B

Effective Date: Tax years beginning after December 31, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

10. Post-Termination Period

Federal Change: The Small Business Act expanded the post-termination transition period for a former S corporation to include the 120-day period that begins on the date of an audit determination (following termination of an S corporation election) that adjusts S corporation income, loss or deduction claimed by the former S corporation. What is considered a determination is expanded to include a final disposition of a claim for refund by the Treasury Secretary and certain tax liability agreements between the Secretary and other persons. Thus, distributions made by a former S corporation during its post-termination period are treated as if made by an S corporation, and distributions after the post-termination period are treated as if made by a C corporation.

Effective Date: Tax years beginning after December 31, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

11. Audit Provisions

Federal Change: The Small Business Act repealed S corporation audit provisions enacted in the Tax Equity and Fiscal Responsibility Act of 1982, and enacted new audit rules requiring consistency between returns of the S corporation and its shareholders.

Effective Date: Tax years beginning after December 31, 1996.

Recommendation: Do not adopt the federal change. Wisconsin has its own audit provisions.

Fiscal Effect: None.

12. Re-elections

Federal Change: The Small Business Act modified the five-year retroactive period for subchapter S re-elections. Small business corporations that terminated their subchapter S election within the five years immediately preceding August 20, 1996, can re-elect subchapter S status without IRS consent.

Effective Date: Terminations occurring in a tax year beginning before January 1, 1997.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

13. Carryovers into Post-Termination Period

Federal Change: The Small Business Act provided that losses of an S corporation suspended pursuant to at-risk rules may be carried forward to the corporation's post-termination period. This conforms the treatment of at-risk losses to the treatment of basis limitation losses.

Effective Date: Tax years beginning after December 31, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

14. Distributions During Loss Years

Federal Change: The Small Business Act required basis adjustments for distributions made by an S corporation during a tax year to be considered before applying the loss limitation for the year. Thus, distributions reduce the adjusted basis for determining allowable loss for the year, but the loss does not reduce the adjusted basis for determining tax status of distributions. Net negative adjustments are disregarded in the accumulated adjustments account when determining the tax treatment of distributions made by an S corporation with accumulated earnings and profits. This change makes the treatment of S corporations during loss years the same as that for partnerships.

Effective Date: Tax years beginning after December 31, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue gain.

15. Earnings and Profits

Federal Change: The Small Business Act reduced accumulated earnings and profits of an S corporation during its first year beginning after December 31, 1996, by the earnings and profits accumulated in any tax year beginning before January 1, 1983, for which the corporation was an S corporation. As a result, earnings and profits are solely for tax years in which the S corporation election was not in effect.

Effective Date: Tax years beginning after December 31, 1996.

Recommendation: Do not adopt the federal change. If Wisconsin adopts this change, some income would not be taxed either to the corporation or to its owners. This is contrary to the principle of S corporation taxation, which precludes taxation of the same income at both the entity and the individual level, but also requires that no income go untaxed. S corporations would not be required to keep any additional records if Wisconsin does not adopt this charge, because differences in state and federal treatment of S corporations prior to 1983 already require them to keep separate records for state and federal tax purposes.

Fiscal Effect: None.

16. Treatment of S Corporations Under Subchapter C

Federal Change: The Small Business Act clarified that Subchapter C rules generally govern liquidation of C corporations into S corporations. The Act repealed a rule that treated an S corporation holding stock of another corporation as an individual. The repeal does not change the general rule governing computation of income of an S corporation. In addition, following a tax-free liquidation, the built-in gains of the liquidating corporation may be subject to tax upon a subsequent disposition. An S corporation may also make an election to have certain stock purchases treated as asset acquisitions, resulting in immediate taxable recognition of all the acquired C corporation gains and losses.

Effective Date: Tax years beginning after December 31, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: None, since this is a clarification.

17. Inherited S Corporation Stock

Federal Change: The Small Business Act required any person who inherits stock in an S corporation to treat as income in respect to a decedent the prorated share of any income of the corporation that would have been income in respect to a decedent had it been received directly from the decedent. A deduction is allowed for the estate tax attributable to the income in respect to a decedent. Stepped-up basis of the stock acquired from a decedent is reduced by the extent that the value is attributable to income in respect to a decedent. This change gives S corporation shareholders the same treatment as partners under current partnership rules.

Effective Date: Decedents dying after August 20, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue gain.

18. Subdivided Real Estate

Federal Change: The Small Business Act allowed S corporations to qualify for capital gain presumptions, permitting capital gain treatment for unimproved subdivided real estate held for five years and otherwise considered ordinary income property. This treatment was formerly available only to noncorporate taxpayers.

Effective Date: Tax years beginning after December 31, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

E. PENSIONS

1. SIMPLE Retirement Plans

Federal Change: The Small Business Act permitted qualified employers not currently maintaining a retirement plan to adopt a Saving Incentive Match Plan for Employees (SIMPLE plan). Under the plan, employers make contribution up to $6,000 annually, and employees are required to make matching contributions.

Employers may generally deduct contributions, including pre-tax employee contributions to the SIMPLE account. Contributions may be excluded from an employee's income, but employee contributions are treated as wages for employment tax purposes. Assets in the plan are not taxable until distributed to employees. Distributions from a SIMPLE IRA or 401(k) are generally included in a participant's income when withdrawn from the account.

The SIMPLE plan is not subject to nondiscrimination rules that are applicable to other qualified plans. Further, trustees of SIMPLE plans and employers maintaining such plans are not required to meet the general reporting requirements of the Employee Retirement Income Security Act (ERISA).

A SIMPLE plan may be structured as an IRA or as a qualified cash or deferred arrangement [401(k) plan]. Contributions to a SIMPLE IRA are limited to employee elective contributions and required employer matching contributions or nonelective contributions. Employee elective contributions are limited to $6,000 per year, an amount adjusted annually for inflation in $500 increments.

