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2017 Joint Committee on Finance Paper #292

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

[LFB 2017-19 Budget Summary: Page 181, #14]

CURRENT LAW

State individual income tax and corporate income/franchise tax provisions are generally referenced to definitions under federal law. With limited exceptions, changes to federal law take effect for state purposes only after action by the Legislature. Generally, the Legislature reviews the previous year's federal law changes each year to update state references to the Internal Revenue Code (IRC). Under current law, state tax references generally refer to IRC provisions enacted as of December 31, 2013, as well as select federal provisions enacted in 2014 and 2015.

GOVERNOR

Update references to the IRC under the individual and corporate income/franchise taxes. For tax years beginning after December 31, 2013, and before January 1, 2017, create provisions adopting selected IRC provisions included in the following public laws that were enacted in 2015 and 2016: (a) P.L. 114-41, the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015; (b) P.L. 114-74, the Bipartisan Budget Act of 2015; (c) P.L. 114-113, Division P (the Consolidated Appropriations Act) and Division Q (the Protecting Americans from Tax Hikes Act of 2015); and (d) P.L. 114-239 (the United States Appreciation for Olympians and Paralympians Act of 2016). For tax years beginning after December 31, 2016, create provisions adopting IRC provisions in effect as of December 31, 2016, with exceptions. Specify that the provisions of federal public laws that directly or indirectly affect the IRC apply for state tax purposes at the same time as for federal tax purposes, with exceptions, and specify that the definition of the IRC does not include amendments to the IRC adopted after December 31, 2016. For purposes of the state tax on tax-option corporations, specify that section 1366(f) of the IRC, relating to pass-through of items to shareholders, would be modified by substituting a reference to state tax provisions for federal tax provisions. For purposes of the state tax on insurance companies, specify that section 847 of the IRC, relating to special estimated tax payments, would not apply. Repeal obsolete provisions pertaining to tax years beginning after December 31, 2003, and before January 1, 2005.

Create a penalty equal to 20% of the portion of any underpayment of taxes that is required to be shown on a Wisconsin tax return, if the underpayment is the result of an inconsistent estate basis reporting. For purposes of the penalty, specify that an inconsistent estate basis reporting occurs if the property basis claimed on a Wisconsin tax return exceeds the property basis determined for federal purposes. Require the Department of Revenue (DOR) to assess, levy, and collect the penalty in the same manner as it assesses, levies, and collects state income and franchise taxes. This provision would first apply to property for which a federal estate tax return is filed after July 31, 2015.

Reduce individual income and corporate income/franchise taxes by an estimated $600,000 in 2017-18 and $800,000 in 2018-19.

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 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, personal exemptions, itemized deductions, and tax credits.

2. During the last legislative session, the Legislature adopted IRC provisions in effect as of December 31, 2013, as well as specific provisions in several public laws enacted in 2014. Since then, several other public laws containing income tax provisions have been enacted. These include the four public laws listed in the Governor's proposal which contain several provisions that would be effective retroactively. Generally, the retroactive provisions have no or minimal fiscal effects. A number of the provisions relate to areas where Wisconsin is already federalized, such as Section 179 expensing, teachers' classroom expenses, and the earned income tax credit. Several provisions relate to pensions, and state law currently specifies that "a qualified retirement fund … for federal income tax purposes is a qualified retirement fund" for state income tax purposes. Other provisions in the four laws would apply beginning in tax year 2017, and the provisions in those laws with a state tax effect are described in greater detail below.

3. P.L. 114-41 modifies the procedures related to the valuation of estates. For estate tax purposes, an executor must report the value of the estate, although heirs may rebut the use of that determination as their basis by presenting clear and convincing evidence. P.L. 114-41 requires consistency between the value of the estate for federal estate tax purposes and the basis for the property received by the heir. An "accuracy-related" penalty like the one imposed for inconsistent reporting at the federal level would be created for state tax purposes. Due to a high exclusion

amount, many estates are not subject to the federal estate tax, and Wisconsin does not impose an estate tax. Nonetheless, establishing an estate's fair market value is important for determining the basis of property received by heirs that might be taxed as a capital gain at a future date. Adopting this provision would increase state income tax collections by an estimated $400,000 annually.

