HOWARD MARKLEIN
STATE SENATOR • 17TH SENATE DISTRICT

January 29, 2020
Senate Committee on Agriculture, Revenue & Financial Institutions
Testimony on Senate Bill 706

Good Morning!

Thank you committee members for hearing Senate Bill 706 (SB 706) that makes modifications to the tax treatment of tax-option corporations (S corporations) that elect to pay tax at the entity level.

Under current law, S corporations, partnerships, and limited liability companies (LLCs) are collectively referred to as pass-through entities (PTEs). 2017 Wisconsin Act 368 (Act 368) made changes to the tax treatment for PTEs that elect to be taxed at the entity level. Under Act 368, businesses may elect to be taxed at the entity level for taxable years beginning in 2018 for S corporations and for taxable years beginning in 2019 for all other PTEs. The different dates for when the changes would take effect was intentional in the legislation. However, there were some differences in tax treatment that were not intended. **SB 706 seeks to align the tax treatment for all PTEs that make the election to be taxed at the entity level.**

The Wisconsin Institute of Certified Public Accountants (WICPA) worked with the Wisconsin Department of Revenue (DOR) to ensure similar treatment for S corporations and partnerships that make the election to be taxed at the entity level. There are three main issues addressed by the bill: 1) capital gains exclusion; 2) excess capital loss deduction 3) interest for underpayment of estimated taxes.

Regarding the capital gains exclusion, the bill allows these corporations to exclude from tax 30 percent of the gains realized from the sale of assets held more than one year and the sale of all assets acquired from a decedent and 60 percent of the gains realized from the sale of farm assets held more than one year and the sale of all farm assets acquired from a decedent.

After netting capital gains and capital losses, a S corporation may use up to $500 of the net loss to offset income. A loss in excess of $500 may be carried forward to the next taxable year in which the corporation makes the election to pay tax at the entity level.

The remaining provision creates an exception from the requirement to pay interest on the underpayment of estimated taxes for corporations whose Wisconsin net income is less than $250,000, and provides that these corporations, when making quarterly estimated tax payments, compute the amount due using the standards applicable to taxpayers with net income of less than $250,000, regardless of the corporation's actual net income.

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This bill is supported by both WICPA and DOR.

Thank you again for hearing SB 706, and your timely action on this proposal.

Wisconsin Institute of
Certified Public Accountants

January 29, 2020

TO: Chairman Marklein and members of the Senate Committee on Agriculture, Revenue and Financial Institutions

FROM: The Wisconsin Institute of Certified Public Accountants

RE: Urge you to support SB 706 (AB 753) authored by Senator Howard Marklein, CPA, Senator Dale Kooyenga, CPA and Senator Chris Kapenga and Rep. John Macco

The Wisconsin Institute of CPAs representing over 7,000 members across this state has worked closely with the Wisconsin Department of Revenue for the past several months to obtain clarifying language for Wisconsin Act 368.

In December 2018, the Wisconsin legislature passed Wisconsin Act 368. The legislation provides for an election for pass-through entities, including partnerships, limited liability companies and tax-option corporations (e.g. S corporations) to be taxed at the entity level with the owners of the pass-through entities allowed an exclusion for the investors' distributive share of income subject to the new pass-through entity tax.

Under the federal Tax Cuts and Jobs Act the deduction for state income, real estate and other taxes is limited at the individual level to $10,000 per year per return. Taxes imposed on pass-through entities should be deductible at the entity level. Several state legislatures have enacted various approaches to assist their taxpayers in mitigating the new $10,000 limitation on federal income tax deductions for state and local taxes.

In the bill that was passed there were different provisions applying to partnerships and tax-option corporations. Basically, the individual tax rules were applied to partnerships and corporation tax rules were applied to tax-option corporations making the entity tax election. The intent was to have similar rules apply to both partnerships and tax-option corporations making the entity tax election. The proposed new bill will accomplish that goal.

The changes to the tax treatment of tax-option corporations that elect to pay tax at the entity level are as follows:

1. The bill allows these corporations to exclude from tax 30 percent of the gains realized from the sale of assets held more than one year and the sale of all assets acquired from a decedent and 60 percent of the gains realized from the sale of farm assets held more than one year and the sale of all farm assets acquired from a decedent.

2. The bill limits the excess capital loss deduction for these corporations to $500. As such, under the bill, an electing tax-option corporation with a net loss after netting capital gains and losses may use up to $500 of the net loss to offset income. A loss in excess of $500 may be carried forward to the next taxable year in which the corporation makes the election to pay tax at the entity level.
3. The bill provides that an exception from the general requirement to pay interest on the underpayment of estimated taxes for corporations whose Wisconsin net income is less than $250,000 does not apply to these corporations.
4. The bill provides that these corporations, when making quarterly estimated tax payments, compute the amount due using the standards applicable to taxpayers with net income of less than $250,000, regardless of the corporation's actual net income.

For tax-option corporations making an entity election, partnerships making an entity election, and for individuals, the law will now be in conformity regarding the above four items.

By adopting these provisions, Wisconsin businesses will benefit and the revenue to the state should increase since the maximum Wisconsin individual tax rate is 7.65% and the Wisconsin entity tax rate is 7.9%.

