as for federal purposes, including some items that would apply to tax year 2001. For such provisions, the Department of Revenue would include instructions with tax forms for 2002 to alert Wisconsin taxpayers to the changes related to the previous tax year (and the need for a taxpayer affected by a retroactive provision to file an amended return for 2001).

3. On June 7, 2001, President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001. EGTRRA included a number of federal changes, such as tax rate reductions, the elimination of income-related limitations on itemized deductions and personal exemptions, relief from the marriage penalty and increases in child and dependent care tax credits, that would have no impact on state tax provisions, regardless of the version of the IRC referenced by state statutes.

4. However, EGTRRA also included many provisions that would lead to state revenue reductions under the proposed IRC update. Of the $32.90 million estimated cost of these provisions in the 2001-03 biennium, 85% ($27.95 million) relate to EGTRRA.

5. In order to comply with the Congressional Budget Act of 1974, EGTRRA included a sunset provision, which specified that EGTRRA provisions do not apply for taxable, plan or limitation years beginning after December 31, 2010. Under the bill, the same sunset provision would apply for state tax purposes.

6. The following sections highlight provisions under EGTRRA that would have the greatest impact on state tax revenues if adopted for state tax purposes. A paper by the Department of Revenue has been attached to provide information on all of the provisions under the proposed IRC update that would have more than a minimal fiscal effect on state taxes. The estimated fiscal effects shown in the paper are the same as those estimated under the bill. The projections are based on federal estimates of the effects of EGTRRA and are concurred with by this office.

INDIVIDUAL INCOME TAX

Increased Contributions to Individual Retirement Accounts

7. This provision would increase the maximum annual dollar contribution limit for individual retirement accounts (IRAs) from $2,000 to the following: (a) $3,000 for 2002 through 2004; (b) $4,000 for 2005 through 2007; and (c) $5,000 for 2008. The contribution limit would be

indexed for inflation in $500 increments thereafter.

In addition, individuals who have reached the age of 50 would be permitted to make catch-up IRA contributions. The catch-up limit would be $500 from 2002 through 2005 and $1,000 in 2006 and thereafter.

These provisions are estimated to reduce state income tax collections by $2.25 million in 2001-02 and by $5.95 million in 2002-03. The annual cost would increase to an estimated $26.75 million by 2008-09, when the scheduled increase in contribution limits would be fully phased-in.

Educational Assistance Programs

8. This provision would make permanent the exclusion for employer-provided education assistance, which had been set to expire for courses beginning after December 31, 2001, and would extend the exclusion to include graduate education. The exclusion is limited to $5,250 per year and is allowed for tuition, fees, books, supplies and equipment. The estimated cost is $2.70 million in 2001-02 and $4.65 million in 2002-03.

Education IRAs

9. An education IRA is a trust or custodial account created exclusively to pay the qualified higher education expenses of a single named beneficiary. These provisions would make multiple changes to education IRAs, effective for tax years starting after December 31, 2001, including but not limited to the following: (a) increase the annual contribution limit from $500 to $2,000; (b) raise the phase-out income level for married couples filing joint returns; and (c) expand the categories of expenses for which a taxpayer may make tax-free withdrawals. The estimated cost of these provisions is $1.05 million in 2001-02 and $2.25 million in 2002-03.

Student Loan Interest

10. Under these provisions, the phase-out income level on the student loan interest deduction would be increased, for tax years starting after December 31, 2001. In addition, the 60-month limitation for the number of months during which interest paid on a student loan is deductible would be repealed, as would the restriction that makes voluntary payments of interest nondeductible, effective with interest paid after December 31, 2001. The estimated cost of these provisions is $0.90 million in 2001-02 and $1.55 million in 2002-03.

11. The total fiscal effect of these and other income tax provisions is estimated to be a decrease in tax revenues of $6.95 million in 2001-02 and $14.80 million in 2002-03, gradually increasing to an estimated annual loss of $43.31 million in 2008-09 (when the increased limits in IRA contributions would be fully phased in).

Higher Education Expenses

12. The bill would exclude provisions under EGTRRA that create an income tax

deduction for tuition and fees for the enrollment or attendance at an eligible higher education institution for the taxpayer, the taxpayer's spouse or the taxpayer's dependent. The federal deduction is limited, depending on the taxpayer's adjusted gross income (AGI) and the tax year in which the deduction is claimed.

