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Internal Revenue Code Update (General Fund Taxes -- Individual and Corporate Income Taxes)

[LFB 2005-07 Budget Summary: Page 175, #7]

CURRENT LAW

State individual income tax and corporate and franchise tax provisions are generally referenced to definitions under federal law. 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, 2002.

GOVERNOR

Update state tax references to the IRC in order to conform to certain federal law changes enacted through December 31, 2004.

With exceptions, the bill would update state references to federal provisions enacted in 2003 and 2004 under the following federal laws: (a) the 2003 Jobs and Growth Tax Relief Reconciliation Act (JGTRRA); (b) the 2003 Military Family Tax Relief Act (MFTRA); (c) the 2003 Medicare Prescription Drug, Improvement, and Modernization Act (MPDIMA); (d) the Working Families Tax Relief Act (WFTRA); (e) the American Job Creation Act (AJCA); and (f) 2004 Public Law 108-476, relating to the YMCA retirement fund. AJCA repeals certain provisions under prior federal law related to foreign sales corporations (Public Law 106-519), which the state did not adopt for state tax purposes. However, the bill would include conformance to such provisions under Public Law 106-519, effective with tax year 2005, in order to facilitate the update to the current federal provisions under AJCA.

The bill would conform to all of the provisions under the federal laws described above with the exception of the following: (a) increases in federal alternative minimum tax exemptions for tax years 2003 and 2004 under JGTRRA [although the increase in the alternative minimum tax exemptions for tax year 2005 (under WFTRA) would be included]; (b) federal bonus depreciation and small business expensing provisions under JGTRRA and AJCA, which modified prior federal provisions that were not adopted for state tax purposes; (c) health savings accounts (HSAs) in MPDIMA and provisions under WFTRA that would provide conformity between distributions from health savings accounts and Archer medical savings accounts; (d) the extension of expiring tax provisions that the state did not previously adopt, which augmented the deduction for donations of computer technology and equipment and provided immediate deductions of brownfield environmental remediation costs (under WFTRA); and (e) and federal provisions that would permit expensing of film and television production costs (under AJCA).

The bill would also include conformance of state statutes with the changes under two additional federal laws enacted in 2004 -- the 2004 Social Security Protection Act and the 2004 Pension Funding Equity Act. These two federal laws provided clarifications and technical corrections as well as adjusted rules relating to pension funds. While these provisions would not have a substantive effect on state tax law, the bill would adopt the federal changes to remain consistent with federal law.

The federal law provisions to which the state would conform, under the bill, would generally apply for Wisconsin purposes at the same time as they apply for federal purposes, with the following exceptions: (a) a deduction for travel expenses of members of the National Guard and Reserves under MPDIMA would be adopted prospectively for tax years beginning after December 31, 2004, rather than retroactively to tax year 2003, when the federal deduction took effect; (b) an extension of a deduction for classroom expenses of educators would be adopted prospectively, for tax year 2005, and not retroactively to tax year 2004, when the federal extension of the expiring provision took effect (under WFTRA); and (c) the provisions of Public Law 106-519, related to foreign sales corporations, would be adopted for tax years beginning on or after January 1, 2005, as described above.

In addition to updating state tax references to the IRC, the bill would clarify and correct certain provisions related to the standard deduction and to innocent spouse relief under the individual income tax. Under current law, the standard deduction for a person claimed as a dependent on another's return equals the lesser of: (a) the deduction for a single tax filer; or (b) $800 (in 2005 – the amount is adjusted annually for inflation), but not more than the tax filer's earned income plus $250. For nonresidents or part-year residents, if the deduction is the first amount, it is prorated by the ratio of Wisconsin adjusted gross income (WAGI) to federal adjusted gross income (FAGI); if the deduction is the second amount, it is not prorated. The bill would correct the statutes so that the standard deduction for nonresidents or part-year residents would be pro-rated by the ratio of WAGI to FAGI in all cases, effective with tax years beginning on or after January 1, 2005.

Wisconsin currently conforms to innocent spouse relief provisions of the Internal

Revenue Code. However, Wisconsin statutes contain an incorrect reference to the IRC and fail to provide the two-year period allowed under federal law for applying for such relief. The bill would correct the IRC reference and provide the two-year period for innocent spouse relief as under federal law. These provisions would first apply to tax liability that arises on the bill's general effective date or that remains unpaid on that date.

The administration estimates that the IRC update under the bill would increase state tax revenues by $620,000 in 2005-06 and by $1,110,000 in 2006-07. The following table provides a list of the items that are projected to have an impact on state revenues, along with their estimated fiscal effects.

TABLE 1

Summary of Federal Law Changes with Substantive Fiscal Effects (In Millions)

	2005-06	2006-07
Individual Income Tax		
Charitable contributions of patents and similar property	$2.30	$1.40
Charitable contributions of motor vehicles, boats, and airplanes	0.90	1.10
Treatment of partnership loss transfers and partnership basis adjustments	0.20	0.15
Alternative minimum tax relief for individuals	None	-0.05
Deduction for costs incurred in civil rights suits	-0.10	-0.10
Military death benefit exclusion	-0.20	Minimal
Exclusion of gain from sale of residence for uniformed personnel	-0.30	Minimal
Deduction for travel expenses by Guard and Reserve members	-0.50	-0.50
Extension of the teachers' expense deduction	None	-1.40
Individual Income Tax Total	$2.30	$0.60
Corporate and Business Taxes		
Reform tax treatment of leasing arrangements to tax-exempt entities	$3.30	$3.30
Consistent amortization period for start-up and organizational expenditures	0.30	1.20
Limitation of employer deduction for certain entertainment expenses	0.80	0.50
Treatment of nonqualified deferred compensation plans	0.65	0.15
Expanded disallowance of deduction for interest on convertible debt	0.40	0.25
Limitation on transfer or importation of built-in losses	0.30	0.30
Depreciation of sports franchises	0.30	0.20
Prevention of mismatching between deductions and income inclusions	0.25	0.20
Denial of installment sale treatment for all readily tradable debt	0.20	0.05
Depreciation of utility grading costs	0.10	0.10
Modification of straddle rules	0.10	0.07
Treatment of certain income of rural electric cooperatives	-0.06	0.00
Depreciation of certain motor racetrack facilities	-0.07	-0.06
Expand bank S corporation eligible shareholders to include IRAs	-0.10	-0.10
Increase the number of eligible S corporation shareholders to 100	-0.10	-0.15
Deduction for clean-fuel vehicles	-0.35	0.00
Method of accounting for naval shipbuilders	-0.20	-0.20
Modification of application of income forecast method of accounting	-0.20	-0.30
Election to expense qualified reforestation costs	-0.40	-0.15
Depreciation of certain leasehold improvement and restaurant property	-0.90	-0.55
Repeal exclusion for extraterritorial income	-6.00	-4.30
Corporate and Business Tax Total	-$1.68	$0.51
IRC Update Total	$0.62	$1.11

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. The proposed IRC update addresses federal laws enacted over the past two years. DOR has prepared papers reviewing these federal laws and provisions that the state could consider as part of an IRC update and making recommendations about which federal provisions the state should adopt. The Department's papers are included as Attachment 1, which reviews federal laws enacted in 2003, and Attachment 2, which reviews federal laws enacted in 2004.

3. In addition to the provisions under AB 100 pertaining to the IRC update, the administration has requested that state statutes be amended to update IRC references as modified under Public Law 108-375, the Ronald W. Reagan National Defense Authorization Act for Fiscal Year 2005 (RRNDAA), with respect to travel benefits donated to members of the military. RRNDAA, which took effect for federal purposes on October 29, 2004, permits tax-deductible donations of frequent flier miles, credits for tickets, and tickets for air or surface transportation to the U.S. Department of Defense for use by: (a) members of the armed forces on active duty in a military operation outside the U.S. for travel while on leave; or (b) family members traveling to be with a member of the military who has been injured or become ill during deployment. The new federal law defined such benefits as qualified military benefits, which are excluded from gross federal income. The administration recommends that these provision be adopted and apply for Wisconsin purposes at the same time as they apply for federal purposes. It is estimated that the provisions would have a minimal fiscal effect.

4. As noted under "Governor," above, the proposed IRC update would exclude certain federal provisions relating to prior years or to prior federal laws that Wisconsin did not conform to. These provisions include: (a) increases in federal alternative minimum tax exemptions for tax years 2003 and 2004; (b) federal bonus depreciation and small business expensing provisions that modified prior federal provisions not adopted for state tax purposes; and (c) the extension of expiring tax provisions that the state did not previously adopt, which augmented the deduction for donations of computer technology and equipment and provided immediate deductions of brownfield environmental remediation costs. In addition, AB 100 excludes from the proposed IRC update provisions that would conform to federal HSAs and to federal provisions that permit expensing of film and television production costs.

5. On January 18, 2005, the Joint Committee on Finance passed out of the Committee identical substitute amendments to Assembly Bill 4 and Senate Bill 7 that would update state tax references to conform to the HSA provisions under federal law. The substitute amendments approved by the Committee would first apply for taxable years beginning on January 1 of the year

in which the bills took effect, except that if the bills took effect after July 31, the provisions would first apply to taxable years beginning on January 1 of the following year. As the HSA provisions are under consideration as stand-alone legislation, they are not addressed further in this paper.

Qualified Production Activities Income Deduction

6. For tax years beginning before January 1, 1995, Wisconsin did not follow the federal treatment of foreign sales corporations (FSCs). However, 1995 Wisconsin Act 27 included provisions that federalized the state treatment of FSCs, for tax years beginning on or after January 1, 1995. To qualify as an FSC, a corporation was required to meet a number of requirements designed to ensure that it has adequate foreign presence. If a corporation qualified as an FSC, a portion of the foreign trade income of the FSC was treated as foreign source income not effectively connected with the conduct of a trade or business within the United States and was exempt from tax.

In 2000, Congress enacted the Federal Sales Corporation Repeal and Extraterritorial Income Exclusion Act (FSCRA). Under FSCRA, the FSC rules were repealed and replaced with an exclusion for extraterritorial income (ETI) that was qualifying foreign trade income. Corporations could claim exclusion for qualified foreign trade income directly rather than having to create specifically defined FSC subsidiaries. This provision was not adopted for state tax purposes.

7. FSCRA was an effort to comply with a World Trade Organization (WTO) decision that ruled that the FSC provisions were an illegal export subsidy. However, the European Union (EU) challenged FSCRA, and in August, 2001, a WTO panel ruled that the provisions violated WTO rules. The United States appealed, and in January, 2002, the WTO Appellate Body affirmed the panel's findings. In August, 2002, the WTO Arbitration Panel ruled that the EU could impose sanctions on approximately $4 billion worth of U.S. exports. In May, 2003, the EU received final authorization from the WTO Dispute Settlement Body to impose sanctions on the U.S. After setting a deadline to repeal the ETI provisions by March 1, 2004, the EU began its retaliatory measures on that date. As a result, the EU imposed an additional duty on 1,608 U.S. products. The duty began at 5% and rose automatically by 1 percentage point each month until it would reach a ceiling of 17% in March, 2005. At that point, the EU indicated it would make a determination on its next course of action if the U.S. had not complied. In October, 2004, Congress passed and the President signed, the American Jobs Creation Act of 2004 (HR 4520). The bill repeals the ETI provisions and provides a deduction for income attributable to production in the Untied States. (The bill contained many other changes to federal tax laws as well.)

Under federal law, the ETI exclusion is being phased out between 2004 and 2007. During the phase-out, taxpayers will be able to claim a portion of the extraterritorial income exclusion according to the following schedule: 2004 - 100%; 2005 - 80%; 2006 - 60%; 2007 and thereafter - complete repeal.

8. To replace the ETI provisions, a qualified production activities income (QPAI) deduction for manufacturers has been created. When the deduction is fully phased in 2010 it will equal 9% of the lesser of: (a) qualified production activities income for the year; or (b) taxable

income for the year. However, the new deduction will be phased in over a number of years with a deduction transition percentage of 3% for 2005 and 2006, and 6% for 2007 through 2009. The deduction is also limited to 50% of the W-2 wages paid during the tax year. For the purpose of the deduction, manufacturing is defined broadly and includes, but is not limited to, traditional manufacturing, construction, engineering, energy production, computer software, films and videotape, and processing of agricultural production. Specifically, gross receipts from the following activities would qualify for the deduction: (a) lease, rental, license, exchange or other disposition of tangible personal property, computer software, or sound recordings that were manufactured, produced, grown, or extracted to a significant extent in the U.S.; (b) film production with at least 50% of total compensation relating to production services for the film in the U.S.; (c) production of electricity, natural gas, or potable water in the U.S.; (d) construction or substantial renovation of real property in the U.S.; and (e) engineering and architectural services relating to a construction project in the U.S. As shown in Table 1, it is estimated that this provision would reduce corporate income and franchise tax revenues by $6.0 million in 2005-06 and $4.3 million in 2006-07 if adopted for state tax purposes.

9. The qualified production activities income deduction is intended to offset the loss of tax benefits due to the phased repeal of the ETI exclusion. The ETI exclusion was the third different provision enacted by Congress to address a tax disadvantage faced by U.S. firms relative to foreign firms. U.S. businesses are generally taxed on worldwide income, while most European taxpayers are taxed only on income earned in the country that imposes the tax. Congress first enacted legislation creating domestic international sales corporations (DISCs), then the foreign sales corporation exclusion, and finally the ETI exclusion. However, each provision failed to be accepted by the WTO. The qualified production activity income deduction is, in part, intended to continue to provide tax relief to U.S. firms. In addition, by reducing taxes of domestic producers, the provision will increase cash flow and could result in increased investment and employment.