4. P.L. 114-41 clarifies the treatment of contributions to health savings accounts for veterans with a service-connected disability. Under that law, medical services received by a veteran for a service connected disability through the U.S. Department of Veterans Affairs do not disqualify the veteran from making contributions to or receiving distributions from a health savings account (HSA) on a tax-advantaged basis. Federal law requires individuals who establish an HSA to also be covered by a high deductible health plan. Generally, these individuals cannot also be covered by other types of health plans. Such health plans included health care provided to veterans through the U.S. Department of Veterans Affairs prior to P.L. 114-41. However, veterans with a service connected disability who receive such treatment are now allowed to establish and maintain HSAs. Adopting this IRC provision would reduce individual income tax collections by an estimated $100,000 in 2017-18 and $200,000 in 2018-19.

5. P.L. 114-74 clarifies the treatment of partnership interests in certain situations. Federal law defines partnership as an unincorporated organization engaged in a business, financial operation, or venture and partner as a member of a partnership. Previously, a separate IRC provision specified that a person is recognized as a partner if the person "owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from another person." However, this second provision was included under IRC provisions related to family partnerships, even though the provision was a recognized standard in defining partner. P.L. 114-74 relocates this provision to the IRC general provision regarding partnerships. Adopting the federal provision would preclude individuals from advancing alternate standards for defining partnership for state tax purposes, resulting in increased individual income tax collections estimated at $1.9 million in 2017-18 and $1.6 million in 2018-19.

6. P.L. 114-113 created parity between transportation fringe benefits. Transportation costs incurred by individuals commuting to and from work are not deductible expenses. However, employers may provide fringe benefits to their employees to cover their commuting expenses related to parking, transit passes, and van pools on a pre-tax basis. Maximum benefit levels are established on a monthly basis and are subject to indexing for inflation. Initially, federal law set the maximum monthly reimbursement rate for parking at a higher level than for transit passes and van pools ($175 versus $100). On a temporary basis, the maximum benefit levels were set at the same amount beginning in 2009. With the expiration of the temporary authorization, the limit on transit passes and van pools was scheduled to decrease to $130 per month in 2015, while the limit on parking benefits remained at $250 per month, the same amount as in 2014. P.L. 114-113 permanently set the limit on transit passes and van pool benefits at the same level as parking benefits. Generally, Wisconsin has not adopted temporary IRC provisions for state tax purposes, so individuals receiving the maximum transit pass and van pool benefit have been required to increase their federal AGI for purposes of state taxation since 2009. Adopting this provision for state tax purposes is estimated to reduce state individual income tax collections by $1.0 million annually. Under the IRC inflation adjustment, the limit on the three transportation fringe benefits is $255 per

month in tax year 2017.

7. P.L. 114-113 makes permanent the higher deduction levels for certain contributions of real property for charitable purposes. Federal law limits the amount of charitable contributions that can be deducted by individuals and corporations for tax purposes. Additional limitations apply if the contribution is capital gain property. Amounts that the taxpayer is unable to deduct in the year of the contribution may be carried forward and deducted for up to five additional years. More liberal limitations were enacted on a temporary basis for interests in real property contributed to a charitable organization for conservation purposes, including contributions by farmers and ranchers. Carry forward provisions were extended to 15 years, also on a temporary basis. These provisions were scheduled to expire for contributions made after December 31, 2014, until P.L. 114-113 extended them on a permanent basis. Adopting the federal treatment of the permanent provisions would reduce individual income and corporate income and franchise tax collections by an estimated $600,000 annually.

8. P.L. 114-113 makes permanent provisions previously enacted on a temporary basis related to charitable contributions of food inventory. As noted above, federal law limits the amount of charitable contributions that can be deducted for tax purposes. Business deductions for contributions of inventory are generally limited to the cost of the inventory, except C corporations may qualify for an enhanced deduction tied to the appreciation in the inventory's value. An enhanced deduction was extended on a temporary basis for contributions by a business of food inventory, even if that business is not a C corporation, but that enhanced deduction would not have applied to food inventory contributions made after December 31, 2014. P.L. 114-113 extends the enhanced deduction for contributions of food inventory on a permanent basis. In addition to other features, the deduction would be enhanced by increasing its limitation from 10% to 15% of taxable income, with a five-year carry forward for unused deductions. Adopting the federal treatment of the permanent provisions would reduce individual income and corporate income/franchise tax collections by an estimated $1.3 million annually.