Employers are generally to match employees contributions, up to 3% of the employee's compensation. However, an employer may choose to match contributions for all eligible employees at a lower percentage, but not lower than 1%. Further, the employer's matching contribution must not drop below 3% in more than two years in a five-year period ending in the current year.

As an alternative to matching contributions, an employer may elect to make a nonelective contribution of 2% of compensation for each eligible employer with compensation of at least $5,000 during the year. There is a $150,000 limit on compensation for the nonelective contribution, which limits the employer's 2% contribution to $3,000, in contrast to the maximum matching contribution of $6,000.

The SIMPLE 401(k) plan has similar rules relating to contributions. For the employee, the deferral may not exceed $6,000 per year. The employer may elect either to match the employee's elective deferrals, up to 3% of compensation, or to make a nonelective contribution of 2% of compensation for each eligible employee earning at least $5,000 in compensation during the year. Unlike the SIMPLE IRA, the employer does not have the option of reducing the matched compensation to less than 3%.

Contributions to both the SIMPLE IRA and 401(k) are fully vested.

Participants may roll over distributions from one SIMPLE account to another SIMPLE account or to an IRA without incurring tax liability or penalty. However, distributions may not be rolled over tax-free to a qualified retirement plan. Early withdrawals—those made before age 59-1/2—are subject to the same 10% penalty for early withdrawals from an IRA, though the penalty is 25% for withdrawals during the two-year period beginning with the date the employee began participation.

The SIMPLE plan must be open to every employee who received at least $5,000 in compensation from the employer in any two preceding years and is reasonably expected to receive at least $5,000 in the current year. Self-employed individuals may also participate.

Eligible employees may choose to participate, through elective contributions or deferrals, during the 60-day period before the beginning of the year, or the 60-day period before the employee becomes eligible to participate. An employee may also modify previous contribution elections during this period. Employees may to choose to terminate participation any time during the year; if they do, they can resume participation during the same year only if the employer agrees. Employer are required to notify employees of the right to make salary reduction contributions under a SIMPLE plan immediately before the 60-day election period; the penalty for failing to provide the notice is $50 per day.

Employers choosing to make a matching contribution less than 3% of compensation, or to make the nonelective contribution equal to 2% of compensation to either a SIMPLE IRA or SIMPLE 401(k), must notify eligible employees of that election within a reasonable period before the 60-day election period.

The trustee of a SIMPLE account must make an annual report containing specified information to the employer, each participating employee and the U.S. Department of the Treasury. The penalty for failing to meet the reporting requirement is $50 per day, although the penalty may be waived for reasonable cause.

The SIMPLE plan is limited to employers with 100 or fewer employees who received at least $5,000 in compensation from the employer in the previous year. In determining the number of employees, "employer" includes any related employers, for example, a subsidiary. An employer that maintains a SIMPLE plan for more than one year, but then becomes ineligible for it may continue to maintain the plan for two years following the last year in which it was eligible.

An employer maintaining a qualified retirement plan, governmental plan, tax-sheltered annuity or simplified employee plan may not establish a SIMPLE plan.

The Act disallows Salary Reduction Simplified Employee Pension (SARSEP) plans after 1996. However, employers with existing SARSEP plans may continue to make contributions to them, and employees hired after December 31, 1996, may participate in SARSEP plans established prior to 1997.

Effective Date: Plan years beginning after December 31, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: -\$0.4 million in FY 1998; -\$0.4 million in FY 1999.

2. Tax-Exempt Organizations Permitted to Offer 401(k) Plans

Federal Change: The Small Business Act allowed tax-exempt organizations to establish 401(k) plans for their employees. State and local governments, and their political subdivisions, agencies and instrumentalities, continue to be barred from maintaining such plans.

Effective Date: Plan years beginning after December 31, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

3. Church Pension Plans

Federal Change: The Small Business Act permitted self-employed ministers and ministers employed by organizations that are not tax-exempt to participate in church plans. Through these plans, which are similar to tax-deferred annuity plans, churches provide tax benefits to church employees or their beneficiaries.

The act treats a self-employed minister—that is, someone who has net earnings from self-employment—as a tax-exempt employer. Compensation for purposes of the plan is determined on the basis of net earnings from self-employment, rather than compensation received form an employer. In determining years of service, the number of years, including portion of years, in which the minister was self-employed with respect to his or her ministry, is included.

Ministers employed by organizations other than tax-exempt organizations, for example, chaplains, are eligible for church plans if the employment is in connection with the exercise of his or her ministry. The employer may exclude such a minister from being treated as an employee. Compensation taken into account for purposes of determining contributions to or benefits from a church plan may not be taken into account for contributions or benefits under a non-church plan.

The act requires that no employee will be treated as an officer, shareholder, supervisory employee or highly compensated employee unless that person also satisfies the ERISA definition of highly compensated employee. In other words, church plans that were previously subject to pre-ERISA nondiscrimination rules must now use the same definition of highly compensated employee applicable to other pensions plans.

Employer contributions to pension and annuity plans on behalf of foreign missionaries are included in the missionaries' basis in the plan, that is, the investment in the contract, even though the amount, if paid directly to the missionary, would have qualified for the foreign earned income exclusion under IRC Sec. 911.

Effective Date: Years beginning after December 31, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

4. Simplified Distribution Rules

Federal Change: The Small Business Act made several changes in distribution rules, including:

- The five-year forward averaging for lump-sum distributions was repealed, effective for tax years beginning after December 31, 1999. For persons age 50 or older before January 1, 1986, prior law rules remain effect. These rules permit an individual, trust or estate to elect ten-year forward averaging, using 1986 tax rates, for a single lump-sum distribution. They also permit capital gains treatment for the pre-1974 portion of a lump-sum distribution.