10. However, the QPAI has been criticized for a number of reasons. The deduction does not benefit the same firms that benefited from the ETI exclusion. The ETI exclusion benefits exporters, while the qualified production activities deduction can be claimed by most domestic production firms. The provision creates tax compliance and enforcement difficulties because businesses have an incentive to characterize income as qualified production income. Critics also indicate that, according to the Joint Committee on Taxation, the QPAI reduces tax revenues by 70% more than the revenue gained by eliminating the ETI exclusion. The Joint Committee on Taxation also estimates that when the deduction is fully phased in it would reduce federal revenues by $10.7 billion annually, which would represent a 3% to 4% reduction in federal business tax revenues. This could have the same effect on state tax revenues. The Massachusetts Department of Revenue estimated that, when fully phased in, the QPAI deduction would reduce annual revenues by an estimated $42 million, or 3.6% of current corporate income tax revenues. Finally, from the state perspective, the QPAI deduction might have little effect on jobs or income. For multi-state businesses, Wisconsin net taxable income is determined by subtracting total allowable deductions from total gross income, and apportioning the remainder to the state. The QPAI deduction would reduce the firm's total income, and, thus, its Wisconsin taxable income. As a result, the business' Wisconsin tax liability could be reduced without new investment or jobs created in the state.

11. The state has not always conformed to federal corporate IRC provisions. For example, the state did not adopt federal bonus depreciation provisions enacted in 2002 and 2003. In addition, expansion of the deduction for the cost of certain depreciable property (section 179 expensing) was not adopted for state purposes. A total of 31 states did not adopt federal bonus depreciation provisions, while 18 did not adopt the increase in the section 179 expensing provisions. Through March, 2005, three states -- Massachusetts, Maryland, and Georgia -- had decoupled from the federal QPAI provisions. The Committee may wish to adopt federal IRC provisions as recommended, except for those related to qualified production activity income.

ALTERNATIVES

1. Approve the Governor's proposal.

2. Modify the Governor's recommendation to update state tax references to include Public Law 108-375 in order to conform to the federal exclusion from gross income for members of the military for travel benefits donated by them. Under this alternative, there would be no change to the estimated fiscal effects under the bill.

3. Modify the Governor's proposal to exclude state tax references to the federal qualified production activities income deduction.

Alternative 3	GPR-REV
2005-07 REVENUE (Change to Bill)	$10,300,000

4. Maintain current law.

Alternative 4	GPR-REV
2005-07 REVENUE (Change to Bill)	- $1,730,000

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Attachments

ATTACHMENT 1

Wisconsin Department of Revenue
Division of Research and Policy
August 17, 2004

INTERNAL REVENUE CODE UPDATE
LAWS ENACTED THROUGH DECEMBER 31, 2003

A. INTRODUCTION

Wisconsin's individual income and corporate income and franchise tax bases closely conform to the bases for the federal individual and corporate income taxes. Conformity is achieved through references in Chapter 71 of the Wisconsin Statutes to the federal Internal Revenue Code (IRC). To maintain conformity, these references must be updated each year – in 2005, to adopt changes made during 2004. To date, there have been no changes to the IRC with a substantive effect on Wisconsin tax law enacted during 2004, though several bills are pending.

In addition, Wisconsin has not yet adopted federal changes to the IRC enacted during 2003. Adoption of these laws for Wisconsin tax purposes, generally effective at the same times they apply for federal purposes, is recommended, with certain exceptions. Federal laws enacted in 2003 include:

- Public Law 108-27, the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA),
- Public Law 108-121, the Military Family Tax Relief Act (MFTRA),
- Public Law 108-173, the Medicare Prescription Drug, Improvement and Modernization Act (MPDIMA).

Provisions of these laws that should not be adopted for Wisconsin tax purposes include bonus depreciation, small business expensing and higher alternative tax exemption amounts in JGTRRA and health savings accounts (HSAs) in MPDIMA. These provisions and the reasons for not adopting them are discussed at the end of this paper. In addition, the deduction for travel expenses of members of the National Guard and Reserve should be adopted prospectively, effective for tax years beginning after December 31, 2004, rather than retroactively to tax year 2003.

Adopting these laws at the same time they apply for federal purposes, with the exceptions identified above, would reduce state income tax revenues by $1.0 million in FY06 and $0.5 million in FY07. Table 1 shows the estimated fiscal impact of provisions with a non-minimal impact on Wisconsin tax revenues. The only provisions with fiscal effects are those from MFTRA providing tax relief for members of the military and their families.

TABLE 1
FISCAL EFFECT OF ADOPTING FEDERAL TAX PROVISIONS

Federal Tax Change	Effective Date	Fiscal Effect ($ millions)	
		FY06	FY07
Military death benefit exclusion	9/11/01	-$0.20	Minimal -
Exclusion of gain from sale of residence for uniformed personnel	5/7/97	-0.30	Minimal -
Deduction for travel expenses by Guard and Reserve members	1/1/05*	-0.50	-$0.50
Total		-$1.00	-$0.50

* The change took effect for federal purposes on 1\1\03, but would take effect for Wisconsin purposes on 1\1\05.

B. INDIVIDUAL INCOME TAX

1. Military Death Benefit Exclusion

Federal Law Change: MFRTA doubles the military death benefit from $6,000 to $12,000 and excludes the full amount of the benefit from income; previously, one-half of the benefit was taxable.

Effective Date: September 11, 2001. The retroactive effective date allows the exclusion to apply to military operations in Afghanistan and Iraq, as well as other locations since that date.

2. Exclusion on the Gain from Sale of Residence for Uniformed Personnel

Federal Law Change: MFRTA eases a restriction on the exclusion for the gain from the sale of a residence for uniformed and foreign service personnel. Generally, taxpayers may exclude up to $250,000 ($500,000 for married couples filing jointly) of gain from the sale of a principal residence if they owned and used the property as a principal residence for two or more years during the five years preceding the sale.

Under MFTRA, uniformed and foreign service personnel called to active duty away from home may elect to suspend the five-year test, for one property, for up to five years. If the election is made, the five-year period does not include any period, up to five years, during which the service member is on extended duty (more than 90 days) at least 50 miles from home or in government quarters under government orders.

Effective date: Sales made after May 6, 1997.

3. Exclusion for Payment to Military Personnel for Losses on Sale of Residence

Federal Law Change: MFTRA provides an exclusion from income for reimbursement paid to members of the military for losses on the sale of their homes resulting from declines in home values due to a military base closure or reduction in operations. The exclusion is limited to the fair market value of the property.

Effective Date: November 12, 2003.

4. Dependent Care Assistance Excludible as a Qualified Military Benefit

Federal Law Change: MFTRA clarifies that dependent care assistance provided by the U.S. Department of Defense is a qualified military benefit that is excluded from a taxpayer's gross income.

Effective Date: Tax years beginning after December 31, 2002.

5. Deduction for Travel Expenses by Guard and Reserve Members

Federal Law Change: MFTRA provides a deduction from gross income for travel expenses for members of the National Guard and Reserve when they travel more than 100 miles away from home and must stay away overnight. Under previous law, the deduction was from adjusted gross income, and thus limited to persons itemizing their deductions. Wisconsin should adopt the deduction prospectively, for 2005 and subsequent tax years, rather than retroactively to tax year 2003, when the deduction takes effect for federal purposes. Retroactive adoption would require eligible taxpayers to file amended returns for tax years 2003 and 2004, often for relatively small refunds. Retroactive adoption of the deduction would also result in a one-time revenue loss of $1.25 million in FY06 in addition to the $0.5 million loss that will result that year from prospective adoption of the deduction.

Effective Date: Expenses paid or incurred for tax years beginning after December 31, 2002 for federal purposes, but tax years beginning after December 31, 2004 for Wisconsin purposes.

6. Tax Relief for Families of Shuttle Columbia Astronauts

Federal Law Change: MFRTA expands the income and estate tax relief provided under the Victims of Terrorism Act of 2001 to astronauts who die in the line of duty. These provisions benefit the families of the astronauts killed in the space shuttle Columbia accident.

Effective date: Deaths occurring after December 31, 2002.

7. Filing Extensions

Federal Law Change: MFTRA allows the filing extension provided to military personnel serving in a combat zone under current law to troops deployed in contingency operations, that is, those who may become involved in military actions. Wisconsin automatically adopts federal filing extensions under current law.

C. CORPORATE INCOME AND FRANCHISE TAX

1. Exclusion for Retiree Subscription Drug Coverage

Federal Law Change: MPDIMA excludes from gross income of employers the special subsidy payment paid to employers that maintain prescription drug coverage for retirees after the drug benefit provided in the Act begins in 2006.

Effective Date: Taxable years ending after December 8, 2003 (effective date of the Act).

2. Repeal of Collapsible Corporation Rules

Federal Law Change: JGTRRA repeals the collapsible corporation rules. Collapsible corporations historically were used by shareholders in the film and real estate industries for favorable long-term capital gain treatment from the sale of stock that would otherwise result in ordinary income. Collapsible corporations are used primarily for certain manufacture, construction, or production of property, purchase of inventory, unrealized receivables and certain trade or business assets, or the holding of stock in another collapsible corporation.

These provisions have been recommended for repeal by the American Institute of Certified Public Accountants (AICPA) and the American Bar Association (ABA) because they are ambiguous and because other laws already ensure corporate level taxation on the sale or liquidation of corporate assets.

Effective Date: Tax years beginning after December 31, 2002.

D. PROVISIONS NOT RECOMMENDED FOR ADOPTION

1. Health Care Savings Accounts

Federal Law Change: MPDIMA creates health care savings accounts (HSAs), effective for taxable years beginning after December 31, 2003. HSAs permit workers covered by a high-deductible health insurance plan to make pre-tax contributions to cover health care costs. Contributions to HSAs may be deducted from gross income in the determination of adjusted gross income, and are limited to 100% of the annual deductible for the high-deductible health plan, but not more than $2,600 for single coverage and $5,150 for family coverage. These latter dollar amounts are the same as those permitted for an Archer Medical Savings Account (MSA) and are adjusted for inflation annually.

MPDIMA defines a high-deductible health plan as a plan with a deductible of at least $1,000 for single coverage and $2,000 for family coverage; these amounts are indexed for inflation. In addition, a plan must limit deductibles, co-payments and other out-of-pocket expenses to $5,000 for individuals and $10,000 for families. Individuals who are age 55 or older by the end of a tax year may boost their annual contributions by $500 in 2004, $600 in 2005, $700 in 2006, $800 in 2007, $900 in 2008 and $1,000 in 2009 and thereafter. No contributions are allowed after the participant retires.

Eligibility for HSAs is determined monthly; a person is eligible if he or she is covered by a high-deductible health plan and is not covered by a plan that is not a high-deductible plan on the first day of the month.

The Act allows taxpayers 60 days to roll over funds from an Archer MSA to an HSA.

Adoption of HSAs for Wisconsin income tax purposes is not recommended because HSAs are not likely to be an effective means of providing health insurance and are likely to increase the number of uninsured. If Wisconsin adopted the federal treatment of

HSAs retroactive to tax year 2004, when the provisions take effect for federal purposes, the revenue loss to Wisconsin would be $7.1 million in FY06 and $4.0 million in FY07.

2. **Alternative Minimum Tax Exemption**

Federal Law Change: JGTRRA increases the alternative minimum tax exemption from $49,000 to $58,000 for married couples filing jointly, from $35,750 to $40,250 for single and head of household tax filers and from $24,500 to $29,000 for married separate tax filers for tax years 2003 and 2004.

Wisconsin generally allows the same exemption for its alternative minimum tax. However, adopting the higher exemption amounts retroactively for 2003 and 2004 would require about 4,000 taxpayers paying the minimum tax to file amended returns for those tax years. If the higher exemptions were adopted retroactively for both 2003 and 2004, there would be a one-time revenue loss of $0.8 million in FY06.

3. **Bonus Depreciation**

Federal Law Change: JGTRRA increases the first-year bonus depreciation provided under the Job Creation and Worker Assistance Act (JCWAA) of 2002 from 30% to 50% for property acquired after May 5, 2003, and placed in service before January 1, 2005. JCWAA provided bonus depreciation for qualifying property acquired after September 10, 2001 and before September 11, 2004, and placed in service before January 1, 2005. JGTRRA eliminates the requirement that property be acquired before September 11, 2004, as long as it is placed in service by January 1, 2005.

The purpose of bonus depreciation is to encourage investment. Since bonus depreciation expires at the end of 2004, Wisconsin adoption of those provisions in 2004 would not encourage any additional investment in Wisconsin – the investment would have occurred anyway. It would simply result in a large revenue loss to the state – in excess of $300 million in FY06.

4. **Section 179 Expensing**

Federal Law Change: JGTRRA increases the maximum amount that businesses may expense under Section 179 of the IRC from $25,000 to $100,000 for property placed in service in 2003, 2004 and 2005. In addition, JGTRRA raises the amount of investment at which phase-out of the expensing deduction begins from $200,000 to $400,000 for property placed in service in 2003, 2004 and 2005. Both the $100,000 maximum that may be expensed and the $400,000 phase-out floor are adjusted for inflation for 2004 and 2005.

JGTRRA also makes off-the-shelf computer software placed in service in 2003, 2004 or 2005 eligible for the expensing deduction.

Property qualifying for these expensing provisions includes sports utility vehicles with a loaded gross vehicle weight rating of more than 6,000 pounds and automobiles with a curb weight exceeding 6,000 pounds.

The purpose of the higher expensing deduction is to encourage investment; however, Wisconsin adoption of the increase in the amount that could be expensed is not likely to spur any additional investment in the state beyond that resulting from the federal expensing provisions. Further, the increased expensing provisions expire at the end of 2005, only a few months after Wisconsin could adopt them. If Wisconsin adopted the increased expensing amounts retroactively, state tax revenues would be reduced by about $24 million in FY06. Prospective adoption, from the date legislation was enacted until the end of 2005, would reduce revenues by about $5 million.

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ATTACHMENT 2

Wisconsin Department of Revenue
Division of Research and Policy
December 23, 2004

INTERNAL REVENUE CODE UPDATE – LAWS ENACTED IN 2004

A. INTRODUCTION

Wisconsin's individual income and corporate income and franchise tax bases closely conform to the bases for the federal individual and corporate income taxes. Conformity is achieved through references in Chapter 71 of the Wisconsin Statutes to the federal Internal Revenue Code (IRC). To maintain conformity, these references must be updated each year – in 2005, to adopt changes made during 2004.

Federal laws enacted in 2004 include Public Law 108-311, the Working Families Tax Relief Act (WFTRA), enacted on October 4, Public Law 108-357, the American Job Creation Act (AJCA), enacted on October 22, 2004, and an act, not yet numbered, relating to the YMCA retirement fund, signed into law on December 21, 2004. The Department of Revenue recommends adoption of most of the provisions of these acts for Wisconsin tax purposes.

