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May 31, 2011 Joint Committee on Finance Paper #311

Implementation Issues Relating to Deferral for Capital Gain Reinvested in Qualified Wisconsin Businesses and Capital Gain Exclusion for Wisconsin Capital Assets (General Fund Taxes -- Income and Franchise Taxes)

[LFB 2011-13 Budget Summary: Page 182, #1 and Page 183, #2]

CURRENT LAW

Under current law, an individual income tax exclusion is provided for 60% of the capital gain from the sale of farm assets and 30% of the capital gain from the sale of other assets held more than one year. A 100% exclusion is provided for gains realized on the sale of business assets to a family member and for gains resulting from the sale of small business stock. Gains from assets held one year or less are fully taxed. Beginning in tax year 2011, a new exclusion is provided for certain capital gains that are reinvested in certain new business ventures.

The amount of capital losses that may be used to offset ordinary income is limited to $500 annually, with the remainder carried over to future years. The state's top marginal income tax rate is 7.75%. Therefore, with the 30% exclusion, long-term capital gains are generally taxed at a maximum rate of 5.425%. The maximum effective tax rate is slightly higher for taxpayers who have income within the phase-out range for the sliding scale standard deduction. The maximum effective rate is lower for taxpayers in the lower tax brackets.

GOVERNOR

Deferral for Capital Gain Reinvested in Qualified Wisconsin Businesses. Authorize claimants calculating their Wisconsin adjusted gross income to subtract from federal adjusted gross income any amount of a long-term capital gain if the claimant: (a) deposits the gain into a segregated account in a financial institution; (b) invests all of the proceeds in the account in a qualified Wisconsin business within 180 days of the sale of the asset generating the gain; and (c) notifies the Department of Revenue (DOR) that the capital gain has been reinvested and, therefore, will not be declared on the claimant's income tax return. The notification would be made on a DOR form accompanying the claimant's income tax return for the year to which the

claim relates. Specify that the basis for the investment in the Wisconsin business would be calculated by subtracting the initial gain from the investment. Prohibit a claimant from using the initial gain to net capital gains and losses as otherwise allowed under current law. (State law limits the amount of capital losses that may be used to offset ordinary income to $500 annually, with the remainder carried over to future years.) Prohibit a claimant from also claiming the gain as a subtraction as a reinvestment in a qualified new business venture, under current law, or as a Wisconsin capital asset, as proposed under the bill (described below). Define "claimant" as an individual; an individual partner or member of a partnership, limited liability company (LLC), or limited liability partnership; or an individual shareholder of a tax-option corporation. Define "long-term capital gain" as the gain realized from the sale of any capital asset held more than one year that is treated as a long-term gain under the Internal Revenue Code (IRC).

Require the Wisconsin Economic Development Corporation (WEDC) to implement a program to certify qualified Wisconsin businesses for purposes of the capital gains deferral, and authorize the WEDC to certify businesses that apply for certification if it determines that the business meets the following criteria in the tax year immediately preceding the application: (a) the amount of payroll compensation paid by the business in Wisconsin is equal to at least 50% of the amount of all payroll compensation paid by the business; and (b) the value of real and tangible personal property owned or rented and used by the business in Wisconsin is equal to at least 50% of all such property owned or rented and used by the business. Require the WEDC to: (a) notify DOR of every Wisconsin business certified under this procedure and the date on which a certification expires or is revoked; and (b) compile a list, which is available on its Internet Web site, of businesses certified under this procedure. Authorize the WEDC, in consultation with DOR, to adopt administrative rules related to these provisions.

The proposed tax deferral would first apply for tax years beginning after December 31, 2010, and would decrease revenues by an estimated $16.1 million in 2011-12 and $20.2 million in 2012-13.

Capital Gain Exclusion for Wisconsin Capital Assets. Authorize claimants calculating their Wisconsin adjusted gross income to subtract from federal adjusted gross income the claimant's qualifying gain from the sale of a Wisconsin capital asset in the year to which the claim relates, but limit the subtraction to no more than the amount of the claimant's federal net capital gain as reported on the claimant's federal income tax return for the taxable year to which the claim relates. Limit the subtraction to Wisconsin capital assets purchased after December 31, 2010, and held for at least five years. Define "claimant" as an individual; an individual partner or member of a partnership, LLC, or limited liability partnership; or an individual shareholder of a tax-option corporation. Define "qualifying gain" as the gain realized from the sale of any asset: (a) which is a Wisconsin capital asset in the year that it is purchased by the claimant and is a Wisconsin asset for at least two of the subsequent four years; (b) that is held for at least five uninterrupted years; and (c) that is a long-term gain under the IRC. Specify that a qualifying gain may not include an amount for which the claimant claimed a subtraction as a reinvestment in a qualified new business venture. Define "Wisconsin capital asset" as: (a) real or tangible personal property that is located in this state and used in a Wisconsin business; or (b) stock or other ownership interest in a Wisconsin business. Define "Wisconsin business" as a business certified by the WEDC. Modify the current law loss carry-forward provision to treat the proposed exclusion the same as other capital gains exclusions.