- The employer-provided death benefit exclusion permitting the beneficiary or estate of a deceased employee to exclude up to $5,000 in benefits paid by or on behalf of an employer was repealed.

- A simplified method for determining the portion of an annuity distribution plan that represents nontaxable return of basis was provided. The nontaxable return of basis is generally equal to the employee's total investment in the contract as of the starting date of the annuity, divided by the number of anticipated payments.

  The investment in the contract is the amount of premiums and other consideration—generally, after-tax contributions—paid, less the amount excluded from gross income that was received before the annuity starting date.

  The number of anticipated payments is based on the employee's age on the starting date of the annuity date, except when the number of payments is fixed under terms of the annuity, in which case that fixed number is used. Anticipated payments equal 360 for persons age 55 and younger, 310 for persons ages 55 to 60, 260 for persons 61 to 65, 210 for persons 66 to 70, and 160 for persons 71 and older.

  This simplified method does not apply when the primary annuitant is age 75 or older on the starting date of the annuity, unless there are fewer than five years of guaranteed payments. Also, if a person receives, in connection with commencement of annuity payments, a lump-sum payment that is not part of the annuity stream, this payment is taxed as if it was received before the annuity starting date. The investment in the contract used to calculate the simplified exclusion ratio for the annuity payment is reduced by the amount of payment.

- The entire investment in an annuity with a refund feature may be recovered tax free if annuity payments cease because of the death or the annuitant. Prior to this change, the investment in the contract that could be recovered was reduced by the present value of the refund feature.

- Participants in qualified plans are no longer required to begin receiving distributions at age 70-1/2 if they are still employed. Rather, distributions must begin by April 1 of the calendar year following the later of the calendar year in which the employee reaches age 70-1/2, or the calendar year in which the employee retires. The accrued benefit for such an employee must be actuarily increased to reflect that value of benefits he or she would have received if benefits had begun at age 70-1/2.

  This change does not apply to employees owing 5% of the business and IRA holders, who must begin receiving distribution at the age 70-1/2. However, this restriction does not apply to governmental or church plans.

Effective Date: Repeal of five-year averaging is effective for tax year beginning after December 31, 1999. Repeal of the exclusion for employer-provided death benefits applies for decedents dying after August 20, 1996. The simplified method of taxing annuity distributions is effective for annuity starting dates after November 18, 1996. The change in the amount of investment that may be recovered in an annuity contract applies to individuals whose annuity starting date is after December 31, 1986. The new required beginning date for distributions is effective for years beginning after December 31, 1996.

Recommendation: Adopt the federal changes.

Fiscal Effect: Minimal revenue gain.

5. Nondiscrimination Rules

Federal Change: The Small Business Act made several changes in the nondiscrimination rules, including:

- Any person who is a 5% owner at any time during the current or preceding year, and any person who had compensation in excess of $80,000 and, if the employer elects, was in the top-paid group of the employer (the top 20% of employees by compensation) during the preceding year is considered highly compensated. The $80,000 amount is indexed to inflation. In addition, the Act repealed family aggregation rules that required that compensation paid to, and plan contributions or benefits made on behalf of, family members of certain highly compensated employees be treated as paid to or made on behalf of that employee.

- Applicability of the 50-40 rule is limited to defined benefit plans. Under this rule, a defined benefit plan must benefit at least the lesser of: 1) 50 employees, or 2) the greater of a) 40% of all employees, or b) two employees (one, if the company has only one employee).

- Safe harbor nondiscrimination rules provide that a 401(k) plans meets the nondiscrimination rules if it meets a notice requirement and one of two contribution requirements. The notice requirement is that each eligible employee must be given written notice, within a reasonable period before any year, of his or her rights and obligations under the plan.

  The two contribution requirements, for non-highly compensated employees, are either a matching contribution or a nonelective contribution. The required matching contribution generally is 100% of the employee's elective contribution, up to 3% of compensation, and 50% of the employee's elective contributions in excess of 3%, but not more than 5%, of compensation.

The nonelective contribution must be at least 3% of the compensation of each employee eligible to participate in the plan, regardless of whether whether or not the employee makes elective contributions.

Nondiscrimination testing may be done by reference to prior year data. Specifically, the actual deferral percentage and actual contribution percentages used to determine contributions for highly compensated employees in the current plan year is determined from these percentages for other employees in the prior plan year. An employer is allowed to elect to use current plan year percentages, but that election can be revoked only as provided by Secretary of Treasury.

An alternative method of satisfying the special nondiscrimination test requires that the plan meet the contribution and notice requirements provided above, and satisfy a special limitation on matching contribution. This limitation is met if matching contributions on behalf of any employee do not exceed 6% of compensation, if the employer's match rate does not increase as the rate of an employee's elective contributions or deferrals increases, and if the matching contribution for highly compensated employees at any rate of employee contribution or elective deferral is not greater than that for other employees.

Finally, excess contributions are to be considered attributable first to highly compensated employees with the greatest dollar amount of elective deferrals, rather than those with the highest actual deferral percentages.

- The definition of compensation, for purposes of limits on contributions and benefits under defined contribution plans, is amended to add: elective deferrals to 401(k) plans and similar arrangements, elective contributions to IRC Sec. 457 nonqualified deferred compensation plans, and salary reductions plans made to a cafeteria plan.

- Qualified plans are permitted to continue to base benefits on the Social Security retirement age without failing nondiscrimination tests. This change was necessitated by scheduled increases in the Social Security retirement age (to 66 for persons born after 1937 but before 1955, and to 67 for persons born after 1954).

- A 401(k) plan that elects to disregard nonhighly compensated employees eligible to participate in the plan before they have completed one year of service and reach age 21 must satisfy minimum coverage rules. These rules take into account only employees not meeting the minimum age and service requirements. A plan can adopt a single test that compares the actual deferral percentage for highly compensated employees eligible to participate to the same percentage for other employees who are eligible to participate and who have met the minimum age and service requirements. A similar rules applies for the actual contribution percentage test.