AJCA contains a provision that would defer gain on sales or dispositions of certain electricity and natural gas transmission property for purposes of implementing federal or state electric restructuring policy. The deferral would apply to transactions occurring before 2008. Because it is not clear how this restructuring policy will affect Wisconsin's electric and gas industry and thus what its fiscal effect will be, recommendation of adoption of this provision is still under consideration by the Department of Revenue (DOR) and the Public Service Commission (PSC).

According to the PSC, transmission property in the state has a net book value of more than $1 billion and if it were sold as a result of electric restructuring policy, it could be sold at 150% to 200% of its net book value. This suggests that Wisconsin adoption of the federal provision deferring the gains on this property could reduce state revenues by as much as $35 to $70 million during the next few years. However, it is not clear whether that restructuring and thus whether these gains will actually occur.

This paper summarizes the items that are recommended for adoption. Items with a revenue impact are listed in Table 1. As the table shows, adoption of these provisions would increase state tax revenues by $1.62 million in FY06 and $1.61 million in FY07.

The Department is not recommending adoption of provisions that would extend three expiring tax provisions that the state did not previously adopt. These include increases in the amount of investments that can be expensed under Section 179 of the IRC, an augmented deduction for donations of computer technology and equipment, and immediate deductions of the brownfield environmental remediation costs. In addition, the Department is not recommending adoption of changes that would provide conformity between distributions from health savings accounts and Archer medical savings accounts and that would permit expensing of film and television production costs. These provisions are summarized at the end of the paper.

Two other federal laws affecting tax provisions were enacted in 2004: Public Law 108-203, the Social Security Protection Act, and Public Law 108-218, the Pension Funding Equity Act. These laws provided clarifications and technical corrections, and adjusted rules relating to pensions funds. Wisconsin should adopt these changes to remain in step with federal law; however, they do not have a substantive effect on state tax law.

TABLE 1
FISCAL EFFECT OF ADOPTING FEDERAL TAX PROVISIONS ENACTED IN 2004

Federal Tax Change	Effective Date	Fiscal Effect ($ millions) FY06	FY07
Extension of the Teachers' Expense Deduction	1/1/05*	None	-$1.40
Deduction for Costs Incurred in Civil Rights Suits	10/23/04	-$0.10	-0.10
Charitable Contributions of Patents and Similar Property	6/4/04	+2.30	+1.40
Charitable Contributions of Motor Vehicles, Boats and Airplanes	1/1/05	+0.90	+1.10
Extension of Alternative Minimum Tax Relief for Individuals	1/1/05	None	-0.05
Repeal Exclusion For Extraterritorial Income	1/1/05	-6.00	-4.30
Prevention of Mismatching Between Deductions and Income Inclusions	10/22/04	+0.25	+0.20
Election to Expense Qualified Reforestation Costs	10/23/04	-0.40	-0.15
Depreciation of Certain Leasehold Improvement and Restaurant Property	10/23/04	-0.90	-0.55
Reform Tax Treatment of Leasing Arrangements to Tax-Exempt Entities	3/13/04	+3.30	+3.30
Depreciation of Certain Motor Racetrack Facilities	10/23/04	-0.07	-0.06
Modification of Application of Income Forecast Method of Accounting	10/23/04	-0.20	-0.30
Depreciation of Sports Franchises	10/23/04	+0.30	+0.20
Depreciation of Utility Grading Costs	10/23/04	+0.10	+0.10
Consistent Amortization Period for Start-Up and Organizational Expenditures	10/23/04	+0.30	+1.20
Deduction for Clean-Fuel Vehicles	1/1/04	-0.35	Minimal +
Increase the Number of Eligible Shareholders to 100	1/1/05	-0.10	-0.15
Expand Bank S Corporation Eligible Shareholders to Include IRAs	10/22/04	-0.10	-0.10
Treatment of Partnership Loss Transfers and Partnership Basis Adjustments	10/23/04	+0.20	+0.15
Limitation of Employer Deduction for Certain Entertainment Expenses	10/23/04	+0.80	+0.50
Modification of Straddle Rules	10/22/04	+0.10	+0.07
Method of Accounting for Naval Shipbuilders	10/23/04	-0.20	-0.20
Limitation on Transfer or Importation of Built-in Losses	10/23/04	+0.30	+0.35
Expanded Disallowance of Deduction for Interest on Convertible Debt	10/4/04	+0.40	+0.25
Denial of Installment Sale Treatment for All Readily Tradable Debt	10/22/04	+0.20	+0.05
Treatment of Certain Income of Rural Electric Cooperatives	10/22/04	-0.06	Minimal -
Treatment of Nonqualified Deferred Compensation Plans	1/1/05	+0.65	+0.15
TOTAL		+$1.62	+$1.61

* January 1, 2004, for federal purposes; Wisconsin should adopt the provision prospectively rather than retroactively.

B. INDIVIDUAL INCOME TAX

1. Uniform Definition of Qualifying Child

Federal Law Change: WFTRA provides a uniform definition of a qualifying child for purposes of the personal exemption for dependents, head of household filing status and the earned income tax credit (EITC), among other provisions. These changes impact Wisconsin because it allows a personal exemption for persons considered dependents under the IRC, defines head of household by reference to the IRC and piggybacks its EITC on the federal credit. In addition, the uniform definition affects other federal provisions to which Wisconsin conforms, including exclusion from the penalty for early distributions from an individual retirement account for education expenses and the exclusion for qualified fringe benefits. The fiscal impact of these changes on Wisconsin is uncertain. To the extent they allow more persons to claim children or other persons as dependents, they will reduce tax revenues and increase EITC expenditures.

WFTRA defined qualifying child for purposes, with limited exceptions, of the personal exemption for dependents, head of household filing status and EITC by means of relationship, age, abode and support tests.

Under the relationship test, a qualifying child must be a child or a descendant of a child, or a sibling or step-sibling or descendant of a sibling or step-sibling of the taxpayer. WFTRA defines children as natural children, step-children, adopted children, including legally adopted children and children placed with a taxpayer for legal adoption by that taxpayer, and foster children who have been placed with a taxpayer by an authorized agency or court order. In defining child, WFTRA retained existing provisions relating to dependents who were students and requiring that dependents generally be U.S. citizens or residents, except for adopted children of U.S. citizens or residents. The act also retained provisions precluding a taxpayer from claiming as a dependent a person who files a joint return (with limited exceptions) and precluding a person claimed as a dependent from claiming dependents.

Under the age test, a qualifying child must be younger than 19 at the end of the calendar year in which the tax year begins, or younger than 24 if the child is a student. The age test does not apply to a child who is permanently and totally disabled.

The abode test requires the qualifying child to live at the same principal place of abode as the taxpayer for more than half of the tax year. A child presumed by law enforcement authorities to have been kidnapped by someone who is not a member of the child's or taxpayer's family satisfies the abode test, until the child is determined to be dead.

Under the support test, a child must not provide more than one-half of his or her own support. Amounts received as scholarships are not considered support.

A child cannot be claimed as a dependent on more than one taxpayer's return, so tie-breaker rules apply when more than one taxpayer may claim the dependent. The taxpayer with rights to the dependency claim is determined as follows:

- When two taxpayers not filing a joint return are the child's parents, the taxpayer with whom the child resided for the longest period; if the child resided with two parents for equal periods, the taxpayer with the highest adjusted gross income (AGI).

- When only one of the taxpayers who may claim the child as a dependent is the child's parent, the taxpayer who is the parent.
- When none of the taxpayers is the child's parents, the taxpayer with the highest AGI.

WFTRA also defines qualifying relative for purposes of a dependency with relationship, gross income and support tests. A qualifying relative cannot be a qualifying child for the taxpayer or any other taxpayer. Persons qualifying as relatives include the taxpayer's children or their descendants, siblings and their children, parents and their ancestors and siblings, step-parents and step-siblings, and any son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law. Qualifying relatives include individuals with no family relationship to the taxpayer when they had the same abode as the taxpayer and were members of the taxpayer's household, so long as their relationship did not violate local law.

The support test requires that the taxpayer provide more than one-half of a qualifying relative's support. Alimony is not treated as support and in cases of remarriage a child's support provided by a parent's spouse is treated as provided by the parent. WFTRA retained two exceptions to the support test for multiple support agreements.

Under the gross income test, a qualifying relative's gross income must be less than the personal exemption amount. For a dependent who is permanently and totally disabled, gross income does not include income attributable to services performed at a qualifying sheltered workshop.

Effective Date: Tax years beginning on January 1, 2005.

2. Exclusion for Education Loan Repayments

Federal Law Change: AJCA excludes from gross income education loan repayments provided by the National Health Service Corps Loan Repayment Program if the recipient of the loan repayment is obligated to provide medical services in certain geographic areas. Also excluded are repayments of state programs that are eligible for funds from the Public Health Service Account.

Effective Date: For amounts received in taxable years beginning after December 31, 2003.

3. Recognition of Gain from the Sale of a Residence Acquired in Like-Kind Exchange

Federal Law Change: AJCA disallows the exclusion for gain on the sale of a principal residence when the residence was acquired in a like-kind exchange, unless the seller owned the property for at least five years. Generally, a taxpayer may exclude from income up to $250,000 ($500,000 for married couples filing jointly) of the gain from the sale of a residence, if the taxpayer owned and used the property as a principle residence for two years of the five-year period ending on the date of sale.

A like-kind exchange is the exchange of property that is similar in nature, character or class; it does not have to be similar in grade or quality. Thus, an exchange of real estate for real estate is generally a like-kind exchange.

Effective Date: Sales or exchanges after October 22, 2004.

4. Extension of the Teachers' Expense Deduction

Federal Law Change: WFTRA extends the $250 per year deduction for unreimbursed expenses incurred by educators to tax years 2004 and 2005. Wisconsin adopted this deduction for 2003, but not 2002, since that would have required taxpayers to file amended returns to receive a small tax benefit (less than $20, or $40 for married couples filing jointly when both spouses were educators). Wisconsin should adopt this extension prospectively, that is, for tax year 2005 only.

If Wisconsin adopted this provision for tax year 2004 as well as 2005, the revenue loss in FY07 would be $2.7 million.

Effective Date: Expenses paid or incurred for tax years beginning on January 1, 2004.

5. Deduction for Costs Incurred in Civil Rights Suits

Federal Law Change: AJCA allows an above-the-line deduction for attorney's fees and court costs paid in connection with an action involving certain claims of unlawful discrimination, certain claims against the federal government, or a private cause of action under the Medicare Secondary Payer statute. The deduction cannot exceed the amount includible in the taxpayer's gross income for the taxable year on account of the judgment or settlement resulting from the claim, whether a lump sum or periodic payments.

Effective Date: Fees and costs paid after October 22, 2004, with respect to any judgement or settlement occurring after that date.

6. Extension of Availability of MSAs

Federal Law Change: WFTRA allows taxpayers to establish new Archer medical savings accounts (MSA) through December 31, 2005. Generally, there is little incentive for taxpayers to establish such accounts, since health savings accounts (HSAs) are available beginning January 1, 2004. The purpose of the extension is to address situations where institutions are reluctant to offer HSAs until they are more fully developed. Since MSAs may be rolled over to HSAs tax-free, under federal law (but not Wisconsin law, since the state has not conformed to federal HSA provisions), the purpose of the extension is to provide a transition vehicle.

Effective Date: January 1, 2004.

7. Charitable Contributions of Patents and Similar Property

Federal Law Change: AJCA limits the deduction for charitable contributions of patents, certain copyrights, trademarks, trade name, trade secret, know-how, certain software, or similar intellectual property or applications or registrations to the lesser of the taxpayer's basis in the property or its fair market value. Generally, the deduction equals the fair market value of the property contributed, though the deduction may be reduced by the amount of gain that would have resulted if the donor had sold the property, depending upon the type of property and the nature of the donee.

AJCA also allows the donor an additional charitable deduction in the year of contribution and in later tax years based on a specified percentage of qualified donee income from the donated property. Qualified donee income is any net income received or accrued to the donee that is allocable to the intellectual property. For purposes of this additional deduction, donations to certain private foundations do not qualify. The additional deduction is allowed only to the extent that the amounts calculated exceed the deduction claimed on the original contribution. No additional deduction is allowed for income of the charitable donee after ten years or after the legal expiration of the property.

Effective Date: Contributions made after June 3, 2004.

8. Charitable Contributions of Motor Vehicles, Boats and Airplanes

Federal Law Change: Under AJCA, the deduction for a charitable contribution of an automobile, boat or airplane with a claimed value exceeding $500 (excluding inventory) depends upon the use of the vehicle by the recipient organization, rather than the fair market value of the property.

If the recipient organization sells the vehicle without any significant intervening use or material improvement, the deduction cannot exceed the gross receipts from the sale. A charitable deduction will be denied to a taxpayer who fails to obtain a contemporaneous written acknowledgement of the vehicle if its value exceeds $500. To be contemporaneous, the written acknowledgement must be provided within 30 days of the contribution or the date of sale. In all other cases, the acknowledgement must contain a certification of the recipient's intended use or material improvement, the intended duration of use and certification that the vehicle will not be sold before completion of the use or improvement.

Effective Date: Contributions made after December 31, 2004.

9. Charitable Contribution Deduction for Alaskan Whaling Expenses

Federal Law Change: AJCA allows certain individuals engaged in subsistence bowhead whale hunting activities who are recognized by the Alaskan Eskimo Whaling Commission as a whaling captain to claim a charitable contribution deduction for up to $10,000 of certain expenses. Eligible expenses include acquisition and maintenance of whaling boats, weapons and gear, supplying food and other provisions to the crew, and storage and distribution of the catch.

Effective Date: Contributions made after December 31, 2004.

10. Expenses of Rural Letter Carriers

Federal Law Change: AJCA allows rural letter carriers to treat their automobile costs in excess of the amount reimbursed by the U.S. Postal Service as miscellaneous itemized deductions subject to the 2% floor. As under current law, rural letter carriers are not required to include reimbursements in excess of actual costs in gross income.

Effective Date: Tax years beginning after 2003.