Thank you for your consideration. We urge you to support this technical clean legislation.

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3. The bill provides that an exception from the general requirement to pay interest on the underpayment of estimated taxes for corporations whose Wisconsin net income is less than $250,000 does not apply to these corporations.
4. The bill provides that these corporations, when making quarterly estimated tax payments, compute the amount due using the standards applicable to taxpayers with net income of less than $250,000, regardless of the corporation's actual net income.

For tax-option corporations making an entity election, partnerships making an entity election, and for individuals, the law will now be in conformity regarding the above four items.

By adopting these provisions, Wisconsin businesses will benefit and the revenue to the state should increase since the maximum Wisconsin individual tax rate is 7.65% and the Wisconsin entity tax rate is 7.9%.

Thank you for your consideration. We urge you to support this technical clean legislation.

WMC

WISCONSIN MANUFACTURERS & COMMERCE

To: Assembly Committee on Ways and Means & Senate Committee on Agriculture, Revenue, and Financial Institutions

From: Cory Fish, General Counsel and Director of Tax

Date: January 28, 2020

Re: **Clarify the Intent of Wisconsin's Dividends Received Deduction**

Background

Since the introduction of the U.S. Treasury Regulations under Sec. 301.7701, commonly referred to as the "check the box" rules, in 1996, partnerships and other types of eligible business entities may elect to be taxed as corporations for federal income tax purposes, regardless of what the legal structure of the entity the company chooses.

Income of a foreign corporate subsidiary is taxable by Wisconsin when it is paid as a dividend to the subsidiary's domestic parent. In order to not discriminate against foreign commerce Wisconsin allows a dividend received deduction if the domestic parent owns 70% or more of the foreign subsidiary's common stock.

Wisconsin tax laws are based on the Internal Revenue Code, and the "check the box" rules have been adopted by Wisconsin statute (Wis. Stat. s. 71.22(1k)) provides that 'corporation' includes corporations and all other entities treated as corporations under Section 7701 of the Internal Revenue Code. Since the creation of the "check the box" election, Wisconsin's dividends received deduction (Wis. Stat. s. 71.26(3)(j)) has been interpreted to allow any parent corporation to receive the deduction provided the foreign subsidiary from which it was receiving dividends had elected to be taxed as a corporation, regardless of what the legal structure of the foreign subsidiary actually was.

Recently, without a change in statute or rule, the Wisconsin Department of Revenue (WDOR) unilaterally changed its interpretation so that the foreign entity must be organized as a corporation that has issued "Common Stock" under the foreign nation's law in order for the domestic parent company to get the deduction for any dividends received. This shift in policy, aside from being inconsistent with Wisconsin statute, discriminates against entities that are taxed the same, based on how they're legally structured, and disincentivizes U.S. parent companies from repatriating foreign income to the United States.

Current Litigation

A number of businesses with large Wisconsin operations have been audited by WDOR, which claims they have inappropriately taken the DRD. Deere & Company and the WDOR took this

issue to the Wisconsin Tax Appeals Commission (a specialized administrative tax court) and the Commission unanimously ruled in favor of the taxpayer.

In that case a foreign subsidiary of Deere "checked the box" to be taxed as a corporation for Wisconsin tax purposes. The subsidiary made distributions to the parent company, Deere.

WDOR argued that those distributions were not dividends and therefore Deere could not claim the DRD because despite the fact the subsidiary was taxed as a corporation it was not structurally a corporation. The Commission ruled that because the subsidiary "checked the box" the distribution were dividends for tax purposes and therefore Deere was entitled to receive the deduction.

Despite this loss, WDOR has appealed the decision to Dane County Circuit Court and has continued to audit other companies in similar circumstances that take the deduction. This has led to Wisconsin businesses incurring significant legal costs. These costs will continue until WDOR stops appealing or until the Legislature acts.

Potential Legislative Fix

The Legislature should make clear that parent companies that receive dividends from foreign subsidiaries are eligible for the deduction regardless of the legal structure of the subsidiary provided the subsidiary has "checked the box" to be taxed as a corporation. To accomplish this, WMC proposes the following updated language to Wis. Stat. s. 71.26(3)(j):

> 71.26(3)(j) Sections 243, 244, 245, 245A, 246 and 246A are excluded and replaced by the rule that corporations and any entity treated as a corporation for federal income tax purposes may deduct from income ordinary dividends or other distributions received from a corporation ~~with respect to its common stock~~, partnership, limited liability company or any other entity that is taxed as a corporation for federal income tax purposes, if the corporation receiving the ordinary dividends or other distributions owns, directly or indirectly, during the entire taxable year at least 70 percent of the total combined voting stock or total combined voting equity interests of the payor entity. In this paragraph, "ordinary dividends or other distributions received" means gross dividends on stock or gross distributions on other equity interests, minus taxes on those dividends or other distributions that are paid to a foreign nation and claimed as a deduction under this chapter. The same dividends may not be deducted more than once. "Ordinary dividends or other distributions received" do not include dividends or distributions on stock or other equity interests that provide the owner with guaranteed or preferential return rights.

WMC appreciates your consideration on this important tax policy issue. Please feel free to contact Cory Fish if you have any questions at cfish@wmc.org or (608) 661-6935.