Effective Date: These provisions generally apply to plan years beginning after December 31, 1996, except as follows: for determining whether an employee falls under the definition of highly compensated employee in 1997, the amendments are treated as having been in effect in 1996; the safe harbors for 401(k) nondiscrimination rules are in effect for years beginning after December 31, 1998; the definition of compensation as it affects limits for defined contribution plans is effective for years beginning after December 31, 1997; the alternative nondiscrimination rules for 401(k) plans providing for early participation are effective for years beginning after December 31, 1998.

Recommendation: Adopt the federal changes.

Fiscal Effect: Minimal revenue loss.

6. Distributions from State and Local Government Deferred Compensation Plans

Federal Change: The Small Business Act allowed participants with accounts not exceeding $3,500 to elect an in-service cash-out without subjecting the total amount to tax. The Act also permitted participants to delay the date when distributions begin, and adjusted the $7,500 limit on elective deferrals for inflation.

Generally, employees participating in governmental deferred compensation plan are taxed on amounts paid or made available to them. However, the option to elect an in-service distribution will not make an employee's total benefit "available", and thus taxable, if the total amount payable does not exceed $3,500. In addition, the amount must only be distributable after a two-year period following the last deferral under the plan, and the participant must have received no prior distributions under the in-service cash-out option.

A participant may make one election to defer the date when distributions begin. That election must be made after the time when distributions may begin—the year the employee reaches age 70-1/2, separates from services or experiences an unforeseen emergency—but before distribution actually begins.

The inflation adjustment for the $7,500 limit on deferrals will follow provisions relating to defined benefit plans, with any increase not a multiple rounded to the next lowest multiple of $500.

Effective Date: Tax years beginning after December 31, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

7. Trust Requirements for State and Local Government Deferred Compensation Plans

Federal Change: The Small Business Act required that amounts deferred under a deferred compensation plan maintained by a state or local government be held in a trust, custodial account or annuity contract for the exclusive benefit of the plan participants and their beneficiaries. Previously, amounts deferred were the property and rights of the employer until deferrals were made available to plan beneficiaries. The change is designed to protect compensation deferred by employees from the general creditors of the employer if it went bankrupt. The trust, custodial account or annuity is not subject to tax.

Effective Date: Plan assets held on or after August 20, 1996, except that amounts deferred and earnings on those amounts under a plan in existence before August 20, 1996, need not be placed in a trust, custodial account or annuity plan until January 1, 1999.

Recommendation: Adopt the federal change.

Fiscal Effect: None.

8. Limits on Compensation and Benefits of Governmental Plans

Federal Change: The Small Business Act limited the distribution under a governmental defined benefit plan to $120,000 per year, an amount that will be adjusted for inflation after 1996. Previously, distributions under governmental plans were subject to the same limits as nongovernmental defined benefit plan distributions: the lesser of $120,000 or 100% of average compensation for the three highest years.

The Act also permitted state and local governmental employers to maintain qualified excess benefits plans, subject to the same rules as those on private employer excess benefit plans. However, participants under such plans may not participate in deferred compensation plans.

The Act also provided that certain limits do not apply to disability and survivor benefits and established a deadline for revocation of a grandfather rule election.

Effective Date: Years beginning after December 31, 1994, except the deadline for revocation of a grandfather rule election is effective for revocations adopted after August 20, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

9. Length of Service Awards Paid to Volunteers

Federal Change: The Small Business Act exempted plans that pay length-of-service awards to volunteers, such as firefighters and emergency medical service personnel, and their beneficiaries from the requirements for deferred compensation plans of state and local governments. Vacation leave, sick leave, compensatory time, severance pay, disability pay and death benefit plans are also exempt from these requirements. Amounts exempt from these requirement are also not considered wages for purposes of social security taxes.

Effective Date: Accruals of length of service awards after December 31, 1995. The exemption from social security taxes applies to remuneration paid after December 31, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

10. Vesting Rules for Multiemployer Plans

Federal Change: The Small Business Act eliminated special vesting rules for multiemployer plans, subjecting them to the same rules applicable to single employer plans. These rules provide that a participant's benefits are fully vested after five years of service or over a period of three to seven years. Previously, employees under a collective bargaining agreement had to vested no later than his or completion of ten years of service. The change does not apply to employees who do not have more than one hour of service under the plan on or after the first day of the plan year to which the change applies.

Effective Date: For plan years beginning on or after the later of January 1, 1997, or the date on which the last collective bargaining agreement under which the plan is maintained terminates, but not later than January 1, 1999.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

11. Football Coaches Plan

Federal Change: The Small Business Act made a technical correction that requires that a qualified football coaches plan under ERISA to be treated as a multiemployer collectively bargained plan and permits the plan to include a qualfied cash or deferred arrangement. The change allows the American Football Coaches Association to establish a 401(k) plan for its members.

Effective Date: Years beginning after December 22, 1987.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

12. Multiple Salary Reduction Agreements

Federal Change: The Small Business Act repealed provisions that prohibited IRC Sec. 403(b) tax-sheltered annuity participants from entering into more than one salary reduction agreement in any tax year. The change applies rules governing 401(k) plan participants to tax-sheltered annuity participants.

Effective Date: Tax years beginning after December 31, 1995.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

13. Indian Tribal Government Plans

Federal Change: The Small Business Act provided that a 403(b) tax-sheltered annuity contract purchased in a plan year before 1995 by an Indian tribal government be treated as purchased by an entity permitted to maintain a tax-sheltered annuity plan. The change permits rollovers from these contracts to be made to 401(k) plans maintained by the tribal government.