11. Extension of Alternative Minimum Tax Relief for Individuals

Federal Law Change: WFTRA extends to tax year 2005 increased exemptions amounts under the alternative minimum tax (AMT) exemptions that were permitted to taxpayers in 2003 and 2004. These amounts are $58,000 for married couples filing jointly and $40,250 for other tax filers. Exemption amounts are not changed for married persons filing separately ($29,000) and estates and trusts ($22,500).

Because Wisconsin has not yet conformed to federal law changes enacted in 2003, it did not adopt the higher minimum tax exemptions for 2003 and 2004. If it adopts the higher exemption amounts, it should do so only prospectively, that is, for 2005 only.

Effective Date: Tax years beginning on January 1, 2005.

12. Earned Income Tax Credit – Combat Pay as Earned Income

Federal Law Change: WFTRA permits taxpayers to elect to treat combat pay otherwise excluded from gross income as earned income when calculating the earned income tax credit (EITC). Because Wisconsin piggybacks its EITC on the federal credit, it automatically conforms to this provision. The fiscal impact on Wisconsin is expected to be minimal.

Effective Date: Tax years ending after October 4, 2004, and before January 1, 2006.

C. FOREIGN CORPORATIONS AND FOREIGN BUSINESS OPERATIONS

1. Repeal Exclusion For Extraterritorial Income

Federal Law Change: U.S. taxpayers are taxed on their worldwide taxable income, regardless of its source; by contrast, most European taxpayers are taxed only on income earned in the country imposing the tax. Efforts to correct this disadvantage for American taxpayers are complicated by international treaties and agreements intended to prevent one nation from discriminating against another in trade policies. Prior to provisions contained in AJCA, the U.S. had enacted three schemes to address the problems of U.S. taxpayers.

The first effort created an entity called a domestic international sales corporation (DISC), which allowed U.S. firms to defer tax on a percentage of export profits. After complaints by trading partners, DISCs were replaced with foreign sales corporations (FSCs). FSCs were designed to promote the export of U.S.-manufactured products by allowing a percentage of FSC income earned from the sale of qualified export property to be exempt from U.S. tax. FSCs generally were foreign subsidiaries of U.S. companies that exported goods manufactured in the U.S. A portion of FSC income was attributed to the U.S. parent company and a portion was exempt. The World Trade Organization (WTO) ruled that the FSC provisions provided unacceptable subsidies to assist U.S. exports.

Extraterritorial Income (ETI) provisions were enacted in 2000 in response to the WTO decision. Under ETI, a U.S. taxpayer's gross income did not include extraterritorial income that was qualifying foreign trade income. Subsequently, ETI was also ruled unacceptable by the WTO.

AJCA repeals the ETI provisions enacted to replace the FSC scheme. Under the act, the ETI is phased so that taxpayers retain 80% of ETI benefits in 2005 and 60% in 2006.

To replace ETI, AJCA phases in a 9% deduction for income from qualified domestic production activities over six years. There is a 3% deduction in taxable years beginning in 2005 and 2006, a 6% deduction in 2007, 2008 and 2009, and a 9% deduction thereafter. Qualified domestic production gross receipts are reduced by the cost of the goods sold that is allocable to the receipts and other direct deductions (selling and marketing expenses) and indirect deductions (general and administrative expenses) allocable to the receipts.

Domestic gross receipts include receipts from: (1) any lease, rental, license, sale, exchange or other disposition of qualifying property that was manufactured, produced, grown or extracted by the taxpayer in whole or in part within the U.S., (2) qualifying film production, (3) electricity, natural gas, or potable water produced in the U.S., (4) construction performed in the U.S., and (5) engineering or architectural services performed for U.S. construction projects. The deduction is not available to the extent that it exceeds 50% of wages paid during the tax year. The 50% wage limitation is intended to discourage outsourcing.

Companies whose products are primarily or are exclusively consumed in the U.S. will receive the greatest benefit under this legislation. Consequently, while companies that produce for export remain beneficiaries of the new legislation, the benefits are much broader and encompass more companies and products than the repealed FSC and ETI legislation.

Wisconsin did not adopt the ETI, and therefore still conforms to prior federal FSC law. The Department recommends repeal of the FSC provisions that currently apply for Wisconsin purposes and adoption of the new AJCA provisions.

Effective Date: ETI for transactions occurring after December 31, 2004. The deduction for taxable years beginning after December 31, 2004.

2. Translation of Foreign Taxes

Federal Law Change: A U.S. taxpayer is allowed a credit against U.S. income tax or excess profits tax liability or a deduction from income for tax on foreign-source income. The purpose of the credit or deduction is to mitigate the potential for double taxation of foreign-source income, which arises because the U.S. taxes the worldwide income of U.S. citizens and resident aliens regardless of where the income was generated.

Under prior law, the amount of foreign income taxes was determined by translating the foreign taxes paid in foreign currencies into a U.S. dollar amount at the average exchange rate for the tax year. AJCA allows taxpayers, other than regulated investment companies (RICs) using the accrual method of accounting, a revocable election to use exchange rates at the time the taxes are paid, provided the taxes are denominated in a currency other than the taxpayer's functional currency. Functional currency is currency in which the taxpayer does significant business and maintains books and records. A special rule is provided for RICs.

Effective Date: Tax years beginning after December 31, 2004.

3. Interest Paid by Foreign Partnerships and Foreign Corporations

Federal Law Change: Under federal law, the residence or place of incorporation of the person who issued an interest-bearing obligation generally determines whether income on that obligation is derived from sources within or outside of the U.S. Interest from an obligation issued by a U.S. resident or domestic corporation is treated as U.S. source income. A foreign corporation or partnership is treated as a U.S. resident if it is engaged in a trade or business in the U.S. at any time during the year and income received from that business is considered U.S. source income.

However, interest paid by the business is treated differently if the business is a corporation or a partnership. Interest paid by a corporation is treated as U.S. source income only if it is paid by a U.S. trade or business that is part of the corporation. Interest paid by the foreign trade or business of the corporation remains foreign source income. No similar exception applies to interest paid by a foreign partnership.

AJCA provides that interest paid by foreign partnerships is treated in a manner similar to interest paid by foreign corporations. The change would apply only to foreign partnerships predominantly engaged in the active conduct of a trade or business outside the U.S. Under the act, interest paid is treated as U.S. source income only if the interest (1) is paid by a U.S. trade or business conducted by the partnership, or (2) is allocable to income that is treated as effectively connected with the conduct of a U.S. trade or business.

Effective Date: Tax years beginning after December 31, 2003.

4. Effectively Connected Income to Include Certain Foreign Source Income

Federal Law Change: Nonresident aliens and foreign corporations are subject to U.S. taxation in the same manner as U.S. persons on income that is effectively connected to the conduct of a U.S. trade or business. Foreign persons are generally not taxed on foreign-source income not effectively connected with a U.S. trade or business. All U.S. source income is generally treated as effectively connected income.

AJCA expands the types of foreign source income considered to be effectively connected with a U.S. trade or business to include income or gain that is equivalent to the types listed above. Under prior law, only the following types of income were included in effectively-connected foreign source income, and only to the extent attributable to an office or fixed place of business in the U.S.:

- rents and royalties for the use or privilege of using intangible property in the active conduct of a trade or business;
- dividends or interest derived from the active conduct of banking, finance or similar business in the U.S. or received by a corporation in the principal business of trading stock or securities for its own account; or
- gain or loss derived through a U.S. office from the sale or exchange outside the U.S. of personal property, unless the foreign office materially participated and the property was sold for use outside the U.S.

Thus, AJCA treats economic equivalents as U.S. effectively connected income in the same circumstances as the treatment applies to rents, royalties, dividends, interest or inventory sales. An example of an economic equivalent is the forgiveness of part of a loan rather than rent or royalties paid for use of an intangible.

Effective Date: For tax years beginning after October 22, 2004.

5. Tax Treatment of Expatriated Entities and Their Foreign Parents

Federal Law Change: The U.S. tax treatment of a multinational corporate group depends significantly on whether the parent corporation is domestic or foreign. Corporations are considered domestic corporations if they are incorporated under the laws of the U.S. or any state. Otherwise, they are treated as foreign corporations. Domestic corporations are taxed on their worldwide income; foreign corporations are taxed on income that is effectively connected with the conduct of a U.S. trade or business and certain other categories of U.S. source income.

Under this regime, a multinational corporate group could reduce U.S. tax liability by replacing its U.S. parent with a foreign parent corporation through an inversion transaction. Using corporate inversions, companies incorporate overseas, in Bermuda and other countries, and transfer stock and other assets to the foreign corporation that is leased back to the domestic corporation.

AJCA defines two types of corporate inversions and establishes a different set of consequences for each:

- *80% Inversions*. These transactions involve at least 80% identity of stock ownership. In this inversion, a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity and the former shareholders of the U.S. corporation hold 80% or more of the stock (by vote or value) of the foreign entity after the transaction. The foreign entity, considered together with all companies connected to it by a chain of greater than 50% ownership, does not have substantial business activities in the country of incorporation.

  AJCA deems the foreign corporation in an 80% inversion as a domestic corporation for all purposes of the Internal Revenue Code.

- *60% Inversions*. These transactions involve at least 60% identity of stock ownership, but less than 80%, and otherwise meet the requirements of the 80% inversion.

  Under AJCA, the inverted U.S. corporation and U.S. related persons are subject to certain restrictions. With limited exceptions, applicable "toll charges" (including income or gain recognized as a result of the transfer) are not offset by tax attributes.

Inversion transactions include certain transactions involving partnerships if the foreign entity acquires substantially all of the properties constituting a trade or business of a domestic partnership if they otherwise meet the 80% or 60% inversion requirements and a substantial business activities test. The tax consequences apply at the partner level.

Effective Date: For tax years ending after March 4, 2003. However, an inversion transaction is not treated as an inversion if, on or before March 4, 2003, the foreign entity acquired more than 50% of the properties held by the domestic corporation, or more than 50% of the properties constituting the partnership trade or business.

6. Prohibition of Nonrecognition of Gain Through Liquidation of Holding Company

Federal Law Change: A U.S. corporation owned by a foreign person is subject to U.S. income tax on its net income. Also, earnings of a U.S. corporation are subject to tax when dividends are paid to the corporation's shareholders.

AJCA treats as a dividend any distribution of earnings by an "applicable holding company" to a foreign corporation in a complete liquidation. An applicable holding company is a domestic corporation that is a common parent of an affiliated group, its stock is directly owned by the distributee foreign corporation, substantially all of its assets are stock in other members of the affiliated group, and it has been in existence for less than five years. The Internal Revenue Service is authorized to issue rules to prevent abuse of the provision.

Effective Date: For distributions of occurring on or after October 22, 2004, the date of enactment.

7. Residence and Source Rules Relating to U.S. Possessions

Federal Law Change: AJCA provides a definition of bona fide resident of U.S. possessions for purposes of the tax treatment of U.S. citizens who are such residents and have possession source income or income effectively connected to the conduct of a trade or business within a possession.

The act defines a bona fide resident of U.S. possessions by a two-part test: (1) the person must be present in the possession for 183 days each tax year, and (2) the person cannot have a tax home outside the U.S. possession during the tax year or have a closer connection to the U.S. or a foreign country during the tax year. Similar rules to those for determining U.S. source income are provided for determining U.S. possession source income.

U.S. possessions include Guam, American Samoa, the Northern Mariana Islands, Puerto Rico and the Virgin Islands.

Effective Date: For tax years ending after October 22, 2004.

8. Clarification of Banking Business for Determining Investment Earnings

Federal Law Change: U.S. shareholders of a controlled foreign corporation (CFC) must include their proportionate shares of certain income in U.S. gross income regardless of whether it is distributed. A foreign corporation is a CFC if more than 50% of its total voting power or value is owned by a U.S. shareholder for an uninterrupted period of 30 or more days during the year. Gross income includes earnings from U.S. property, which is broadly defined to include tangible real and personal property located in the U.S., stock of a domestic corporation, obligations of U.S. persons, or rights to use U.S.

patents, copyrights, inventions, models, designs, secret formulas or processes, or other similar property.

AJCA clarifies an exception to the definition of U.S. property relating deposits with persons carrying on the banking business by replacing that phrase with definitions from the Bank Holding Company Act of 1956. The exception is limited to deposits with any bank or corporation in which a bank holding company or financial holding company owns more than 80% of the vote or value of the corporation's stock. A bank is defined as an institution organized under U.S. law that accepts demand deposits and is engaged in the business of making commercial loans. A bank holding company is a company with control over a bank by owning at least 25% of any class of securities or by controlling the majority of the directors or trustees, or is determined to exercise controlling influence over management policies.

Effective Date: October 22, 2004.

9. Prevention of Mismatching Between Deductions and Income Inclusions

Federal Law Change: Under original issue discount (OID) rules, the holder of a debt instrument that is issued at a discount is required to accrue daily portions of the discount and include the amounts in income. OID is the difference between the issue price and the stated redemption price at maturity. Generally, the daily accruals are deductible for the issuer. When a foreign person related to the issuer holds the debt, the accrued OID is not deductible until it is paid to the related foreign person. Accrued OID that is owed to a related foreign person can be deducted before it is paid as long as it is effectively connected income to the foreign person and fully subject to U.S. tax.

Under AJCA, amounts accrued but unpaid to related persons are deductible only to the extent that the amounts are currently includible in the income of U.S. owners of the related foreign corporation. Deductions accrued but not allowed are taken when the amounts are paid. This provision is intended to apply to OID, interest and other amounts that are noneffectively connected foreign source income of a related foreign person.

Effective Date: Payments accrued on or after October 22, 2004.

10. Reinsurance of U.S. Risks in Foreign Jurisdictions

Federal Law Change: In the case of reinsurance agreements between related persons, the IRS may allocate deductions, assets, reserves, credits and other items related to the agreements among the parties or make other adjustments to reflect the proper source and character of the items.

AJCA replaces the term "source and character" with the term "amount, source and character" to reflect the broad authority of the IRS. The change is not intended to indicate more authority than exists in current law.

Effective Date: Any risk reinsured after October 22, 2004.

11. Delay in Regulations Governing Exclusion from Operation of Ships or Aircraft

Federal Law Change: AJCA delays the effective date of regulations relating to income derived from foreign corporations from the international operation of ships and aircraft to taxable years of a foreign corporation seeking qualified foreign corporation status beginning after September 24, 2004.

