Legislative Fiscal Bureau
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May 8, 2003 Joint Committee on Finance Paper #353

Internal Revenue Code Update (General Fund Taxes)

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). The current statutes refer to the federal IRC in effect on December 31, 2001.

GOVERNOR

No provision

DISCUSSION POINTS

1. In a letter dated April 11, 2003, the administration requested that the Joint Committee on Finance incorporate an IRC update into the Committee's version of the budget. Specifically, with two exceptions described below, the administration recommends that state tax references to the IRC be updated to conform to federal law changes enacted through December 31, 2002, and that the new provisions would apply for Wisconsin purposes at the same time as for federal purposes.

2. The changes to federal law that affect the IRC were enacted under the following federal acts: (a) the Victims of Terrorism Tax Relief Act (VTTRA); (b) the Job Creation and Worker Assistance Act (JCWAA); (c) the Clergy Housing Allowance Clarification Act (CHACA); (d) the Trade Act; (e) Public Law 107-276, which eliminated notification and return requirements for political parties and candidates; and (f) the Holocaust Restitution Tax Fairness Act (HRTFA). Most of the provisions that would be referenced for state tax purposes would be from the JCWAA.

3. One of the excluded federal provisions would be the bonus depreciation deduction provided under the JCWAA. Under the federal provision, taxpayers may claim an additional first-year depreciation deduction equal to 30% of the adjusted basis of qualified property that was acquired after September 10, 2001, and placed in service before January 1, 2005. The Department of Revenue estimates that, if this provision were adopted for state tax purposes, state income and franchise tax revenues would be reduced by $180 million in 2003-04 and $21 million in 2004-05. Prior to enactment of 2001 Wisconsin Act 109 (the 2001-03 budget adjustment bill), state depreciation and amortization provisions were automatically referenced to the IRC. However, Act 109 included a provision that eliminated the automatic referencing of state provisions. Instead state depreciation and amortization provisions are referred to the Code in effect on December 31, 2000. The Legislature must take action to update these references to future years.

4. A second excluded provision would be retroactive adoption of the deduction for teachers' classroom expenditures. The Department indicates that retroactive adoption of the provision for tax year 2002 would require eligible taxpayers to file amended returns for a small tax benefit. If the provision were adopted retroactively, the Department estimates that state individual income tax revenues would be reduced by an additional $1.4 million in 2003-04. This provision would be adopted for tax year 2003, however.

5. The Department of Revenue estimates that the IRC provisions would decrease individual income tax revenues by $1.8 million in 2003-04 and by $400,000 in 2004-05. Corporate and business income and franchise tax revenues would decrease by an estimated $250,000 in 2003-04 and by $650,000 in 2004-05. Total state income and franchise tax revenues would be reduced by an estimated $2.05 million in 2003-04 and by $1.05 million in 2004-05. The following table provides a summary of the items that are estimated to have a significant impact on state revenues.

Summary of Federal Law Changes with Significant Fiscal Effects
($ in Millions)

	2003-04	2004-05
Individual Income Tax		
Tax Deduction for Teachers' Classroom Expenditures	-$1.30	-$0.10
Expansion of Exclusion for Foster Care Payments	-0.50	-0.30
Individual Total	-$1.80	-$0.40
Corporate and Business Income and Franchise Taxes		
Discharge of Indebtedness of an S Corporation	$0.40	$0.25
Limit of Use of Nonaccrual Experience Method of Accounting	0.25	0.10
Qualified Clean-Fuel Vehicle and Refueling Property Deduction	-0.60	-0.30
Tax Incentives for Indian Reservations	-0.30	-0.70
Corporate/Business Total	-$0.25	-$0.65
IRC Update Total	-$2.05	-$1.05

6. 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 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.

7. The following sections briefly describe the new federal IRC provisions that would have a significant state fiscal effect. A paper by the Department of Revenue has been attached to provide information on all provisions under the proposed IRC update that would have a substantive effect on Wisconsin tax law.