Effective Date: August 20, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

14. Elective Deferral Limits on Tax-sheltered Annuity Contracts

Federal Change: The Small Business Act provided that elective deferrals for each 403(b) tax-sheltered annuity contract, and not the tax-sheltered annuity plan, be limited to the annual limit, which is $9,500 in 1996. The change clarifies that excess deferrals by some employees do not affect employees whose deferrals do not exceed the limit.

Effective Date: Years beginning after December 31, 1995, except that a tax-sheltered contract is not required to comply with the rule before November 18, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: None, since the change is a clarification.

15. Distributions under Rural Cooperative Plans

Federal Law Change: The Small Business Act allowed rural cooperative plans with a cash or deferred arrangement (CODA) to permit distributions to plan participants after age 59-1/2 on account of the participant's hardship. This change conforms the treatment to that governing distributions by other qualified CODAs. The Act also expanded the definition of rural cooperative to include certain public districts providing electric service.

Effective Date: The distributions provisions are effective for distributions made after August 20, 1996. The definition change is effective for plans years beginning after December 31, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

16. Waiting Period for Joint and Survivor Annuities

Federal Change: The Small Business Act codified a regulation permitting a plan participant to waive the 30-day minimum waiting period between the date a written explanation of the terms and conditions of a qualified joint and survivor annuity is provided, and the annuity starting date, providing that the distribution from the annuity begins more than seven days after the written explanation is provided. The Act also required a plan to provide written explanation of the annuity after its starting date if the distribution begins at least 30 days after the explanation, subject to the same waiver of the 30-day minimum waiting period. The provision allows retroactive payments of payments attributable to the period before the explanation was provided.

Effective Date: Plan years beginning after December 31, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: None, since the Act incorporated existing practices provided by regulation.

17. Combined Plan Limit

Federal Change: The Small Business Act repealed the overall limit on contributions made on behalf of an employee participating in both a defined contribution and defined benefit plan. The 15% excise tax on excess distributions—those exceeding $150,000 per year or lump-sum distributions exceeding $750,000—is suspended until the combined plan limit takes effect.

Effective Date: Repeal of the combined plan limit takes effect for limitation years beginning after December 31, 1999. Suspension of the excise tax is effective for years beginning after December 31, 1996.

Recommendation: Adopt the federal changes.

Fiscal Effect: Minimal revenue loss.

18. Actuarial Assumptions in Computing Maximum Benefits

Federal Change: The Small Business Act provided that the interest used to reduce the dollar limit on benefits in IRC Sec. 415 when a benefit is payable before age 62 cannot be less than the greater of the interest rate required by the General Agreement on Trade and Tariffs (GATT) or the rate specified in the plan. The change makes the interest rate used to reduce the dollar limit the same regardless of the form of benefit. The Act also conformed the effective date of the new interest rate and mortality assumptions used to calculation the limits on benefits and contributions to the effective date on provisions relating to the calculation of lump-sum distributions. Transition rules are provided for plans adopted and in effect before December 8, 1994.

Effective Date: Generally effective for plan years and limitation years beginning after December 31, 1994.

Recommendation: Adopt the federal changes.

Fiscal Effect: Minimal revenue loss.

19. Contributions on Behalf of Disabled Employees

Federal Change: The Small Business Act eliminated the requirement that an employer must make a special election in order to continue contributions to a defined contribution plan on behalf of a permanently and totally disabled employee. However, a plan is required to provide for the continuation of contributions, for a fixed or determinable period, for all participants who are permanently and totally disabled in order to contributions on behalf of a particular employee.

Effective Date: Years beginning after December 31, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

20. Definition of Leased Employees

Federal Change: The Small Business Act modified the definition of leased employee to be an individual whose services are performed under the "primary direction or control" of the employer. Previously, a leased employee was an individual performing services of a type "historically performed" by employees of the employer. Leased employees are eligible for benefits provided by an employer, and the revised definition reduces the risk that an individual with whom the employer contracts for services will be eligible fore benefits.

Effective Date: Years beginning after December 31, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

21. Reemployment Rights of Veterans

Federal Change: The Small Business Act allowed employers to meet the requirements of the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA) without jeopardizing the qualified status of their retirement plans. USERRA entitles veterans returning to employment from military service to make up employee contributions and elective deferrals that were not made during military service.

Under the Small Business Act, make-up contributions on behalf of a reemployed veteran to tax-sheltered annuity, simplified employee pension, salary reduction arrangement, or governmental deferred compensation plan by an employer or employee, or to a defined benefit plan by an employee, are not subject to contribution limits that would otherwise apply. However, contributions, including elective deferrals, are limited to the aggregate amount of contributions that would have been applicable for the year for which contributions are made had the individual been employed by the employer during the period of military service.

employment. In addition, employer must match any elective deferrals or employee contributions by reemployed veterans at the same rate that would have applied during the period of military service.

Effective Date: December 12, 1994.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

22. Miscellaneous Pension Simplification

Federal Change: The Small Business Act included several pension simplification provisions, specifically:

- provisions that permit pensions plans to delay adoption of pension simplification amendments—until the start of the plan year that begins in 1998 for nongovernmental plans and in 2000 for governmental plans;
- a requirement that the IRS develop, by January 1, 1997, easy-to-understand sample language for inclusion in forms for spousal consent to a waiver of joint survivor benefits and qualified domestic relations orders;
- repeal of special aggregation rules that had applied exclusively to plans maintained by self-employed individuals, effective for years beginning after December 31, 1996;
- in response to a U.S. Supreme Court decision that insurance company general accounts are subject to ERISA requirements, a requirement that the Labor Department issue proposed regulations by June 30, 1997, and final regulations by December 31, 1997, clarifying the status of pension plan assets held in insurance company accounts so that the interests of the plan and its participants and beneficiaries are protected. The rules are to be generally effective on January 1, 1975, the date a Labor Department bulletin the court decision overturned had been put in effect, but will not apply to any civil action begun before November 7, 1995.
- provisions, effective for plan years beginning after 1989, that entitle qualified beneficiaries of an employee covered under a health plan to continued health coverage for three years if the employee becomes entitled to Medicare benefits due to an event involving separation from service or reduction in hours.