For 2002 and 2003, the deduction is limited to $3,000 of qualified expenses and is available to single taxpayers with AGI less than or equal to $65,000 ($130,000 for married couples filing joint returns). The deduction is not available to married taxpayers filing separately or to an individual who can be claimed as a dependent by another taxpayer.

For tax years 2004 and 2005, the same AGI ceilings apply but the maximum deduction increases to $4,000. In addition, a maximum deduction of $2,000 is available to taxpayers with AGI between $65,000 and $80,000 ($130,000 and $160,000 for joint filers) for tax years 2004 and 2005. The deduction is eliminated after 2005.

13. Under current law, the state provides a deduction of up to $3,000 in tuition expenses for post-secondary institutions in the state or in Minnesota under the Minnesota-Wisconsin tuition reciprocity agreement. A maximum deduction of $3,000 is available to single taxpayers with federal AGI of $50,000 or less, married-joint taxpayers with federal AGI of $80,000 or less and married-separate taxpayers with income of $40,000 or less. The deduction phases out as income increases and is eliminated when federal AGI exceeds $60,000 if single, $100,000 if married filing jointly and $50,000 if married filing separately.

14. The current state deduction is more limited than the new federal deduction in the following ways: (a) the state deduction applies only to tuition, while the federal deduction applies to tuition and fees; (b) the state deduction applies only to educational institutions in Wisconsin and Minnesota, while the federal deduction has no limits with respect to location; (c) the income limits under the state deduction are more restrictive than those that apply for the federal deduction; and (d) the maximum state deduction is $3,000 while the federal deduction increases to $4,000 in 2004 and 2005.

15. However, the state deduction is ongoing, whereas the federal deduction is eliminated after 2005. In addition, the state deduction is allowed for married individuals filing separately and for individuals claimed as dependents of other taxpayers, whereas such individuals are ineligible for the federal deduction.

16. Not adopting the federal deduction would complicate tax filing for the approximately 70,000 persons eligible for both the current Wisconsin deduction and the new federal deduction. Such taxpayers would have to complete Wisconsin Schedule I, on which they would have to add back the amount deducted from federal AGI for the federal deduction and then subtract the amount allowed for purposes of the state deduction to arrive at Wisconsin AGI. In some (but not all) cases, the amount of the federal deduction added back would be the same as the amount subtracted for the state deduction. However, taxpayers would still be required to show both modifications on Schedule I.

17. In addition, there could be other consequences of not adopting the federal deduction as a result of the discrepancy that would exist between federal AGI and federal AGI referred to for state tax purposes (which would exclude the higher education deduction). For example, the Wisconsin itemized deduction credit is based on federal itemized deductions, some of which are limited by federal AGI. If Wisconsin references an earlier version of federal AGI (as under current law), Wisconsin taxpayers using the federal education expense deduction would have to recalculate federal AGI without the deduction for the purpose of calculating the allowable Wisconsin itemized deduction credit.

18. One option that would avoid the complications described above would be to update state tax references to include the federal higher education expense deduction and to allow taxpayers to claim either the federal or the state deduction, but not both. Under this option, the state deduction would continue to be available to married taxpayers filing separately and to individuals who are dependents of other taxpayers, even though such filers are not eligible for the federal deduction. It is estimated that the fiscal effect would be a reduction in state tax revenues of $3.5 million in 2002-03.

19. Another option would be to conform to the federal deduction and to eliminate the existing state deduction. This alternative would be the most simple administratively, for taxpayers as well as for DOR. Under this option, taxpayers would determine the higher education deduction for federal tax purposes and it would flow through for state tax purposes as part of federal AGI. There would be no need to make Schedule I modifications to get the deduction at the state level. However, several thousand taxpayers who are eligible for the existing state deduction but not for the federal deduction would lose eligibility for any deduction under this option. It is estimated that the fiscal effect would be a decrease in state tax revenues of $2.3 million in 2002-03.

PENSION PROVISIONS

20. Under the bill, the state would conform to the many revisions in retirement savings laws enacted under EGTRRA. Significant changes would be made with respect to pension contributions and funding. Among these changes would be increases in limits for the following: (a) contributions to qualified retirement plans; (b) benefit limits under defined benefit plans; (c) employer deduction limits for qualified plan contributions; and (d) elective deferrals under deferred compensation plans. In addition, catch-up contributions in the form of higher limits for elective deferrals would be authorized for employees age 50 and older. The limits on elective deferrals and catch-up contributions would be phased in over a number of years.