Effective Date: October 22, 2004.

D. EXPENSING AND DEPRECIATION PROVISIONS

1. Election to Expense Qualified Reforestation Costs

Federal Law Change: AJCA allows a taxpayer to elect to expense up to $10,000 of qualified reforestation expenses each year. Under prior law, a taxpayer could depreciate up to $10,000 of qualified reforestation expenses over seven years. Qualified costs include planting or seeding, site preparation, labor and tools.

Effective Date: Expenditures paid or incurred after October 22, 2004.

2. Expensing of Capital Costs Incurred in Complying with EPA Sulfur Regulations

Federal Law Change: AJCA allows small business refiners to elect to expense up to 75% of costs paid or incurred for complying with rules to limit the amount of sulfur in gasoline and highway diesel fuel that were issued recently by the Environmental Protection Agency (EPA). Generally, taxpayers would be allowed an annual depreciation deduction for such costs.

Qualifying expenditures are those paid with respect to a facility beginning January 1, 2003, and ending either one year after the date that the taxpayer must comply with EPA regulations or December 31, 2009, whichever is earlier. A small business refiner is a taxpayer in the business of refining petroleum products that has employs no more than 1,500 employees directly in refining and has less than 205,000 barrels on average per day of total refinery capacity.

Effective Date: Expenses paid or incurred after December 31, 2002 in taxable years ending after that date.

3. Depreciation of Certain Leasehold Improvement and Restaurant Property

Federal Law Change: AJCA establishes a 15-year depreciation recovery period for certain leasehold improvement and restaurant property that are part of a building; under prior law, the recovery period was 39 years. The act requires the property be recovered using a straight-line method of depreciation. Qualified improvements must be placed in service more than three years after the date the building was first placed in service.

Qualified leasehold improvement property is an improvement to an interior portion of nonresidential real property under or pursuant to a lease. The lessor and lessee may not be related. Expenditures to enlarge a building, for elevators or escalators or structural components of common areas do not qualify. For restaurant property to be qualified, 50% of the building's square footage must be devoted to on-premises consumption of prepared meals.

Effective Date: Property placed in service after October 22, 2004.

4. Reform Tax Treatment of Leasing Arrangements to Tax-Exempt Entities

Federal Law Change: A tax-exempt or tax-indifferent entity (charitable organization, governmental unit, foreign person or entity) generally is not able to take advantage of depreciation and other deductions for property it owns. However, certain arrangements, such as sale-in, lease-out (SILO) arrangements, effectively transfer those deductions to taxpayers that can use them. In a SILO arrangement, a taxpayer purchases property, such as buses, subways, sewers and bridges, from a municipality and immediately leases it back to the original owner. The taxpayer claims the deduction and the tax savings are apportioned between the parties according to their agreement.

Depreciation rules requiring that tangible property leased to a tax-exempt entity using straight-line depreciation over the class life or 125% of the lease term, whichever is longer, discourage such arrangements, since this recovery period is usually considerably longer than normal recovery periods.

AJCA modifies the recovery period for technological equipment, computer software and certain other intangible property to at least 125% of the lease term, even if some shorter period has previously been specifically assigned to that type of property. Under prior law, technological equipment, computer software and other property leased for a short term was not included in the definition of tax-exempt property. In addition, the act provides that the lease term for purposes of the 125% rule includes all service contracts and other similar arrangements that follow a lease of property and are part of the same transaction as the lease.

Effective Date: Leases entered into after March 12, 2004. The provision does not apply to qualified transportation equipment located in the U.S. and subject to a lease that meets specific requirements.

5. Deductions for Property Used by Governments or Other Tax-Exempt Entities

Federal Law Change: AJCA limits a taxpayer's aggregate deductions directly allocated to property leased to a government or other tax-exempt entity to the amount of the taxpayer's income from the property for the tax year. Deductions limited include depreciation and interest expense. The provision also applies to property owned by a partnership that has a tax-exempt entity as a partner, but not to property that qualifies for the federal low-income housing or rehabilitation credits.

A lease to a tax-exempt entity is not subject to the limits if it satisfies all of the following requirements:

(1) the tax exempt entity does not monetize its lease obligation beyond an acceptable amount;
(2) if the lease is longer than five years, the taxpayer makes and maintains a substantial equity in the leased property and the lessee does not assume or retain more than a minimal amount of risk; and

(3) if the class life of the property is more than seven years and the lessee has an option to purchase the property, the purchase price under the option equals the fair market value of the property determined at the time the option is exercised.

Effective Date: Leases entered into after March 12, 2004. The provision does not apply to qualified transportation equipment located in the U.S. and subject to a lease that meets specific requirements.

6. Depreciation of Certain Motor Racetrack Facilities

Federal Law Change: AJCA provides a seven-year depreciation period for motor sports entertainment complexes if they are permanent racing track facilities that schedule at least one public racing event for automobiles, trucks or motorcycles during the three year period after being placed in service. Under prior law, most property associated with theme parks or amusement parks is depreciated over a seven-year period, but motor racetracks have sometimes been treated as 15-year property. The seven-year recovery period would apply to land improvements and support facilities, but not to transportation equipment, warehouses, administrative buildings, hotels and motels.

Effective Date: Property placed in service after October 22, 2004, and before 2008.

7. Modification of Application of Income Forecast Method of Accounting

Federal Law Change: Depreciation under the income forecast method of accounting is determined by multiplying the adjusted basis of property by a fraction equal to income generated during the year divided by total forecasted income over the first ten tax years. This method of depreciation is often used for films, videos, sound recordings and other creative properties.

Under AJCA, taxpayers can include participations and residuals in their adjusted basis in the year the property is placed in service and income used in the computation is gross income, not income reduced by distribution costs.

Effective Date: Property placed in service after October 22, 2004.

8. Depreciation of Sports Franchises

Federal Law Change: AJCA allows the amortization of sports franchises and items acquired in connection with the franchise over 15 years. In addition, the act repeals for special rules determining the basis in player contracts when a sports franchise is sold or exchanged and the transfer of player contracts is part of the sale.

Effective Date: For property and franchises acquired after October 22, 2004.

9. Depreciation of Utility Grading Costs

Federal Law Change: AJCA provides a 15-year recovery period for improvements related to gas utility property and a 20-year period for improvements related to electric utility property.

Effective Date: Property placed in service after October 22, 2004.

10. Certain Alaska Natural Gas Pipeline Property Treated as Seven-Year Property

Federal Law Change: AJCA establishes a seven-year recovery period and a class life of 22 years for any Alaska natural gas pipeline system placed in service after December 31, 2013. To qualify, the property must be located in Alaska and have a capacity of more than 500 billion Btu of natural gas per day. In addition, the property must either be placed in service after 2013 or the taxpayer who placed the system in service earlier must elect to have it treated as placed in service on January 1, 2014.

Effective Date: Property placed in service after 2004.

11. Consistent Amortization Period for Start-Up and Organizational Expenditures

Federal Law Change: AJCA allows a deduction up to $5,000 per business for start-up expenditures of a trade or business, organizational expenditures for a corporation, and organizational and syndication fees for a partnership in the year in which the business begins. Any excess is deducted ratably over a 15-year period. The $5,000 deduction is reduced dollar-for-dollar as expenditures exceed $50,000.

Under prior law, a taxpayer could elect to amortize certain otherwise nondeductible start-up, organizational or organizational and syndication fees over a period of not less than 5 years. Start-up expenditures were deductible as trade or business expenses if they were incurred after the business began operating.

Effective Date: Amounts paid or incurred after October 22, 2004; however, amounts incurred both before and after October 22, 2004, are considered in determining whether the $50,000 limit is exceeded.

12. Deduction for Clean-Fuel Vehicles

Federal Law Change: WFTRA eliminates a phase-out limitation for qualified clean-fuel vehicles placed in service in tax years 2004 and 2005. Under prior law for years prior to 2004, taxpayers were allowed to deduct the cost of a clean-fuel vehicle in the year in it was placed in service. This deduction was reduced by 25% of the cost of the vehicle in 2004, by 50% of the cost in 2005 and by 75% of the cost in 2006. WFTRA restores the 100% deduction for 2004 and 2005, and retains the 75% reduction for 2006.

Effective Date: Property placed in service after December 31, 2003.

13. Recovery Periods for Indian Reservation Property

Federal Law Change: WFTRA extends for one year, to December 31, 2005, shortened recovery periods for depreciable property used on Indian reservations. These provisions otherwise would have expired on December 31, 2004. Because Wisconsin may not tax tribal entities, adoption of this provision has a limited fiscal impact.

Effective Date: October 4, 2004.

E. S CORPORATION REFORM AND SIMPLIFICATION

1. Treat Members of a Family as One Shareholder

Federal Law Change: An S corporation is a corporation that is not taxed at the entity level; instead, income, loss, deductions and credit are passed through to shareholders who report these items in calculating their individual income tax liability. S corporation election is popular with closely held businesses because it offers limited liability protection and because income is subject to the individual income tax only, and not the corporate income tax as well.

Under AJCA, all members of a family within six generations are treated as a single shareholder. Under prior law, a husband and a wife were treated as one shareholder.

Effective Date: Taxable years beginning after December 31, 2004 and for elections and terminations after December 31, 2004.

2. Increase the Number of Eligible Shareholders to 100

Federal Law Change: AJCA increases the maximum number of shareholders for an S corporation from 75 to 100.

Effective Date: Taxable years beginning after December 31, 2004.

3. Transfer of Suspended Losses Incident to Divorce

Federal Law Change: Under AJCA, if S corporation stock is transferred to a shareholder's spouse, or former spouse incident to a divorce, any suspended loss or deduction is treated as incurred by the S corporation in the subsequent taxable year.

A suspended loss is one that exceeds the basis of the shareholder in stock and debt of the corporation. Under prior law, a loss or deduction was not allowed to S corporation shareholders of S corporations if the loss was a suspended loss, but was carried over to subsequent tax years only with respect to that shareholder. If the shareholder transferred all of his or her shares to another person, the suspended losses and deductions were irretrievably disallowed and not available to any shareholder. Thus, AJCA allows the spouse or former spouse to whom stock is transferred to claim the suspended losses in subsequent years if the S corporation has taxable income or the transferee has basis in the stock.

Effective Date: Taxable years beginning after December 31, 2004.

4. Disregard of Unexercised Powers of Appointment

Federal Law Change: An electing small business trust (ESBT) is permitted to be a shareholder in an S corporation. An ESBT is a trust that does not have any beneficiaries other than individuals or estates eligible to be S corporation shareholders, except that charitable organizations may hold contingent remainder interests. The portion of any ESBT that consists of stock in one or more S corporations is treated as a separate trust. An ESBT is taxed at the maximum individual rate on ratable shares of income, deduction, gain or loss passed through from the S corporation.

Persons are treated as shareholders during the period they may receive distribution from the trust for purposes of determining the maximum number of shareholders (potential current beneficiaries). AJCA narrows the definition of "potential current beneficiaries" by disregarding power of appointment if the power of appointment is unexercised.

Effective Date: For taxable years beginning after December 31, 2004.

5. Qualified Subchapter S Trust Income Beneficiaries

Federal Law Change: A qualified Subchapter S trust (QSST) can be a shareholder of an S corporation. A QSST is generally a trust with only one income beneficiary for the life of the beneficiary, who is taxed on the QSST share of income of the S corporation. However, the QSST and not the beneficiary is treated as the owner of the S corporation stock in disposition. Under AJCA, the beneficiary is generally allowed to deduct suspended losses under the at-risk and passive activity loss rules when the trust disposes of the S corporation stock.

The act also limits, for certain taxpayers, deductions from specified leveraged investment activities to aggregate amounts the taxpayer has "at risk." Taxpayers are considered at risk for amounts of money and the adjusted basis of property the taxpayer contributed to the activity and for borrowed amounts to the extent the taxpayer is personally liable.

Effective Date: Transfers after December 31, 2004.

6. Expand Bank S Corporation Eligible Shareholders to Include IRAs

Federal Law Change: Banks may elect S corporation status; however, prior law did not permit individual retirement accounts (IRAs) to be members of an S corporation. As a result, when bank employees owned stock in the bank through their IRAs, banks had to remove the shares out of the IRAs in order to make the S corporation election.

AJCA permits a bank to elect S corporation status without first redeeming shares held by an IRA. The act allows an IRA to be a shareholder of a bank that is an S corporation to the extent of bank stock held by the IRA on October 22, 2004. The individual for whose benefit the IRA is held is treated as the shareholder. The act also provides an exemption from the prohibited transaction rules when an IRA sells bank stock to an IRA beneficiary if the sale is pursuant to an S corporation election and is for fair market value, if the IRA incurs no commissions or expenses from the sale, and if the stock is a single transaction for cash within 120 days after the S corporation election is made.

Effective Date: October 22, 2004.

7. Exclusion of Investment Securities Income from the Passive Income Test

Federal Law Change: An S corporation election is terminated if the S corporation has accumulated earnings and profits for three consecutive years and more than 25% of its gross receipts is passive investment income. Passive income includes gross receipts from royalties, rents, dividends, interest, annuities and sales or exchanges of stock or securities.

Under AJCA, interest income and dividends on assets required to be held by a bank, bank holding company or financial holding company are not considered passive investment income for applying the excess net profit rules.

Effective Date: Taxable years beginning after December 31, 2004.

8. Relief from Inadvertently Invalid Qsub Elections and Terminations

Federal Law Change: AJCA allows the IRS to waive inadvertent qualified Subchapter S subsidiary (Qsub) elections and terminations, in addition to waivers of inadvertent Subchapter S corporation elections and terminations permitted under prior law. A Qsub includes any domestic corporation that qualifies as an S corporation, is 100% owned by an S corporation parent and makes the proper election. Inadvertent elections and terminations can occur because S corporations and their shareholders are frequently unfamiliar with the technical or procedural requirements of the elections.

The act also permits an S corporation to own a Qsub, and provides that the Qsub is not taxed as a separate corporation, but treats all of its tax items as belonging to the parent.

Effective Date: For elections and terminations after December 31, 2004.