Require the WEDC to implement a program to certify Wisconsin businesses for purposes of the capital gains subtraction, and authorize the Corporation to certify businesses that apply for certification if it determines that the business meets the following criteria in the tax year immediately preceding the application: (a) the amount of payroll compensation paid by the business in Wisconsin is equal to at least 50% of the amount of all payroll compensation paid by the business; and (b) the value of real and tangible personal property owned or rented and used by the business in Wisconsin is equal to at least 50% of all such property owned or rented and used by the business. Require the WEDC to: (a) notify DOR of every Wisconsin business certified under this procedure and the date on which a certification expires or is revoked; and (b) compile a list, which is available on its Internet Web site, of businesses certified under this procedure. Authorize the WEDC, in consultation with DOR, to adopt administrative rules related to these provisions.

[The WEDC would use the same criteria to certify a "Wisconsin business" under these provisions and a "qualified Wisconsin business" under the proposed capital gains tax deferral described above. The administration indicates that it intended to allow a deferred gain reinvested in a qualified Wisconsin business to also be used for an investment that could qualify under this exclusion. If that investment is sold after a holding period of five or more years, the deferred gain would be subject to tax, but any additional gain would be excluded. A modification is needed to ensure that this intent is fulfilled.]

The proposed exclusion would first apply for taxable years beginning after December 31, 2015. Due to the provision's delayed applicability, no fiscal effect is estimated for the 2011-13 biennium. DOR estimates that (in 2012-13 dollars) the exclusion would reduce individual income tax collections by $6 million in the first year of the phase-in (2016-17) and by approximately $79 million annually when fully phased in. Due to fluctuations in capital asset markets and the proposal's delayed effective date, these estimates are subject to substantial variation.

DISCUSSION POINTS

1. SB 27/AB 40 would create two new provisions regarding the taxation of capital gains income. Another paper (LFB Paper #310) provides information regarding the policy implications of these provisions. This paper presents information about how the proposals should be structured.

2. As noted in LFB Paper #310, only six states, including Wisconsin, with individual income taxes, provide partial capital gains exclusions where some percentage of long-term gains is exempted from taxation. Special treatment of gains from the sales of assets, where the asset has some presence in the state, such as a business, are somewhat more common and are offered in 13 states, including Wisconsin. Wisconsin's treatment of gains reinvested in qualified new business ventures is one example of such treatments.

3. 2009 Wisconsin Act 28 created a capital gains deferral for long-term gains reinvested in qualified new business ventures. In order to claim the deferral, a taxpayer must: (a) deposit the gain into a segregated account in a financial institution; (b) invest all of the proceeds in the account in a qualified new business venture within 180 days of the sale of the asset generating

the gain; and (c) notify DOR that the capital gain has been reinvested and, therefore, will not be declared on the claimant's income tax return. The Department of Commerce (WEDC under the bill) is required to certify qualified new business ventures.

4. Under current law, to be certified as a "qualified new business venture", the business must be engaged in: (a) developing a new product or business process; or (b) manufacturing, agriculture, or processing or assembling products and conducting research and development. Businesses desiring certification must submit an application to Commerce each taxable year for which certification is desired. In less than two years since the program's enactment, 109 Wisconsin businesses have been certified as qualified new business ventures that qualify investors for the deferral. The Department of Commerce was able to certify these companies in such a short period of time because many of the companies were already certified as qualified new business ventures for purposes of the angel investment tax credit.

5. The Act 28 deferral for reinvested gains in qualified new business ventures first applies in tax year 2011. Rather than authorize two new capital gains provisions in the same year that the Act 28 deferral is taking effect, one alternative would be to not create a new capital gains deferral for reinvestments in qualified Wisconsin businesses. Instead, the Act 28 deferral for qualified new business ventures could be interfaced with the proposed capital gain exclusion so that the exclusion would apply to the gains from the sale of investments in qualified new business ventures, provided the investment is held for five or more years. This option is presented as Alternative 2. Under this alternative, a taxpayer could reinvest capital gains income in a qualified new business venture, and defer the tax on those gains until the subsequent investment is sold. In addition, if the investment in the qualified new business venture is held for five years or more, the taxpayer could claim a 100% exclusion for any additional gain generated by the new investment. This option would simplify the Governor's proposal, but also narrow it because it would only apply to "qualified new business ventures" (as defined in Act 28), instead of to "qualified Wisconsin businesses" and "Wisconsin capital assets" (as defined in the current budget bill).

6. To claim the proposed exclusion, taxpayers would be required to hold Wisconsin capital assets for at least five uninterrupted years. A recent article in the Internal Revenue Service's Statistics of Income Bulletin (Winter 2010) provides data on sales of capital assets reported on 2007 federal individual income tax returns. The holding period could not be identified for 21.4% of the transactions with long-term gains. Among the gains where holding periods could be identified, 16.3% of the transactions and 42.6% of the gains involved holding periods of five or more years. Table 1 provides information on the number of transactions and amount of gains by holding period for long-term gains.