9. P.L. 114-113 modifies the calculation of a shareholder's basis in stock of an S-corporation in certain instances. When an S-corporation makes a charitable contribution, the owners of the corporation must reduce the basis of their stock in the corporation by the amount of the contribution. Previously, two procedures were used to calculate the reduction, depending on whether the contribution occurred in a tax year beginning before January 1, 2015 or after December 31, 2014. P.L. 114-113 makes the pre-2015 procedure permanent for contributions made in tax years beginning after December 31, 2014. Under that procedure, the shareholder's basis reduction is equal to the shareholder's pro rata share of the adjusted basis of the contributed property. Adopting this provision would reduce state individual income tax collections by an estimated $100,000 annually.

10. P.L. 114-113 excludes certain federal grants from taxation. The federal Energy Policy Act of 2005 provided grants and other financial assistance to fund power projects employing clean coal technologies. P.L. 114-113 excludes grants and other financial assistance received under that Act from income for purposes of the individual income tax. This treatment was already extended for corporate tax purposes. If the assistance is for depreciable property, the property's basis is reduced

by the amount of the assistance. Adopting this provision would reduce state individual income tax collections by an estimated $200,000 in 2018-19.

11. P.L. 114-113 generally prohibits a real estate investment trust (REIT) from participating in a tax-free spin-off as either a distributing or controlled corporation unless: (a) both the distributing and controlled corporations are both REITs; or (b) the spin-off is a taxable REIT subsidiary under certain instances. An entity qualifies as a REIT if it makes an election to be treated as such and it meets certain organizational requirements and other requirements regarding its assets, income sources, investment activity, and distribution of income. A REIT can claim a deduction for dividends paid to shareholders against ordinary income and net capital gains. P.L. 114-113 generally requires that a REIT must recognize a gain on the distribution of property to its shareholders as if the REIT had sold such property for its fair market value. Adopting this provision would increase state tax revenues by an estimated $300,000 in 2017-18 and $400,000 in 2018-19.

12. P.L. 114-113 makes permanent the inclusion of regulated investment companies (RIC) as a qualified investment entity under federal law. A RIC includes several types of investment entities under federal law, such as mutual funds, exchange-traded funds, or REITs. In general, a foreign person is not subject to U.S. source capital gains tax unless that person has an active business or personal presence in this country. However, a foreign person who sells a U.S. real property interest is subject to tax at the same rates as a U.S. person, including federal withholding taxes, under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). A distribution from a qualified investment entity that is regularly traded on an established securities market located in the U.S. where the recipient is a foreign corporation or nonresident alien, subject to certain limits on ownership interest, is generally not subject to tax under FIRPTA. Wisconsin did not adopt federal provisions including RICs as qualified investment entities because the provisions were enacted on a temporary basis. Adopting this provision would reduce state tax revenues by $400,000 in 2017-18 and 2018-19.

13. P.L. 114-113 modifies the determination as to whether the disposition of a U.S. real property interest by a RIC or REIT is subject to tax under FIRPTA. Under current state and federal law, an interest in a corporation is not a U.S. real property interest if: (a) as of the date of the disposition of such interest, such corporation did not hold any such interest; or (b) all of such interest held by such corporation during the shorter of: (i) the period of time after June 18, 1980, during which the taxpayer held such interest; or (ii) the five-year period ending on the date of the disposition of such interest were either disposed of in transactions in which the full amount of the gain was recognized or ceased to be a U.S. real property interest. P.L. 114-113 states that "b" does not apply to the disposition of the stock of a corporation if either the transferor or transferee corporation (or its predecessor corporation) was a RIC or REIT and such stock remains a U.S. real property interest subject to tax under FIRPTA. Adopting this provision would increase state tax revenues by $100,000 in 2017-18 and 2018-19.