INDIVIDUAL INCOME TAX

Deduction for Teacher's Classroom Expenditures

8. For tax years 2002 and 2003, JCWAA provides eligible educators a federal income tax deduction of up to $250 per year for unreimbursed expenses for certain materials used in the classroom. Such materials include books, supplies, computer equipment, and other equipment and supplementary materials. To be eligible for the deduction, an educator must be an individual who, for at least 900 hours during a school year, is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school that provides elementary or secondary education.

Under prior federal law, educators were permitted to deduct unreimbursed educator expenses as a miscellaneous itemized deduction for expenses in excess of 2% of adjusted gross income. Wisconsin does not allow federal miscellaneous itemized deductions to be used for purposes of the state's itemized deduction credit.

As described above, the Department recommends adopting the new federal provision for Wisconsin purposes for tax year 2003 only. The Department indicates that retroactive adoption of this provision for tax year 2002 would require eligible taxpayers to file amended returns for a small tax benefit, and would reduce state income tax revenues by an estimated $1.4 million in 2003-04. The estimated fiscal effect of adopting the provision for tax year 2003 only would be to reduce individual income tax revenues by $1.3 million in 2003-04 and by $100,000 in 2004-05.

Expansion of Exclusion for Foster Care Payments

9. Prior federal law provided an individual income tax exclusion for payments received from government and not-for-profit foster care placement agencies contracting with state and local governments. For tax years beginning after December 31, 2001, JCWAA expands the exclusion to include payments from for-profit foster care placement agencies. Adopting this provision for state tax purposes would reduce individual income tax revenues by an estimated $500,000 in 2003-04 and $300,000 in 2004-05.

CORPORATE AND BUSINESS TAX

10. The remaining IRC update provisions that would have a significant state fiscal effect relate to corporate and other business tax provisions. The following sections describe the new business tax provisions.

Discharge of Indebtedness of an S Corporation

11. Provisions included in JCWAA reverse a U. S. Supreme Court ruling that discharge of indebtedness (exclusion from income for amounts related to forgiveness or discharge of debt in certain circumstances) was an item of income that passes through to a shareholder of an insolvent S corporation and increases the shareholder's basis in the stock of the S corporation. The decision allows shareholders in insolvent S corporations to increase their stock basis by the discharge (cancellation) of indebtedness income and then deduct suspended losses (net operating losses) up to the amount of the increased stock basis. Under the JCWAA provision, income from the discharge of indebtedness of an insolvent S corporation that is excluded from the corporation's income does not flow through to any shareholder. Thus, a shareholder's basis in the insolvent S corporation's stock does not increase and the suspended loss does not pass through to the shareholder. The provision generally applies to discharges of indebtedness after October 11, 2001. The estimated fiscal effect is a tax revenue increase of $400,000 in 2003-04 and $250,000 in 2004-05.

Limit Use of Nonaccrual Experience Method of Accounting

12. Certain accrual-basis taxpayers are not required to accrue as income any amounts to be received for the performance of services that, based on experience, will not be collected. This nonaccrual of amounts attributable to the performance of services is treated as a method of accounting: the nonaccrual experience method. Under the federal IRC provisions, the nonaccrual experience method of accounting is only available to service providers for: (a) amounts received for the performance of certain services (health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting); or (b) if the service provider meets the $5 million gross receipts test. A business meets the $5 million gross receipts test for a prior tax year if its annual gross receipts for the three-year period ending with the prior tax year do not average over $5 million. The provision is generally effective for tax years ending after March 9, 2002. The estimated fiscal effect is a revenue increase of $250,000 in 2003-04 and $100,000 in 2004-05.

Qualified Clean-Fuel Vehicle and Refueling Property Deduction

13. Certain taxpayers are permitted to elect to deduct all or part of the cost of certain qualifying property in the year they place it in service, instead of depreciating the cost over a specified number of years. Taxpayers may deduct, subject to limitation, the cost of qualified clean-fuel vehicle property and qualified clean-fuel vehicle refueling property. The IRC defers the phase-out of the deduction for purchases of qualified, clean-fuel vehicle property and clean-fuel vehicle refueling property. The full deduction is available for vehicles placed in service in 2002 and 2003. The deduction is then reduced by 25% for vehicles placed in service in 2004, by 50% for vehicles

placed in service in 2005, and by 75% for vehicles placed in service in 2006. The deduction is eliminated beginning in 2007. Under prior law, the phase-out began in 2001 and no deduction was allowed after December 31, 2004. The IRC provisions also extend the time period for exceptions to the depreciation deduction limits for electric vehicles and retrofit clean-fuel vehicles by two years, so that the exceptions apply to property placed in service before 2007.