21. Effective with tax year 2006, EGTRRA also authorizes certain types of qualified plans to offer a Roth contribution program, in which all or a portion of allowable elective deferrals could be designated as after-tax contributions. As under a Roth IRA, earnings and distributions under such a program would be tax-free.

22. Additional changes were enacted under EGTRRA in the areas of pension distributions and rules on nondiscrimination and coverage. Under the bill, the state would adopt these revisions, including (but not limited to) the following: (a) tax-free rollovers permitted among a

variety of retirement plans; (b) repeal of special minimum distribution rules that had applied only to deferred compensation plans sponsored by state and local governments and tax-exempt organizations; (c) expanded deductions for certain dividends paid to an employee stock ownership plan and reinvested in qualified employer securities; and (d) modification of top-heavy rules that would reduce the number of plans deemed top-heavy and therefore subject to the special rules. More information on these and all of the pension provisions can be found in the attached paper by DOR.

23. While certain changes are phased-in over time, the revisions in federal pension law are generally effective with years beginning after December 31, 2001. Adopting the pension provisions for state purposes would decrease state tax revenues by an estimated $1.60 million in 2001-02 and $4.60 million in 2002-03. It is expected that the reduction in state tax revenues would be approximately $8.5 million in 2006-07, when all phased-in changes would be effective.

24. As is generally the case with individual and corporate income tax provisions, conforming state references to federal law with respect to retirement savings would provide greater simplicity for Wisconsin taxpayers. In addition, conforming to current federal law would enable Wisconsin taxpayers to take advantage of some of the federal revisions that they might not be able to utilize in the absence of a state law change.

25. For example, EGTRRA raised the limit on elective deferrals under IRC section 457 deferred compensation programs of tax-exempt organizations and state or local government plans to $11,000 (the limit had been $8,500 in 2001, and would have been increased for inflation under prior federal law). Without a change in current state law, elective deferrals through the Wisconsin Deferred Compensation program would be held to the deferral limits under prior federal law.

CORPORATE AND BUSINESS TAX PROVISIONS

26. The remaining IRC update provisions that would have a fiscal effect relate to federal laws enacted in 2000 and concern corporate and other business tax provisions. With exceptions, the three federal laws enacted in 2000 (described under "Governor," above) were included in the state 2001-03 biennial budget as passed by the Legislature. However, the Governor vetoed these provisions because, as passed by the Legislature, the budget bill inadvertently adopted three provisions that were not intended to be included.

27. The budget reform bill would update state tax references to the three federal laws enacted in 2000. The following sections briefly describe the new federal provisions that would have a state fiscal effect.

Environmental Remediation Costs

28. The expiration date for the election to deduct certain environmental remediation expenditures that would otherwise be charged to a capital account would be extended to include

expenses paid or incurred before 2004. The requirement that expenditures be in a targeted area would be eliminated so that most other sites certified by state environmental agencies as containing hazardous substances are eligible. This provision is effective for expenditures made after December 21, 2000. The estimated fiscal effect is a revenue decrease of $1.25 million in 2002-03.

Corporate Donations of Computer Technology

29. The expiration date for deductions of certain computer equipment donated to elementary and secondary schools would be extended through 2003. The deduction would be extended to include donations to public libraries, donations of property up to three years after acquisition, rather than two years under prior law, and donations of property reacquired by a computer manufacturer. This provision applies to donations made after December 31, 2000. The estimated fiscal effect is a revenue decrease of $1.1 million in 2002-03.

Duplication or Acceleration of Loss Through Assumption of Certain Liabilities

30. The basis of stock received in certain tax-free exchanges would be required to be reduced by the amount of any liability assumed in exchange for the stock that does not otherwise reduce the transferor's basis. Stock could not be reduced below its fair market value. The provision would generally not apply if the trade or business with the liability or substantially all of the assets associated with the liability is transferred to the corporation in the exchange. This provision is effective for assumption of liabilities on or after October 19, 1999. The estimated fiscal effect is a revenue increase of $0.20 million in 2002-03.

Foreign Sales Corporations

31. The present foreign sales corporation (FSC) rules would be repealed and replaced with an exclusion for extraterritorial income. The tax benefit under the exclusion is expected to mirror the tax benefit under the FSC rules, but apply to a greater number of taxpayers. Corporations could use the new benefit directly rather than having to create specifically defined FSC subsidiaries.