9. ESOP Repayment of Exempt Loans with Distributions from S Corporation Stock

Federal Law Change: A loan to an employee of a stock ownership plan (ESOP) is not a prohibited transaction between an employee benefit plan and a disqualified person if certain requirements are met. An ESOP is often funded by a loan from a bank or the employer and the loan proceeds are used to purchase employer securities. Typically, most of the employer securities are held in a plan suspense account and allocated as the loan is repaid. The loan is repaid as the employer makes annual plan contributions. In a C corporation, dividends paid on stock held by the plan can be used to repay the loan, if certain requirements are met.

AJCA provides that an S corporation ESOP does not violate the qualification requirements or is not deemed to have made a prohibited transaction merely because a distribution relating to S corporation stock held by the ESOP is used to repay the ESOP loan. Special provisions that apply to C corporations will also apply to S corporation distributions.

Effective Date: Distributions of S corporation stock made after December 31, 2004.

F. REGULATED INVESTMENT COMPANIES AND REAL ESTATE INVESTMENT TRUSTS

1. Net Income of Publicly Traded Partnerships Treated as Qualifying Income of RICs

Federal Law Change: Regulated investment Companies (RICs), commonly referred to as mutual funds, are domestic corporations that act as investment agents for shareholders. RICs are entitled to a deduction for dividend payments against ordinary income and net capital gain.

At least 90% of the gross income of a RIC must be derived from dividends, interest, payments with respect to securities loans and gains from the sale of stock or securities, or other investment income. Under prior "look-through" rules, income from a partnership met that requirement only if it would have met the requirement if it were income of the RIC itself. AJCA modifies this rule so that it applies only to income from a partnership that is not a publicly traded partnership. Generally, publicly traded partnerships (whose interests are traded on an open exchange) are treated as corporations for income tax purposes, but an exception exists if at least 90% of gross income is interest, dividends, real property rents or other qualifying income. A special rule exists for publicly traded partnerships under passive loss rules that apply the rules separately to items attributable to each partnership.

RICs are also subject to limitations on the composition and ownership of assets. Under composition rules, no more than 25% of assets may be invested in securities of any one issuer or in securities of two or more controlled issuers in the same trade or business. Under ownership rules, at least 50% of the assets must be cash, government securities, securities of other RICs and other securities (so long as the securities of other issuers do not exceed 5% of the value of the corporation's assets or 10% of the issuer's outstanding voting securities).

AJCA provides that the limitations on composition and ownership of assets that apply to other investments also apply to investments in publicly traded partnership interests and that income derived from publicly traded partnerships is income that can be included in determining whether the 90% rule is satisfied. The act also clarifies that the special passive loss rule for publicly traded partnerships also applies to a RIC holding a partnership interest.

Effective Date: Taxable years beginning after October 22, 2004.

2. Asset and Income Requirements for REITs

Federal Law Change: A Real Estate Investment Trust (REIT) is any domestic corporation, trust or association that acts as an investment agent specializing in real estate and real estate mortgages. REITs are treated as pass-through entities because they are allowed a deduction for dividend payments against ordinary income and net capital gains.

Under prior law, 75% of a REIT's assets had to be invested in real estate, cash and government securities. Securities could not represent more than 25% of the value of the REIT's assets. Further, securities of any one issuer could not represent more than 5% of the value of REIT assets, more than 10% of the voting securities of any one issuer nor more than 10% of the value of outstanding securities of any one issuer.

Under prior law, the 10% test for value of the issuer did not include straight debt if the issuer was an individual, if the only securities of the individual held by the REIT were straight debt, or if the issuer was a partnership and the trust held at least 20% profits interest in the partnership. Generally, straight debt is a written unconditional promise to pay a certain sum on demand or on a specified date if the interest rate is not contingent on profits, the borrower's discretion or other factors. REITs may hold stock of taxable REIT subsidiaries if the value of all taxable REIT securities held by the REIT do not exceed 20% of the REITs assets. A taxable REIT subsidiary is a corporation other than a REIT with which the REIT makes a joint election to be subject to special rules.

AJCA expands the types of securities that are excluded from the 10% test for value of the issuer and makes other changes to the provisions. Not included in the 10% test for value of the issuer are loans to individuals and estates; certain rental agreements; obligations to pay rent from real property; certain securities issued by a state or its political subdivision, District of Columbia, foreign government or its political subdivision, or the Commonwealth of Puerto Rico; securities issued by a REIT; or other arrangements determined by the IRS to be an exception. The act also makes several changes to the straight debt exception so that an obligation does not fail to qualify as straight debt solely because the time or payment is subject to specified contingencies. The straight debt change is not available to a corporate or partnership issuer under certain circumstances.

Under prior law, at least 95% of gross income of a REIT had to be derived from certain passive sources and at least 75% from certain real estate sources, including rents from real property and gain from the sales or other disposition of real estate. Payments to a REIT in hedging transactions and gain from the disposition of the investment were treated as qualifying income for the 95% test. REITs that failed to meet the 95% and 75% tests would not lose REIT status if they met other requirements: they attached an income disclosure schedule to their income tax return and any errors were not due to willful neglect. The REIT would have to pay a tax measured by the greater of the amount by which 90% of REIT gross income exceeded items subject to the 95% test multiplied by the net income of the REIT, or the amount by which 75% of the gross income exceeded items subject to the 75% test times the net income of the REIT.

Under AJCA, income and gain from hedging transactions are excluded from gross income for purposes of the 95% test. The tax liability for a REIT that fails the 95% income test is recalculated so that the tax is measured by the amount by which 95% of REIT gross income exceeds items subject to the 95% test.

Effective Date: Tax years beginning after 2000, except some changes are effective for tax years beginning after October 22, 2004.

3. Taxable REIT Subsidiaries

Federal Law Change: Taxable REIT subsidiaries can engage in business operations that produce income that does not qualify for the 95% and 75% income tests (see previous item) because the taxable subsidiary income is not attributable to the REIT. Transactions between the taxable subsidiary and the REIT are subject to rules intended to prevent shifting taxable income to the pass-through REIT or shifting expenses to the subsidiary. A 100% excise tax on rents received by the REIT as a result of services rendered by the taxable subsidiary can be imposed in certain circumstances.

AJCA deletes an exception to imposition of this excise tax for services that are customarily furnished or rendered in connection with the real property rental. The act provides new safe harbor rules for testing whether 90% of REIT property is rented to unrelated persons and whether rents paid by related persons are substantially comparable to unrelated party rent. The tests must be satisfied at the time the lease is entered into, at the time of each extension and at the time of certain other modifications.

The new tests are available only for permitting rents from a taxable subsidiary to be treated as qualified income for the 95% and 75% income tests.

Effective Date: Tax years beginning after 2000.

4. Consequences for Failure to Meet REIT Requirements

Federal Law Change: AJCA allows a REIT to avoid disqualification in the event of certain failures if the failure was not the result of willful neglect, it was corrected and a penalty was paid. Only certain limited failures are eligible for relief and additional conditions apply.

Effective Date: Tax years beginning after 2000.

5. Modification of FIRPTA for REITs

Federal Law Change: Special tax rules, collectively referred to as the Foreign Investment Real Property Tax Act (FIRPTA), apply to gains of foreign persons in dispositions of U.S. real property involving REITs. FIRPTA generally provides that a foreign person is subject to U.S. tax on any gain from a disposition of U.S. real property at the same rates that apply to similar income of U.S. persons. Receipt of a distribution from a REIT is treated as a disposition of a U.S. real property interest to the extent that it is attributable to a sale or exchange of a U.S. real property interest by the REIT. Recipients are treated as having income effectively connected to a U.S. trade or business and are required to file U.S. tax returns.

Under AJCA, a capital gain REIT distribution to a foreign investor is not treated as effectively connected trade or business income if the distribution is received with respect to a class of stock regularly traded on an established securities market in the U.S. and the foreign investor does not own more than 5% of the stock at any time during the tax year in which the distribution was made.

Effective Date: Tax years beginning after October 22, 2004.

6. Modification of Safe Harbor Rules for Timber REITs

Federal Law Change: A REIT has to derive income from certain types of passive income, primarily rents from real property and interest on mortgages secured by real property. AJCA codifies the IRS position, previously outlined in private letter rulings, that the sales of trees does not constitute prohibited transactions under REIT rules, if certain requirements are met. To not be considered a prohibited transaction:

(1) the asset must have been held for at least four years in the trade or business of producing timber;
(2) the aggregate expenditures of the REIT during the previous four years that are directly related to timber production cannot exceed 30% of the net selling price of the property;
(3) the aggregate expenditures during the previous four years that are includible in the basis of the property and not directly related to timber production cannot exceed 5%;

(4) the REIT does not make more than seven sales of property or the aggregate adjusted bases of property sold during the year does not exceed 10% of the aggregate bases of all property of the REIT;
(5) substantially all of the marketing expenditures of the property are made by persons who are independent contractors and from whom the REIT does not derive any income; and
(6) the sales price is not based on income or profits of any person, including income or profits from the sale of the properties.

Effective Date: Taxable years beginning after October 22, 2004.

7. Repeal FASITs and Liberalize Use of REMICs

Federal Law Change: AJCA repeals the rules that permit financial asset securitization investment trusts. A FASIT pools revolving, nonmortgage consumer debt, such as credit card receivables, home equity loans and automobile loans, and issue its own debt obligations with terms that differ from the underlying debts. By combining loans and remarketing them as securities, risk can be spread among many investors. FASITs are frequently abused and used for tax avoidance. The repeal does not apply to FASITs in existence on October 22, 2004, the date of enactment, to the extent that certain issues remain outstanding under original terms.

AJCA also modifies rules to liberalize the use of real estate mortgage investment conduits. REMICs are self-liquidating pass-through entities that hold fixed pools of mortgages and issue several classes of investor interests. REMICs were enacted to facilitate the securitization of fixed pools of mortgages. An entity may qualify as a REMIC if substantially all of its assets consist of qualified mortgages and permitted investments within three months after the start up date. The modified rules allow certain types of real estate loans and loan pools to be transferred to or purchased by a REMIC. The act also amends definitions of "regular interests," "permitted investments," and "qualified mortgages" of REMICs to allow securitization of reverse mortgages and certain obligations of the U.S. and any state that are secured by real property.

Effective Date: January 1, 2005, but a transition period is provided for existing FASITs.

G. OTHER PARTNERSHIPS

1. Recognition of Cancellation of Indebtedness Income

Federal Law Change: Subject to certain exceptions, a creditor's cancellation of debt can result in gross income to the debtor. A corporation that transferred shares of stock in satisfaction of debt is required to recognize cancellation of indebtedness income in the amount that would have been realized if the debt were satisfied with money equal to fair market value. Under prior law, this provision did not apply to partnerships.

AJCA applies the stock for indebtedness provision to partnership interests. Cancellation of indebtedness under this rule is required to be allocated solely among partners who hold interests immediately prior to satisfaction of the debt.

Effective Date: Cancellation of indebtedness occurring on or after October 22, 2004.

2. Treatment of Partnership Loss Transfers and Partnership Basis Adjustments

Federal Law Change: Generally, no gain is recognized by either a partnership or its partners when property is contributed to the partnership in exchange for partnership interest. The partnership takes a carryover basis in the property and the contributing partners increase their basis in the partnership interest by the adjusted basis of the contributed property. Items of taxable income, gain, loss and deduction regarding the contributed property are allocated among partners to take into account built-in gain or loss at the time of transfer to prevent the transfer of built-in gain or loss to other partners.

Under prior law, if the contributing partner transferred his or her partnership interest, the built-in gain or loss was allocated to the transferee. Thus, losses could be transferred if the contributing partner no longer remained a partner. Also under prior law, the partnership generally did not adjust the basis of the partnership property following the transfer or liquidation of partnership interest, or following a distribution to a partner. The partnership could make an election to adjust the basis in either case.

Under AJCA, a built-in loss (not a gain) is taken into account only by the contributing partner. In determining the amount of items allocated to other partners, the basis of the contributed property is its fair market value at the time of contribution. If the contributing partner's partnership interest is transferred or liquidated, the partnership's adjusted basis in the contributed built-in loss property is its fair market value at the time of contribution. As a result, any built-in loss is eliminated. The act also makes basis adjustments of the partnership mandatory if there is substantial basis reduction or built-in loss, generally more than $250,000.

The act also provides special rules for electing investment partnerships and securitization partnerships. A partnership is an electing investment partnership if:

(1) it makes an election;
(2) it would satisfy certain requirements of the Investment Company Act of 1940 for investment companies;
(3) it has never been engaged in a trade or business;
(4) substantially all of its investments are held for investment;
(5) at least 95% of the assets contributed consist of money;
(6) no contributed assets have an adjusted basis in excess of fair market value at the time of contribution;
(7) all partnership interests are issued pursuant to a private offering during a two-year period beginning with the first capital contribution;
(8) the partnership agreement has substantial restrictions on each partner's ability to cause a redemption of the partner's interest; and
(9) the partnership agreement provides for a term not in excess of 15 years.

Under the act, an electing investment partnership is not required to make basis adjustments. Instead, a partner-level loss limitation rule applies under which the transferee partner's distributive share of losses from the sale or exchange of property is not allowed, except to the extent that losses exceed the loss recognized by the transferor partner.

A partnership is a securitization partnership if its sole business activity is to issue securities that provide fixed principal amounts that are primarily serviced by the cash flows of a discrete pool or receivables or other assets that convert into cash in a finite period. The sponsor of the pool must reasonably believe that the receivables or other assets of the pool are not acquired to be disposed of. Securitization partnerships are not required to make basis adjustments to partnership property. The partner loss-level rule does not apply.

Effective Date: Generally, contributions, distributions and transfers after October 22, 2004.

3. No Reduction of Certain Basis in Stock Held by Partnership in Corporate Partner

Federal Law Change: When a partnership distributes money or other property to a partner, the basis of the undistributed partnership property is generally not adjusted. If the partnership makes an election, the basis of undistributed partnership property is adjusted to reflect gain or loss recognized by the distributee partner and change to the basis of the property. In the case of a partnership holding stock of a corporate partner, these rules could cause the basis of stock to be reduced as a result of a distribution of other property. However, any gain on subsequent disposition of the stock could escape taxation because provisions of the IRC generally exempt a corporation from recognizing gain on the sale of its own stock.