The deduction for qualified clean-fuel vehicle property is limited to $50,000 for a truck or van with a gross weight of more than 26,000 pounds or for a bus with a seating capacity of 20 or more adults (not including the driver). The deduction is limited to $5,000 for a truck or van with a gross vehicle weight of more than 10,000 pounds, but not more than 26,000 pounds. The deduction is limited to $2,000 for all other qualified clean fuel motor vehicles. Two types of property qualify as clean-fuel vehicle property. One type is a motor vehicle that is produced by an original equipment manufacturer and is designed to be propelled by a clean-burning fuel (subject to certain conditions). The second type of property that qualifies for the deduction is property that is installed on a motor vehicle and permits the vehicle to be propelled by a clean-burning fuel. Qualified clean-fuel vehicle refueling property includes property used for storing clean-burning fuel or for dispensing clean-burning fuel into the fuel tank of a motor vehicle that is propelled by a clean-burning fuel. In addition, the property must be located at the point where the fuel is delivered into the tank of a motor vehicle. For the purposes of the deduction, a motor vehicle is defined as any vehicle with at least four wheels that is manufactured primarily for use on public streets, roads, and highways. Clean-burning fuel includes natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and electricity. This definition also includes any fuel that is at least 85% methanol, ethanol, any other alcohol, ether, or a combination of these.

The provision is effective for property placed in service after December 31, 2001. The provision would reduce state tax revenues by an estimated $600,000 in 2003-04 and by $300,000 in 2004-05.

Special Depreciation Rules for Indian Reservation Property

14. Special recovery periods that permit faster write-offs are provided under the modified accelerated cost recovery system (MACRS) of depreciation for certain property placed in service on Indian reservations. The special recovery periods are shown in the following table.

Recovery Periods for Indian Reservation Property

Property Class	Recovery Period
3-Year Property	2 years
5-Year Property	3 years
7-Year Property	4 years
10-Year Property	6 years
15-Year Property	9 years
20-Year Property	12 years
Nonresidential Real Property	22 years

Eligible property includes 3-, 5-, 7-, 15-, and 20-year property, and nonresidential real property that is: (a) used predominantly in the active conduct of a trade or business within an Indian reservation: (b) not used or located outside an Indian reservation on a regular basis; (c) not acquired (directly or indirectly) from a related person; and (d) not used for certain gaming purposes. Indian reservation is defined under certain federal laws for the purpose of the special depreciation provisions. This provision would apply to property placed in service after March 9, 2002. The provision would reduce state tax revenues by an estimated $300,000 in 2003-04 and by $700,000 in 2004-05.

ALTERNATIVES

1. Adopt the provisions requested by the Department of Revenue to update state tax references to the federal IRC in effect as of December 31, 2002. Decrease projected individual income tax revenues by $1.8 million in 2003-04 and by $400,000 in 2004-05 and decrease projected corporate franchise tax and business tax revenues by $250,000 in 2003-04 and by $650,000 in 2004-05.

Alternative 1	GPR
2003-05 REVENUE (Change to Bill)	**-** $3,100,000

2. Adopt provisions requested by the Department of Revenue to update state tax references to the federal IRC in effect as of December 31, 2002, except for provisions relating to (a) the deduction for teachers' classroom expenditures; (b) expansion of the exclusion for foster care payments; (c) the deduction for qualified clean-fuel vehicle and refueling property; and (d) special depreciation provisions for Indian reservations. This option would not adopt the new federal provisions that were recommended by DOR but which would result in decreased state tax revenues. Increase corporate franchise tax and business tax revenues by an estimated $650,000 in 2003-04 and by and estimated $350,000 in 2004-05.

Alternative 2	GPR
2003-05 REVENUE (Change to Bill)	$1,000,000

3. Maintain current law.

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Attachment