The law change is in response to a decision by the World Trade Organization (WTO) that the FSC provisions breach WTO rules by providing subsidies to assist U.S. exports, thus giving U.S. companies an unfair advantage in international trade. The European Union initially brought the complaint to the WTO and has indicated that it expects to ask the WTO to rule on the new scheme, suggesting that it may still not be compliant with WTO rules. Regardless of whether the new scheme would ultimately withstand such a challenge, it would remain in effect during the dispute.

This provision is effective for transactions entered into after September 30, 2000. No corporation may elect to be an FSC after that date. Transition rules are included for current FSCs. The estimated fiscal effect is a revenue decrease of $2.80 million in 2002-03.

32. It was the Legislature's intent to exclude the provisions regarding environmental remediation costs, donations of computer equipment and foreign sales corporations from the IRC

update adopted in the biennial budget bill last summer in order to avoid the associated revenue loss. As described above, these provisions would be included in the current IRC update recommended by the Governor.

TREATMENT OF AMORTIZATION AND DEPRECIATION

33. As, noted, state tax provisions are generally referenced to federal definitions under the federal IRC and changes in federal law take effect for state tax purposes only after action by the Legislature. However, the Legislature does not have to take action to reference state tax provisions related to amortization and depreciation to the federal IRC. Specifically, for property placed in service on or after January 1, 2000, amortization or depreciation may be computed under either the federal IRC as amended to December 31, 1999, or the federal IRC in effect for the tax year for which the return is filed. As a result, Wisconsin automatically adopts federal IRC provisions for computing amortization or depreciation.

34. This automatic referencing to federal IRC provisions provides taxpayers with the benefits of any federal tax reductions. Conforming state tax treatment of depreciation and amortization with federal law greatly simplifies state tax accounting for taxpayers. However, if federal law is modified to increase depreciation or amortization deductions, state tax revenues could be significantly reduced as a result of the federal law change. As a result, the Committee may wish to delete the current law provisions that permit taxpayers to compute amortization or depreciation under the federal IRC in effect the tax year for which the return is filed. Rather, federal amortization and depreciation provisions could be adopted for state tax purposes only after action by the Legislature. Amortization and depreciation provisions would be treated as most other federal IRC provisions. There would be no fiscal effect related this change in treatment.

ALTERNATIVES TO BILL

1. Adopt the Governor's recommendation to update state statutes to conform to provisions under the four federal laws described above, with the exception of an individual income tax deduction for higher education expenses. In addition, reduce the estimated revenue loss in 2002-03 under the bill by $100,000, to reflect the administration's intended estimate. Compared to current law, the fiscal effect would be a reduction in general fund tax revenues of $8,550,000 in 2001-02 and $24,350,000 in 2002-03, for a total reduction of $32,900,000 for the 2001-03 biennium.

Alternative 1	GPR
2001-03 REVENUE	$100,000

2. Adopt Alternative 1. In addition, include as part of the IRC update the federal individual income tax deduction for higher education expenses. Specify that a taxpayer could use either the federal or the state deduction, but not both.

Compared to current law, the fiscal effect would be to reduce general fund tax revenues by $8,550,000 in 2001-02 and $27,850,000 in 2002-03, for a total reduction of $36,400,000 for the 2001-03 biennium. As compared to the bill, this option further reduce state tax revenues by an estimated $3,400,000 in 2002-03 (a loss of $3,500,000 from the higher education deduction and a gain of $100,000 from the correction to the administration's estimate).

Alternative 2	**GPR**
2001-03 REVENUE	- $3,400,000

3. Adopt Alternative 1. In addition, modify the provisions to include the federal individual income tax deduction for higher education expenses and to eliminate the current state deduction for tuition expenses. Compared to current law, the fiscal effect would be a reduction in general fund tax revenues of $8,550,000 in 2001-02 and $26,650,000 in 2002-03, for a total reduction of $35,200,000 for the 2001-03 biennium. As compared to the bill, this option would decrease state tax revenues by an additional $2,200,000 in 2002-03 (a loss of $2,300,000 from the higher education deduction and a gain of $100,000 from the correction to the administration's estimate).

Alternative 3	**GPR**
2001-03 REVENUE	- $2,200,000

4. Delete current law provisions that permit taxpayers to compute amortization or depreciation under the federal IRC in effect for the tax year for which the return is filed and provide that federal amortization and depreciation provisions could be adopted for state tax purposes only after action by the Legislature.

5. Maintain current law.

Alternative 5	**GPR**
2001-03 REVENUE	$33,000,000

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