AJCA provides that in the case of liquidations of a partner's interest, a partnership may not decrease the basis of corporate stock of a partner or related person. Any decrease that may have been allocated to the stock is allocated other partnership assets. If the decrease exceeds the basis of other partnership property, the partnership recognizes gain equal to the amount of the excess.

Effective Date: Distributions after October 22, 2004.

H. OTHER BUSINESS PROVISIONS

1. Special Rules for Livestock Sold on Account of Weather-Related Conditions

Federal Law Change: A taxpayer can defer recognition of gain on certain property that is involuntarily converted if similar replacement property is purchased within a specified period of time. AJCA expands the rules for involuntarily converted livestock. Under the act, the applicable period for a taxpayer to replace certain livestock sold because of drought, flood or other weather-related conditions is extended from two to four years after the close of the first taxable year in which the taxpayer realized gain on the involuntary conversion. The IRS may extend the four-year period on a regional basis if the weather-related conditions last longer than three years. Gain can be deferred if the proceeds of the conversion are invested in other farming property, not including real property, if the conversion is from drought, flood or other weather-related conditions.

Effective Date: Tax years for which a return is due, without regard to extensions, after December 31, 2002.

2. Payment of Dividends on Stock Cooperatives

Federal Law Change: A cooperative is not taxed as long as any patronage income is distributed to its members. Patronage dividends are amounts paid based on the quantity and net income attributable to business done with the patron. A cooperative may deduct dividends paid to patrons from taxable income, but only to the extent of net income derived from transactions with its members. Special allocation rules limit the amount that can be attributed to patronage dividends and may impose penalties for cooperatives that issue and pay dividends on capital stock, which discourages the cooperative from issuing non-voting stock as a method of raising capital.

AJCA provides that dividends, to the extent provided in the cooperative's organizational documents, do not reduce patronage income or prevent the cooperative from operating on a cooperative basis.

Most cooperatives are not subject to tax in Wisconsin, so this provision has a limited fiscal impact.

Effective Date: Distributions in tax years beginning after October 22, 2004.

3. Capital Gain Treatment of Outright Sales of Standing Timber

Federal Law Change: AJCA eliminates the requirement that a landowner retain an economic interest in timber cut from land in order to qualify to treat gains as capital gains. Under the act, outright timber sales also qualify for capital gain treatment.

Effective Date: Timber sales after December 31, 2004.

4. Modifications to Cooperative Marketing Rules for Processing of Animals

Federal Law Change: Cooperatives of farmers, fruit growers and other persons engaged in similar pursuits may qualify for tax-exempt status if organized and operated for the purpose of marketing the products of members and returning net proceeds to them or for purchasing supplies and equipment for use by the members at cost plus expenses. Entities that qualify as cooperatives are subject to special tax rules, including a provision that allows farmers to deduct patronage dividends paid to its members based on the quantity and net earnings of the cooperative attributable to business with the members.

AJCA provides that marketing expenses for purposes of calculating net earnings of a cooperative includes expenses for feeding farm animals (cattle, hogs, fish, chickens, or other animals) in anticipation of the sale of the animals or the products derived from the animals. As a result, the expense is included in calculating the patronage dividends for members.

Most cooperatives are not subject to tax in Wisconsin, so this provision has a limited fiscal effect.

Effective Date: Taxable years beginning after October 22, 2004.

5. Treatment of Certain Income of Rural Electric Cooperatives

Federal Law Change: A cooperative may qualify for tax-exempt status if it is organized and operated for the purpose of either marketing products of members and returning them net proceeds or purchasing supplies and equipment for use by members at cost plus expenses.

AJCA modifies one of the tests for exempt status, which provides that a cooperative can deal with nonmembers as long as that business does not account for more than 15% of all of its business. Under the act, income received from any nuclear decommissioning transactions, open access transactions, income from asset exchange or conversion transactions, and income from load loss transactions are not considered in this test.

Effective Date: Taxable years beginning after October 22, 2004.

6. Modification of Straddle Rules

Federal Law Change: Straddle rules are intended to thwart transactions that would allow selective loss recognition. A straddle generally consists of two economically offsetting positions with respect to actively traded personal property (for example, long and short commodity positions).

Under prior law, if a taxpayer recognized a loss from one leg of a straddle, the loss was suspended if there was unrecognized gain in the other leg of the straddle. By deferring the loss recognition until the offsetting gains were recognized, the straddle rules achieved matching offsetting loss and gain. AJCA creates a new identified straddle regime in which the taxpayer may identify offsetting positions. Loss recognized with respect to one leg of an identified offsetting straddle is capitalized into the basis of the other leg rather than suspended. The act clarifies the straddle rules for taxpayers that settle positions that are part straddle by delivering property, so that the taxpayer would be treated as having sold the property at fair market value. The act eliminates a prior law exception for actively traded stock. As a result, offsetting positions of stock and a position with substantially similar property would constitute a straddle.

Effective Date: Positions established on or after October 22, 2004.

7. Treatment of Stripped Interests in Bond and Preferred Stock Funds

Federal Law Change: Under a stripping arrangement, there is a separation in ownership between underlying property and the right to receive interest or dividends from the property. Prior law contains rules for certain stripping transactions involving bonds and preferred stock when one taxpayer strips an interest coupon from them and sells either the underlying bond or stock or the coupon.

When interest coupons are stripped from a bond, and either the stripped interest coupon or the stripped bond is disposed of, the IRC treats both the stripped interest coupons and the stripped bond as individual newly issued bonds that have original issue discount (OID). OID is the difference between the issue price and the stated redemption price at maturity. If the difference is less than 0.25% per year on the redemption price from the date of issue to the date of maturity, the OID is "zero." The taxpayer who strips a bond and disposes of either the bond or the coupon must allocate its basis between the retained and disposed items. The difference is treated as OID.

A taxpayer that acquires stripped preferred stock is required to include in ordinary income the amounts that would have been includible if the stripped stock had been a bond issued on the purchase date with OID equal to the excess of the redemption price over the purchase price. The taxpayer who strips future dividends and disposes of them is treated as having purchased the stripped preferred stock on the date of disposition for a price equal to the adjusted basis in the stock.

AJCA authorizes the IRS to promulgate regulations that apply similar rules to direct and indirect interests in an entity or account if substantially all of its assets are bonds or preferred stock.

Effective Date: Purchases and dispositions after October 22, 2004

8. Expansion of Designated Renewal Community Area

Federal Law Change: The Community Renewal Tax Relief Act of 2000 provides that communities meeting geographical, population and economic distress criteria may be designated as community renewal areas, and thus are eligible for certain tax incentives.

AJCA authorized the Secretary of Housing and Urban Development to add a contiguous census tract to a renewal community if the renewal community with the added tract would have met the requirements at the time of the original nomination and if the communuty's poverty rate based on 2000 census data exceeds the poverty rate using 1990 census data. A tract may be added even if the additional tract would have caused the community to fail the original test if after inclusion of the new tract, the population does not exceed 200,000, the tract has a poverty rate of at least 20% and the poverty rate exceeds the 1990 rate. A tract may also be added if the tract has no population or poverty rate in the 2000 census, the tract is generally distressed and the renewal community with the new tract is within the jurisdiction of one or more local governments.

Effective Date: December 21, 2000, as if included in the amendments made in the Community Renewal Tax Relief Act of 2000. Under the 2000 act, the designation of an area as a renewal community could be in effect beginning on January 1, 2002, and ending December 31, 2009.

9. Exclusion from UBTI of Gain or Loss on Sale of Certain Brownfield Sites

Federal Law Change: Tax-exempt organizations may be subject to tax on unrelated business taxable income (UBTI), which is income from a trade or business not substantially related to the organization's exempt purpose. Income that an organization derives from property that is debt-financed is generally considered UBTI in the same percentage as the property is debt-financed. Acquisition indebtedness is the amount of unpaid funds borrowed by an organization for acquiring or improving property that otherwise would not have been incurred by the organization.

AJCA excludes from UBTI any gain or loss from the qualified sale, exchange or other disposition of a qualifying brownfield property by an eligible tax exempt organization or qualifying partnership. A qualified brownfield property is an real property that has been certified under the Comprehensive Environmental Response, Compensation and Liability Act of 1980. The exclusion is generally available with respect to property acquired between January 1, 2005 and December 31, 2009. To qualify for the exclusion, the taxpayer must acquire a qualifying brownfield from an unrelated person, pay or incur eligible remediation expenditures exceeding the greater of $500,000 or 12% of the fair market value of the property, and make a qualified transfer of the remediated site to an unrelated person. The amount of gain or loss excludible from the UBTI is not limited to or based on the increase or decrease in the value of the property that is attributable to the remediation expenditures.

The act also modifies the unrelated debt-financed income rules to exclude qualifying property from the definition of debt-financed property.

Effective Date: Gain or loss on the sale, exchange or other disposition of property acquired by the taxpayer during the period beginning January 1, 2005 and ending December 31, 2009.

10. Modification of UBTI Limitation on Investment of Certain SBICs

Federal Law Change: A percentage of the unrelated debt-financed income of an exempt organization is taxed as unrelated business taxable income (UBTI). The percentage of total gross income from the debt-financed property to be included in UBTI is the same percentage as the average acquisition indebtedness for the year is of the average amount of adjusted basis. Debt financed property includes most income-producing properties on which there is an acquisition indebtedness during the tax year.

AJCA provides that acquisition indebtedness does not include certain debt incurred by a small business investment company (SBIC) licensed under the Small Business Investment Company Act of 1958. The exclusion would not apply during any period in which an exempt organization owns more than 25% of the capital or profits in the SBIC, or exempt organizations in aggregate own 50% or more of the capital or profits.

Effective Date: Debt incurred after October 22, 2004, by SBICs licensed after October 22, 2004.

11. Method of Accounting for Naval Shipbuilders

Federal Law Change: Generally, taxpayers are required to use a percentage-of-completion method of accounting to determine taxable income from long-term contracts. An exception exists under prior law for certain shipbuilders that use a 40/60 percentage-of-completion of capitalized costs method. Under this method, 40% of the items are accounted for under the percentage-of-completion method and 60% under the exempt contract method of accounting. Under prior law, qualified ship construction contracts were for the construction of more than five ships that were constructed in the U.S. if the taxpayer reasonably expected to complete them within five years and they were not constructed for the federal government.

Under AJCA, a qualified contract also includes any contract to construct one ship or submarine within the U.S. for the federal government, under which the taxpayer reasonably expects the acceptance date to occur no later than nine years after the date on which the physical fabrication begins. The cumulative reduction in tax resulting from the method is recaptured in the sixth year.

Effective Date: Contracts for which the construction commencement date occurs after October 22, 2004.

12. Limitation on Transfer or Importation of Built-in Losses

Federal Law Change: The basis of property received by a corporation in a tax-free exchange, reorganization or liquidation of a subsidiary corporation is the same as the adjusted basis of that property in the hands of transferor, adjusted for gain or loss of the transferor. Under AJCA, if persons not subject to U.S. tax import a net built-in loss into the U.S. in a tax-free transfer, the corporate transferee's basis is fair market value. If a transferee's aggregate basis in all properties transferred exceeds total fair market value at the time of transfer, there is net built-in loss. If the transferee is a partnership, the property is treated as having been transferred by the partners in proportion to their ownership interests. Similarly, under the act, a domestic corporation's basis in property distributed in a tax-free liquidation of a foreign subsidiary is limited to fair market value if the parent's aggregate basis in the property exceeds its fair market value immediately after liquidation.

Prior to these changes, there was potential for tax avoidance where assets with foreign-generated built-in losses are imported into the U.S. or certain domestic built-in losses are transferred and used to shelter U.S. income.

Effective Date: Transactions after October 22, 2004.

13. Interest on Underpayments Attributable to Undisclosed Reportable Transactions

Federal Law Change: Under AJCA, taxpayers may not deduct interest paid or accrued on underpayment of tax that is attributable to an underpayment arising from an undisclosed listed transaction or undisclosed reportable avoidance transaction. A reportable avoidance transaction is generally a transaction where a significant purpose is to avoid or evade income tax.

Effective Date: Underpayments attributable to transactions entered into in taxable years beginning after October 22, 2004.

14. Expanded Disallowance of Deduction for Interest on Convertible Debt

Federal Law Change: Convertible or equity-linked debt is debt issued by a corporation that is payable in stock of the corporation on maturity. Interest paid or accrued on straight debt during the year is generally deductible by the issuer and includible in the income of the holder of the debt. Interest paid or accrued on convertible debt is not deductible by the issuer because it does not represent a true borrowing transaction. The issuer is giving up ownership interest rather than paying back an amount when the debt matures.

AJCA expands the disallowance of interest deductions on certain corporate convertible debt to include interest on corporate debt payable in equity held by the issuer or any party related to the issuer or held by the issuer or related party in any other entity. The deduction is denied whether or not the issuer or related party holds more than a 50% ownership interest in the other entity. The change addresses attempts to avoid the disallowance rule by issuing debt payable in stock of an affiliate that was slightly less than 50% owned by the issuer.

Effective Date: Debt instruments issued after October 3, 2004.

15. Denial of Installment Sale Treatment for All Readily Tradable Debt

Federal Law Change: Taxpayers are permitted to recognize gain on the disposition of property under the installment method, in which income reported is the amount of any payment multiplied by the gross profit ratio (the gross profit realized from the sale over the total contract price).

AJCA denies installment sale accounting treatment for any sale in which the taxpayer receives readily tradable debt, even if it is issued by a party other than a corporation or government. Thus, debt that is payable on demand or readily tradable is considered a payment regardless of the nature of the issuer. For example, if a taxpayer receives readily tradable debt of a partnership in a sale, the partnership debt is treated as payment on the installment note, and the installment accounting method is not available to the taxpayer.

Effective Date: Sales on or after October 22, 2004.

16. Modification of Treatment of Transfers to Creditors in Divisive Reorganizations

Federal Law Change: Under rules for divisive reorganizations, in which corporations may separate their businesses in tax-free transactions, a corporation may distribute the stock or securities of a controlled subsidiary to shareholders without recognizing gain or loss if certain requirements are met. A transaction may qualify as an acquisitive type "D" reorganization with no gain or loss to the corporation if, as part of a complete liquidation, a corporation transfers substantially all of its assets to a controlled subsidiary solely for stock or securities of the subsidiary, and then distributes the stock or securities to its shareholders. Similar rules apply for a divisive spin-off, split-off or split-up type D reorganizations in which part or the corporation's assets are transferred to a controlled subsidiary.