Effective Date: As indicated above.

Recommendation: Adopt the federal changes.

Fiscal Effect: None.

23. Prohibited Transactions Excise Tax and Rule Changes

Federal Change: The Small Business Act increased the excise tax imposed on disqualified persons participating in a prohibited transaction from 5% to 10% of the amount involved in the transaction. Prohibited transactions are certain transactions between an employee benefit plan and a party related to the plan, which are prohibited by ERISA and the IRC. The Act also clarified that transactions exempt from the ERISA prohibited transactions are also exempt from IRC prohibited transactions rules.

Effective Date: The excise tax increase applied to prohibited transactions occurring after August 20, 1996. The clarification on exempt transactions is effective December 22, 1987.

Recommendation: Adopt the federal change.

Fiscal Effect: None. Wisconsin does not have a similar excise tax on prohibited transactions, and the change regarding exempt transactions is a clarification.

F. MISCELLANEOUS

1. Financial Asset Securitization Investment Trusts

Federal Change: The Small Business Act created a new entity, the financial asset securitization investment trust (FASIT). Activities of a FASIT are generally limited to holding portfolios of qualified loans, and they may not independently engage in lending. The Act provided that FASITs may be used to securitize certain debt, such as credit card receivables, home equity loans and auto loans. The primary advantage to a FASIT is the certainty that instruments issued by it will be treated as debt for federal income taxes.

FASITs are equitably owned by a single taxable C corporation and issue asset-backed securities that are treated as debt for federal tax purposes. FASIT residual income (roughly equal to the difference between income earned from loan portfolios and interest paid to investors) is passed through and taxed to FASIT owner. Even though a FASIT is generally not subject to entity-level tax, because the FASIT must be entirely owned by a C corporation, income earned by the FASIT is subject to corporate level tax. Taxes paid by a FASIT at the entity level are limited to a corporate tax on foreclosure property and certain excise taxes designed to prevent impermissible activities.

To qualify as a FASIT, an entity must: (1) make an election to be treated as a FASIT for the year of the election and subsequent years; (2) have assets that are substantially permitted assets; (3) issue only nonownership security instruments that qualify as regular interests; (4) have a single ownership interest held by a domestic bank or C corporation; and (5) not qualify as a regulated investment company.

Permitted assets must consist of:

- Cash and cash equivalents;
- Debt instruments that are considered debt for federal income tax purposes and that have their interest rates tied to a predictable index, according to rules governing real estate mortgage investment conduits (REMICs) . Debt instruments may include trade

receivables, regular interests in a REMIC, or an interest in another FASIT. FASITs may not hold debt obligations issued, directly or indirectly, by the owner or a person related to the owner of the FASIT.

- Property acquired on default or imminent default of debt instruments if the property would be foreclosure property for a real estate investment trust (REIT). FASITs may also hold property that would be foreclosure property for a REIT if not for leases entered into or construction performed while the property was held by the FASIT.

- Interest rate or foreign currency notional principal contracts, letters of credit, insurance, guarantees against payment defaults or similar instruments that hedge against risks associated with a FASIT's obligations to holders of its regular interest securities.

- Securities issued by a FASIT, which are treated as debt for federal income tax purposes regardless of whether similar instruments with similar terms would be debt if issued by another type of entity. FASITs may issue two categories of securities: regular interests yielding no more than 5% above the applicable federal rate at the time or issue, or high-yield instruments held only by domestic C corporations or by dealers acquiring the security for resale in the ordinary course of business.

A regular interest in a FASIT is an asset-backed security with fixed terms and that meets five requirements: (1) the instrument unconditionally entitles the holder to receive a specified principal amount; (2) the instrument pays interest that is either fixed, indexed to a predictable schedule with rates that measure current variations in the cost of newly borrowed funds, or has variable rates similar to the REMIC rules; (3) the instrument has a term to maturity of no more than 30 years (or as prescribed by regulations); (4) the instrument is issued to the public with a premium not exceeding 25% of the stated principal amount; and (5) the instrument has a yield to maturity at issue of no more than 5% above the applicable federal rate for the calendar month in which the instrument is issued. Interest paid to regular interests in a FASIT is deductible to the FASIT in computing its net income to be passed through to the owner of the FASIT.

High-yield debt instruments involve more risk than regular interest debt instruments and may be held only by taxable C corporations and by dealers for resale to customers in the ordinary course of business. An excise tax is imposed at the highest corporate rate (35%) on a dealer if there is a change in status or if the dealer holds the instruments for investment. A safe-harbor rule allows a dealer to hold an instrument for 31 days before ownership may be treated as investment. Attempts to transfer high-yield instruments to disqualified holders will be ignored for federal income tax purposes; the transferor will remain liable for taxes from interest paid on the transferred interest.

Holders of regular and high-yield interests in FASITs must account for the income earned on the instrument using an accrual method of accounting, regardless of the method of accounting otherwise used by the holder. High-yield holders may not use net operating losses to offset income derived from high-yield debt. Net operating loss carryovers must be computed without the income from the disallowed loss. The constant yield method and principles that apply for determining original issue discount accrual on debt obligations apply to all debt obligations held by a FASIT for determining interest and discount income and premium deductions or adjustments

The character of income to the owner is the same as the character to the FASIT, except that tax-exempt interest is treated as ordinary income. All of the FASIT assets are treated as assets and liabilities of the FASIT owner. As such, income, gain, deduction or loss is directly allocable to the owner. Securities held by the FASIT are treated as held for investment by the owner. The owner cannot offset income from FASIT ownership interest with any other losses. Any net operating loss carryover of the FASIT owner is computed without income from the disallowed loss. The alternative minimum taxable income of a FASIT owner cannot be less than the FASIT income for the year.