TABLE 1

Distribution of Transactions and Gains by Holding Period for Taxpayers Reporting Long-term Gains on Federal Individual Income Tax Returns, 2007*

Length of Time Held	Percent of Transactions	Cumulative Percent	Percent of Gains	Cumulative Percent
20 years or more	1.6%	1.6%	13.3%	13.3%
15 years to under 20 years	1.2	2.8	5.4	18.7
10 years to under 15 years	3.1	5.9	8.5	27.2
5 years to under 10 years	10.4	16.3	15.4	42.6
4 years to under 5 years	5.2	21.5	4.4	47.0
3 years to under 4 years	9.2	30.7	5.7	52.7
2 years to under 3 years	16.6	47.3	7.1	59.8
18 months to under 2 years	13.9	61.2	4.3	64.1
Under 18 months	38.8	100.0	35.9	100.0

* Excludes transactions and gains where the holding period could not be determined. Internal Revenue Service, Statistics of Income Bulletin, Winter 2010, Washington, D.C.

7. To claim the exclusion, the bills would impose a five-year holding requirement for the Wisconsin capital asset before it is sold. Colorado also imposes a five-year holding requirement in order to claim an exclusion for gains from the sale of stock or an ownership interest in a Colorado company or from the sale of real or tangible property located in Colorado. Other states specify longer or shorter holding periods. For example, Iowa requires a ten-year holding period in order to claim an exclusion for gains from the sale of real property used in a business or from the sale of a business. New York extends a deferral on the gain from the sale of a qualified emerging technology investment, provided the gain is rolled into the purchase of another qualified emerging technology investment and the original investment was held for more than three years.

8. As the proposed exclusion becomes effective, individual income tax collections are estimated to decrease by $6 million in 2016-17 and by approximately $79 million five years later. Based on the data in Table 1 on the percent of gains claimed by holding period, a ten-year holding period would reduce revenues by an estimated $5 million in 2016-17 and by $62 million five years later, or $1 million and $17 million less, respectively, than the five-year holding period in the bill. A three-year holding period would reduce revenues by an estimated $8 million in 2016-17 and by $99 million five years later, or $2 million and $20 million more, respectively, than the five-year holding period in the bill. Replacing the five-year holding period with holding periods of ten or three years is presented as Alternatives 3a. and 3b., respectively.

9. Exclusions differ from deferrals in that deferred capital gains are eventually subject to taxation. Also, deferrals are not as widespread as exclusions among states imposing state income taxes. As explained above, New York allows taxpayers to defer the tax on the gain from the sale of qualified emerging technology investments (QETI), provided the investment is held more than 36 months and is rolled into the purchase of a second QETI. At the time the second QETI is sold, the deferred gain from the sale of the first QETI is subject to tax.

10. A provision in the bill prohibits any of the gain resulting from a deferral from being used to subsequently claim a capital gain exclusion by reinvesting the gain from the deferral in a Wisconsin capital asset. The administration indicates that the bill should be amended to: (a) allow a

deferred gain to be reinvested in a Wisconsin capital asset; (b) require that the deferred gain be subject to taxation when the subsequent investment in the Wisconsin capital asset is sold, and (c) provide that any additional gain on the subsequent investment is eligible for the proposed exclusion, provided the investment is held for at least five years and meets the criteria specified in the bill for being an investment in a Wisconsin capital asset. This would mirror New York's treatment of QETIs described above. These modifications of the Governor's proposal are presented as Alternative 4.

ALTERNATIVES

1. Approve the Governor's recommendation to create a deferral for capital gains reinvested in qualified Wisconsin businesses and to create a capital gain exclusion for Wisconsin capital assets.

2. Delete the Governor's recommendation to create a deferral for capital gains reinvested in qualified Wisconsin businesses and modify the Governor's recommendation to create a capital gain exclusion by extending the exclusion to gains resulting from an investment in a qualified new business venture instead of gains from the sale of Wisconsin capital assets. Provide that taxpayers claiming the exclusion must have held the investment in a qualified new business venture for at least five uninterrupted years and that the gain is a long-term capital gain under the IRC. Specify that a qualifying gain may not include an amount which the claimant claimed as a subtraction as a reinvestment in a qualified new business venture. Provide that the exclusion would first apply for taxable years beginning after December 31, 2015. [This alternative is described in Discussion Point # 5.]

ALT 2	**Change to Bill** Revenue
GPR	$36,300,000

3. Modify the recommendation to create an exclusion for the capital gain on sales of Wisconsin capital assets by changing the required holding period from five uninterrupted years to:

a. Ten uninterrupted years; or

b. Three uninterrupted years.

4. Modify the recommendation to create a deferral for capital gains reinvested in qualified Wisconsin businesses by: (a) deleting the provision that specifies a claimant may not use a deferred gain to claim an exclusion for Wisconsin capital assets and (b) creating a provision specifying that a deferred gain cannot be part of a gain excluded as a Wisconsin capital asset. Modify the recommendation to create an exclusion for Wisconsin capital assets to specify that any gain deferred from taxation as a gain reinvested in qualified Wisconsin businesses may not be included under the exclusion. [Note: This change would allow a deferred gain to be used as an investment that could qualify for the exclusion for investments in Wisconsin capital assets, but the amount originally deferred would become taxable when the subsequent investment in the Wisconsin capital asset is sold.]

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