In both acquisitive and divisive reorganizations, a corporate transferor may receive property or money in addition to the permitted stock and securities tax-free if it is distributed to shareholders as part of the reorganization plan. AJCA limits the amount of money or other property that a corporation can distribute to its creditors without recognizing gain in a type D divisive reorganization to the total adjusted basis of the properties. In addition, it provides that type D acquisitive reorganizations are no longer subject to the liabilities assumption rules.

Effective Date: Transactions in connection with a reorganization occurring on or after October 22, 2004.

17. Clarification of Definition of Nonqualified Preferred Stock

Federal Law Change: No gain or loss is recognized on the transfer of property to a corporation solely in exchange for stock of that corporation if the transferor is immediately in control of the corporation. Nonqualified preferred stock is not treated as stock transferred for property. Preferred stock, which is stock limited and preferred as to dividends and not participating to any significant extent in corporate growth, is nonqualified if:

(1) the holder of the stock can require the issuer to redeem or purchase the stock;
(2) the issuer is required to redeem the stock;
(3) the issuer has the right to redeem or repurchase the stock and that right, as of the date of issue, is more likely than not to be exercised, or
(4) the dividend rate varies in whole or in part with reference to interest rates, commodity prices, or similar indices.

Under AJCA, in order for stock to be treated as participating in corporate growth to a significant extent, and therefore avoid being classified as preferred stock, there must be a real and meaningful likelihood that the shareholder will actually participate in the earnings and growth of the corporation. This provision is intended to thwart attempts to avoid characterization of an instrument as nonqualified preferred stock by including illusory participation rights.

Effective Date: Transactions after May 14, 2003.

18. Modification of Definition of Controlled Group of Corporations

Federal Law Change: Generally, the IRC treats every corporation as a separate taxable entity and imposes a tax on the income of each corporation. By dividing a single business into two or more related corporations under common control, taxpayers may exploit the tax system to their advantage. To prevent members of controlled groups from obtaining multiple tax benefits, the IRC treats controlled groups as one entity for certain tax benefits.

Controlled groups are subject to these provisions only if they are connected through a parent-subsidiary or brother-sister relationship. A parent-subsidiary controlled group includes one or more chains of corporations connected to a common parent through stock ownership if certain tests for 80% of voting power and value are met for each corporation and for the group as a whole. A brother-sister controlled group is two or more corporations owned by five or fewer persons (individuals, estates or trusts) that possess at least 80% of the total combined voting power and value of each corporation and more than 50% of the total combined voting power and value of all stock.

AJCA broadens the definition of a brother-sister-controlled group to include a group where at least 50% of the voting power and value of each corporation and 50% of total combined voting power and value of all stock. Although the provision applies only for purposes of federal corporate graduated income tax rates, this provision should be adopted by Wisconsin for definition references that could affect other provisions in the future.

Effective Date: Tax years beginning after October 22, 2004.

19. Limitation of Employer Deduction for Certain Entertainment Expenses

Federal Law Change: AJCA imposes additional limitations on the amount an employer can deduct for certain entertainment, amusement or recreation expenses. In the case of specified individuals, entertainment expenses for goods, services or facilities are deductible only to the extent that they do not exceed the amount of treated by the employee as compensation. A specified individual is someone who is subject to the

Securities Exchange Act of 1934, and generally includes officers, directors and 10% or greater owners of private of publicly held companies.

The provision is intended to close a loophole in the use of company aircraft by executives. In a 2000 Tax Court opinion, an employer was allowed to deduct the full cost of flying its officers on vacation on the corporate jet even though the officers recognized only a small portion of the cost as income.

Effective Date: Expenses incurred after October 22, 2004.

I. COMPENSATION AND EMPLOYEE BENEFIT PROVISIONS

1. Modification of Minimum Cost Requirement for Transfer of Excess Pension Assets

Federal Law Change: Excess benefit plan assets generally may not revert to the employer. Reversion of plan assets prior to termination of the plan can result in a prohibited transaction and plan disqualification.

Under prior law, a pension plan could provide medical benefits to retired employees through a separate account that was part of the plan. Excess assets could be transferred to the separate account to fund retiree health benefits. Qualified transfers were not considered reversions. To be qualified, the transfer had to meet minimum cost requirements that were not met if the employer significantly reduced retiree health coverage.

AJCA allows certain employers to transfer excess assets without failing the minimum cost requirement if, instead of reducing health coverage, the employer reduces its cost by an amount not greater than the amount that could have been reduced for retiree health coverage. An eligible employer has qualified current retiree health liabilities that are at least 5% of gross receipts for the preceding tax year.

Effective Date: Taxable years ending after October 22, 2004.

2. Treatment of Nonqualified Deferred Compensation Plans

Federal Law Change: Nonqualified plans are deferred compensation arrangements that do not meet specific requirements to receive favored tax treatment. They are typically used to provide executive and middle management employees with special incentives in excess of those allowed under qualified plans.

If a plan is qualified, the employer can deduct contributions immediately, but employees are not taxed until they receive distributions. If a plan is nonqualified, tax consequences depend upon a number of factors, including if the plan is funded or nonfunded. Most nonqualified deferred compensation plans are unfunded, unsecured promises to pay an amount in the future.

If the arrangement is unfunded, the compensation is included in income when actually or constructively received. If the arrangement is funded, the income is included for the tax year that the individual's rights are vested. The arrangement is considered funded if the employee has a beneficial interest in assets that are transferred or set aside from the claims of creditors, such as in a trust or escrow account.

Rabbi trusts (so named because the first such trust was established for a rabbi) are used to provide some assurance that compensation will be paid, while avoiding immediate taxation to the employee. In a rabbi trust, an irrevocable grantor trust is set up for the benefit of employees, but remains subject to claims of the employer's creditors. The employer is considered the owner of the assets and includes income earnings on trust assets in its income.

Under AJCA, deferred compensation is taxable currently if not subject to substantial risk of forfeiture, unless certain requirements are met. Deferred compensation includes any plan that is not a qualified employer plan and that provides for the deferral of compensation, or any bona fide vacation, sick leave, compensatory time, disability pay, or death benefit plan. To defer compensation, distributions from the plan cannot be distributed earlier than (1) generally, the employees separation from service disability or death, (2) a specified fixed time or schedule under the plan established at the time of deferral, or (3) the occurrence of an unforeseeable emergency.

The act does not permit accelerated benefits. Elections to defer generally must be made in the preceding year, prior to services being performed. Assets set aside in an offshore rabbi trust to fund deferred compensation are immediately taxable, unless substantially all services to which it applies are performed in the foreign jurisdiction.

Effective Date: Amounts deferred after 2004. Amounts deferred in tax years beginning before January 1, 2005, are subject to these rules if the plan was materially modified after October 3, 2004.

3. Conflict-of-Interest Requirements for Stock Acquired by Exercise of Stock Options

Federal Law Change: Under prior law, if an incentive stock option (ISO) or stock acquired through an employee stock purchase plan (ESPP) were sold to comply with conflict of interest requirements, the sale had to meet holding period requirements. Otherwise, the sale was considered a disqualifying disposition and gain was treated as ordinary income.

AJCA provides that if stock acquired pursuant to an ISO or ESPP is sold to comply with conflict of interest requirements, the sale is treated as having met the holding period requirements regardless of how long the stock is actually held. An eligible person generally would include an officer or employee of the executive branch of the federal government. Because the sale would not be a disqualifying disposition, the individual would receive capital gain treatment on resulting gains. The employer granting the option would not be allowed a deduction on the sale of the stock.

Effective Date: Sales after October 22, 2004.

4. Application of Basis Rules to Nonresident Aliens

Federal Law Change: Certain provisions of the IRC provide rules for taxing annuities, such as employer retirement plans. Distributions are not taxed on the amount that is the "investment in the contract," or the basis. The investment in the contract is the aggregate amount received under the contract before the date of distribution, to the extent it was excludible from gross income.

Under prior law, if a foreign national was covered under a funded deferred compensation plan while working outside the U.S., contributions to the plan that were vested before the individual's residency in the U.S. were treated as an investment in the contract and excluded from income on distribution in the U.S.

AJCA provides that the investment in the contract does not include any applicable nontaxable contributions. An applicable nontaxable contribution is defined as any employer or employee contribution to a plan on behalf of a nonresident alien when the compensation:

(1) is for labor or personal services from sources outside the U.S.;
(2) is treated as source income outside the U.S.; and
(3) is not subject to income tax in the U.S. or any foreign country, but would have been subject to tax if paid as cash compensation when the services were rendered.

Similar provisions apply for earnings on employer or employee contributions and for determining the basis of property received as compensation.

Effective Date: Distributions on or after October 22, 2004.

5. YMCA Retirement Fund

Federal Law Change: The act relating to the YMCA Retirement Fund provides that any plan maintained by that fund will be treated as a church plan under the IRC. The fund has operated as church plan for more than 80 years, but the IRS has questioned whether that is appropriate. The act ensures that the YMCA fund will retain its status as a church plan.

Effective Date: Plan years beginning after December 31, 2004.

J. PROVISION STILL UNDER REVIEW

1. Sales or Dispositions to Implement Electric Restructuring Policy

Federal Law Change: AJCA allows a taxpayer to elect to recognize qualified gain from a qualifying electric transmission transaction ratably over an eight-year period beginning in the year of sale if the amount realized from the sale is used to purchase exempt utility property within four years. Without this change, the gain would be recognized in the year received. Exempt utility property is defined as: (1) property used in the trade or business of generating, transmitting, distributing, or selling electricity, or producing, transmitting, distributing, or selling natural gas, or (2) controlling stock in a corporation described above.

A qualifying electric transmission transaction is the sale or other disposition of property used by the taxpayer in the trade or business of providing electric transmission services, or an ownership interest in such an entity to an independent transmission company before 2007. An independent transmission company is generally defined as:

(1) an independent transmission provider approved by the Federal Energy Regulatory Commission (FERC);
(2) a person FERC determines is not a market participant and whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider within a prescribed period of time; or
(3) a person approved by the Public Utility Commission of Texas as consistent with Texas law regarding independent transmission providers.

Effective Date: Transactions after October 22, 2004, in taxable years ending after October 22, 2004.

K. PROVISIONS NOT RECOMMENDED FOR ADOPTION

1. Extension of Increased Small Business Section 179 Expensing Election

Federal Law Change: Section 179 of the IRC allows certain taxpayers to elect to expense investment in depreciable assets in the year of the expenditure, up to prescribed limits. AJCA extends, for two years, through 2007, the increased expensing deduction and the increased reduction ceiling provided by the Jobs and Growth Tax Reconciliation Act of 2003 (JGTRRA).

JGTRRA increased the maximum amount of section 179 deduction that can be taken annually to $100,000 for taxable years through 2005. It also raised, to $400,000, the threshold for eligible qualifying property placed in service during the year above which the expensing deduction decreases dollar-for-dollar.

Wisconsin did not adopt the JGTRRA increases; thus the maximum amount that can be expensed for Wisconsin purposes is $25,000 and dollar-for-dollar reduction of this amount begins when eligible qualifying property placed in service during the tax year exceeds $200,000.

Wisconsin adoption of these provisions would reduce tax revenues by $7.3 million in FY06 and $15.1 million in FY07.

Effective Date: October 22, 2004.

2. Charitable Contributions of Computer Technology and Equipment

Federal Law Change: WFTRA extends to tax years 2004 and 2005 an augmented deduction for charitable contributions of computer technology and equipment by corporations that expired after 2003. The augmented deduction equal to the corporation's basis in the property plus one-half of the ordinary income that would have been realized if the property had been sold, but more than twice the basis.

Qualified contributions include software, computer or peripheral equipment and fiber optic cable related to computer use. Eligible donees include educational organizations, tax-exempt entities supporting elementary and secondary organizations, a private foundation that within 30 days contributes the gift to an eligible educational organization or tax-exempt entity, or a public library.

Wisconsin did not conform to the deduction that expired after 2003. Wisconsin adoption of these provisions would reduce tax revenues by $0.45 million in FY06, with a minimal loss in FY07.

Effective Date: Contributions in tax years beginning after December 31, 2003.

3. **Expensing of Brownfields Environmental Remediation Costs**

Federal Law Change: WFTRA extends through tax year 2005 an election to deduct environmental cleanup costs incurred in connection with the abatement or control of hazardous substances at a qualified contamination site. Without this treatment, the expenses are depreciated. The election expired on December 31, 2003.

If Wisconsin adopted these provisions, the revenue loss would be $1.2 million in FY06 and minimal in FY07.

Effective Date: Expenditures paid or incurred in tax years beginning after December 31, 2003.

4. **Conformity Between HSA and MSA Distributions**

Federal Law Change: WFTRA treats distributions from HSAs the same as MSA distributions for two specific purposes: for the additional tax on distributions not used for medical expenses and for the restriction on using distributions to pay health insurance premiums that would otherwise qualify for the health insurance credit. The HSA penalty on distributions not used for medical expenses cannot be used to reduce any alternative minimum tax that the taxpayer may owe since the HSA penalty is not included in the taxpayer's regular tax liability.

Adoption of HSA provisions contained in the Medicare Prescription Drug, Improvement and Modernization Act of 2003 is not being recommended, therefore this provision should not be adopted.

Effective Date: Tax years beginning on January 1, 2004.

5. **Expensing of Qualified Film and Television Production Costs**

Federal Law Change: The revenue stream of a film or television show decreases markedly as viewer interest declines after the initial showings, which results in special problems for depreciating production costs. The Taxpayer Relief Act of 1997 made film and videotape property eligible for straight-line income forecast method of depreciation.

AJCA allows smaller taxpayers to elect to expense the costs of any qualified film or television production in the year the expenditure is incurred. Generally, productions are eligible if aggregate costs are less than $15 million. A qualified production is one in which at least 75% of total compensation are for services in the U.S. Only the first 44 episodes of a television series qualify under the provision.

Wisconsin adoption of these provisions would reduce tax revenues by $0.2 million in FY06 and $0.2 million in FY07.

Effective Date: Qualifying productions whose first date of principal photography is after October 22, 2004, and before 2009.

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