Gain is recognized immediately by the owner of the FASIT upon the transfer of assets to the FASIT. Assets transferred to the FASIT by someone other than an owner are treated as if they were acquired by the owner and then contributed to the FASIT. Any assets of the owner or a related person used to support the FASIT's obligations to its regular interest holders are treated as contributed to the FASIT. The FASIT basis in contributed assets is increased by any taxable gain recognized by the owner.

The value of the assets contributed to the FASIT is computed as the sum of the present values of the cash flows expected from the obligations, discounted over the weighted average life of the contributed loans. The applicable discount rate is 120% of the applicable federal rate compounded semiannually. Each extension of credit is treated as a separate debt instrument for computing the value of the contributed pool of revolving loan accounts. Instrument maturity is determined according to a reasonably anticipated periodic payment rate for principal payments, as a proportion of their aggregate outstanding principal balances, assuming payments are first applied to the earliest credit extension.

Losses on assets contributed to a FASIT are recognized by the owner when the FASIT disposes of the assets.

FASITs are subject to tax at the highest corporate rate on net income from any foreclosure property acquired in connection with the default or imminent default of its loans. Foreclosure property includes any property that would be foreclosure property to a real estate investment corporation, plus property subject to a lease or construction contract. Foreclosure property does not include property acquired by the FASIT pursuant to a security interest created for the principal purpose of having the FASIT acquire the property.

To discourage FASITs from engaging in prohibited activities, an excise tax of 100% is imposed on all net income derived from: (1) an asset that is not a permissible asset; (2) disposition of an asset other than a permitted disposition; (3) income attributable to loans issued by a FASIT; and (4) compensation for services other than certain fees or waivers, amendments, or consents under permitted assets. Permitted dispositions of assets include those resulting from a complete liquidation of a class of regular interests; those incident to foreclosure, default, or imminent default of the asset; those incident to bankruptcy or insolvency of the FASIT; those necessary to avoid a default on an indebtedness of the FASIT attributable to a default on a loan held by the FASIT; those facilitating a clean-up call; or those substituting a permitted debt instrument for another instrument to avoid over-collateralization, if the purpose of the disposition is not to avoid recognizing gain from an increase in the assets market value.

<u>Effective Date</u>: September 1, 1997. A transitional rule provides guidance for entities created prior to September 1, 1997.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

2. Qualified State Tuition Programs

Federal Change: The Small Business Act clarified that state-sponsored prepaid tuition and educational savings programs are exempt from all federal tax except the tax on unrelated business income of a charitable organization. A qualified state tuition program is a program, established and maintained by a state or state agency, through which a person provides for the qualified higher education expenses of a designated beneficiary. The qualified higher education expenses may be provided by either purchasing tuition credits or certificates, or making cash contributions to an account established solely to meet the higher education needs of the designated beneficiary. The designated beneficiary may either waive rights to or use these credits or certificates for payment of qualified higher education expenses.

In addition, the program must provide separate accounting for each designated beneficiary and impose a penalty on any refund of earnings from the account that is not used for qualified higher education expenses of the designated beneficiary. Exceptions from penalty provisions are provided for refunds made because of the death or disability of the beneficiary, or because the beneficiary receives a scholarship, allowance or payment that is used for qualified higher education expenses. The program may not allow any contributor or designated beneficiary to direct the investment of any contributions or earnings of the program, or to use interest in the program as security for a loan. Finally, the program must provide adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for qualified higher educational expenses of the beneficiary.

A beneficiary must be designated when participation in the program is initiated; a change of beneficiary is permitted. When a state or local government or tax-exempt entity purchases an interest as part of a scholarship, the designated beneficiary is any future recipient of a scholarship. Qualified higher education expenses are tuition, fees, books, supplies, and equipment required for enrollment or attendance of a designated beneficiary at an eligible educational institution (college, university or certain vocational schools).

Contributions to a qualified state tuition program are treated as incomplete gifts for federal gift tax purposes. Federal gift tax consequences are determined at the time a distribution is made. Amounts contributed (and any earnings) to a qualified state tuition program are included in the contributor's estate for federal estate tax purposes if the contributor dies before distribution under the program. The waiver by or payment of qualified education expenses of a designated beneficiary to an educational institution is treated as a qualified transfer and not a taxable gift.

Effective Date: Generally for tax years ending after August 20, 1996, except the exemption applies to earlier contributions to a tuition program maintained by a state on the date of enactment if that program meets the requirements of the Small Business Act before the first day of the calendar quarter after the close of the first regular session of the state legislature that begins after August 20, 1996, but no later than August 20, 1997.

Recommendation: Adopt the federal change.

Fiscal Effect: None, since the change is a clarification.

3. Insurance Contracts on Retired Lives

Federal Change: The Small Business Act provided that the term "variable contract" includes contracts that provide for the funding of group term life or group accident and health insurance on retired lives. Such a contract must allocate all or part of amounts received to an account segregated from the insurance company's general asset account. Rules on payments to and from the account and on adjustment to the basis of a variable contract were also established.

Effective Date: Tax years beginning after December 31, 1995.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

4. Alternative Minimum Tax: Adjustment for Energy Performance

Federal Change: The Small Business Act clarified that the amount of the alternative tax net operating loss (NOL) that may be used in any tax year must be adjusted for the amount of the special energy deduction claimed for that year. This change preserves a portion of the alternative tax NOL carryover by reducing the amount of NOL used by amount of the special energy deduction claim. The special energy deduction, repealed by the Energy Policy Act of 1992, was in effect for tax years beginning after December 31, 1990 and before January 1, 1993.

The Act also clarified that the limit on using the investment tax credit for alternative minimum tax must be determined without adjustment for the special energy deduction.