14. P.L. 114-113 makes permanent special rules that apply to income derived by a tax exempt organization from a controlled (50% common ownership) subsidiary. Organizations exempt from federal income tax are generally subject to the unrelated business income tax on business income that is not substantially related to the tax-exempt functions of the organization. Interest,

rents, royalties, and annuities of a tax-exempt organization are generally excluded from the unrelated business income tax, except that such income is taxed as unrelated business income if the income is received from a taxable or tax-exempt subsidiary that is 50% controlled by the parent tax-exempt organization to the extent the payment reduces net unrelated income, or increases any unrelated loss, of the controlled entity. This rule only applies to the portion of payments received that exceed the amount of payment that have been paid or accrues if the amount of such payment was an arms-length transaction, as determined under federal law, for payments made pursuant to a binding written contract in effect on August 17, 2006 or the renewal of that contract (or a contract of similar terms). A 20% penalty is imposed on the larger of such excess determined with regard to any amendment or supplement of a tax return or such excess determined with regard to all amendments and supplements. Adopting these rules would reduce state tax revenues by $100,000 in 2017-18 and 2018-19.

15. P.L. 114-113 specifies that, in the case of an early termination of a net income only charitable remainder annuity unitrust (CRUT) or a net income CRUT with a make-up feature, the remainder interest is valued using rules similar to the rules for valuing a charitable remainder trust when determining the grantor's charitable contribution deduction. Under federal and state law, for purposes of calculating the amount of the grantor's charitable contribution, the remainder interest of a CRUT is equal to five percent of the net fair value of its assets, or a greater amount under the terms of the trust instrument, to be distributed each year to the income beneficiary. P.L. 114-113 provides rules for valuing the interests in a CRUT in the event of early termination for federal tax purposes, but state law did not automatically adopt this provision. A CRUT is a trust that generally is required to pay, at least annually, a fixed percentage of at least five percent of the fair market value of the trust's assets determined at least annually to an income beneficiary for the life of an individual for 20 years or less, where the remainder passes to charity. A net income only CRUT allows the trustee to pay the income beneficiary the lesser of the trust income for the year or a fixed percentage of the value of the trust. A net income CRUT with a make-up feature allows a distribution to be made in excess of the fixed percentage if the distribution in the prior year was less than the fixed percentage, subject to the net income limit. Adopting this provision would increase state tax revenues by an estimated $200,000 in 2017-18 and $100,000 in 2018-19.

16. In cases where a taxpayer transfers property to a related party and is unable to recognize a loss for tax purposes under federal laws governing losses with respect to transactions between related parties, P.L. 114-113 provides that the related party may not reduce their gain on a subsequent disposition of the property by the amount of unrecognized loss incurred by the original transferor. Under prior law, if property was transferred to a related entity at a loss, the tax benefit of the loss was shifted to the related party in calculating any gain on a future disposition of the property. Adopting this provision would increase state tax revenues by $400,000 in 2017-18 and 2018-19.

17. A number of other IRC changes were enacted, but not included for adoption, generally because of their fiscal effect. One provision relates to tax-free distributions from individual retirement accounts to qualified charitable organizations. This provision was originally enacted on a temporary basis but was made permanent by P.L. 114-113. The provision allows individuals aged 70 ½ years or older to exclude from taxable income up to $100,000 distributed from an individual

retirement account (IRA) directly to a qualified charitable organization. Currently, Wisconsin law requires those individuals to add the contributions back to federal adjusted gross income (AGI) when computing Wisconsin AGI for state tax purposes. However, those individuals may include the contributions in their calculation of the state itemized deduction credit. Adopting the federal treatment would eliminate the add-back, and the contribution would not be included in the tax credit calculation. Assuming a tax year 2017 effective date, state individual income tax collections would decrease by an estimated $4.2 million in 2017-18 and $4.8 million in 2018-19. In the current legislative session, two bills proposing the same treatment have been introduced, SB 121 and AB 176.

ALTERNATIVES

1. Approve the Governor's recommendation to update statutory references to the Internal Revenue Code.

ALT 1	**Change to**	
	Base	**Bill**
GPR-Tax	- $1,400,000	$0

2. Modify the Governor's recommendation by including provisions identical to those contained in SB 121 and AB 176, concerning charitable distributions from IRAs included in P.L. 114-113, beginning in tax year 2017.

ALT 2	**Change to**	
	Base	**Bill**
GPR-Tax	- $10,400,000	- $9,000,000

3. Delete provision.

ALT 3	**Change to**	
	Base	**Bill**
GPR-Tax	$0	$1,400,000

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