The adjusted current earnings (ACE) is computed without regard to the special energy tax deduction for tax years beginning in 1991 and 1992. Thus, the ACE for 1991 and 1992 equals 75% of the excess of a corporation's ACE over its alternative minimum taxable income computed without the ACE adjustment, the alternative NOL deduction, or the special energy tax deduction.

Effective Date: Tax years beginning after December 31, 1990.

Recommendation: Adopt the federal change.

Fiscal Effect: None, since this is a clarification.

5. Charitable Risk Pools

Federal Change: The Small Business Act provided an exception to the prohibition against providing commercial-type insurance for qualified charitable risk pools. Formerly, religious, charitable and educational organizations, social welfare organizations, and civic leagues were exempt from tax if no substantial part of their activities consisted of providing commercial-type insurance. Insurance provided at substantially below cost to a class of charitable recipients is not considered commercial-type activities. Under the Act, charitable risk pools may qualify for tax-exempt status if they perform commercial-type insurance activities.

Qualified charitable risk pools are entities organized and operated solely to pool the insurance risks (other than malpractice risks) of their members and to provide members with information on loss control and risk management. All members of the pool must be tax-exempt organizations. The risk pool must also satisfy other requirements for tax-exemption, such as prohibitions against private inurement, political campaign activities and substantial lobbying. In addition, the risk pools must be organized as a nonprofit under state law provisions authorizing risk pooling arrangements for charitable entities, must be exempt from state income tax, must obtain at least $1,000,000 in start-up capital from nonmember charitable organizations, must be controlled by a board of directors elected by its members, and must provide in its organizational documents requirements that members must be tax-exempt charitable organizations and procedures to follow should a member lose that status.

A pool does not forfeit its tax-exempt status if one of its members ceases to qualify, as long as it removes the nonqualifying member within a reasonable period of time.

Effective Date: Tax years beginning after August 20, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

6. State-Sponsored High-Risk Health Insurance Pools

Federal Change: The Health Insurance Act exempted state-sponsored organizations that provide medical insurance to high-risk individuals from income tax. To qualify for the exemption, an organization must be established by the state exclusively for providing high-risk medical care to state residents on a not-for-profit basis, either through issuing insurance or by agreement with a health maintenance organization. High-risk individuals are those who are unable to acquire medical care coverage through insurance or an HMO because of a pre-existing medical condition, or able to acquire coverage only at a price substantially higher than the rate charged by the pool. The state is required to specify membership composition. No part of the net earnings of the organization may inure to the benefit of any private shareholder or individual.

Effective Date: Tax years beginning after December 31, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

7. State-Sponsored Workmen's Compensation Reinsurance Organizations

Federal Change: The Health Insurance Act exempted state-sponsored workmen's compensation reinsurance organizations from income tax. An organization is exempt if it was established before June 1, 1996, exclusively to reimburse members for losses arising under workmen's compensation acts, has membership, as required by the state, that consists only of persons who either issue insurance covering workmen's compensation losses in the state or are persons or governmental entities that self-insure against such losses, is non-profit, returning surplus income to its members or workmen's compensation policyholders on a periodic basis, and reduces initial premiums in anticipation of investment income.

Effective Date: Tax years ending after August 21, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

8. Energy Policy Act Effective Date

Federal Change: The Small Business Act corrected two cross references and clarified that the corrections apply to tax years beginning after December 31, 1990. The Act also clarified the relationship between the basis adjustment rules for electric vehicle credit and the alternative minimum tax.

Effective Date: Tax years beginning after December 31, 1990.

Recommendation: Adopt the federal change.

Fiscal Effect: None, since these are clarifications.

III. ESTATE AND OTHER MISCELLANEOUS TAX CHANGES

A. ESTATE TAX

1. Special Valuation Rules

Federal Change: The Small Business Act provided special rules for valuing the rights retained in conjunction with the transfer of interest in a corporation or partnership to an applicable family member. The rules apply to retained interest with respect to liquidation, put, call or conversion rights. The special valuation rules are only in effect when the retained interest allows the right to receive payment, but does not actually involve a liquidation, put, call or conversion. Retained interest in the form of distribution rights held in the form of a junior equity interest position are also subject to the special valuation rules. In order for these rules to apply, the transfer must be to an applicable family member which includes any lineal descendant of any parent of the transferor or the transferor's spouse. All affected rights under the Act are valued at $0.

Effective Date: Effective for transfers after October 8, 1990.

Recommendation: Adopt the federal changes.

Fiscal Effect: Minimal revenue loss.

2. Coordination of Unified Estate Tax Credit with Treaties

Federal Change: The Small Business Act provided that, in determining the unified credit for tax treaties with foreign countries, the property exempted from U.S. estate tax is not treated as being situated in the U.S. This federal change prevents the estates of foreign decedents from using property that is exempt under a tax treaty to calculate the applicable unified credit amount.

Certain tax treaties with foreign countries exempted property located outside the country of domicile. In 1976, this exemption was replaced with a unified credit, which allowed nonresident aliens to receive a credit equal to the credit amount allowed to U.S. citizens and residents, adjusted by the proportion of property owned in the U.S. The law change states that property which has been exempt under a tax treaty cannot be included in the calculation of the unified credit.

Effective Date: Effective on August 20,1996.

Recommendation: Adopt federal change.

Fiscal Effect: Minimal revenue gain.

B. ESTATES AND TRUSTS

1. Foreign Nongrantor Trusts

Federal Change: The Small Business Act authorized the Secretary of the Treasury to issue regulations applying to estates, trusts and beneficiaries that prevent abusive transactions..

The Act also provided that the full amount of a cash or marketable securities loan by a foreign nongrantor trust to a U.S. grantor or beneficiary is treated as distributed to the grantor or beneficiary, though exceptions for loans structured at arm's length and for loans may be provided by regulation.

The Act changed the interest rate applicable to accumulated distributions from 6% to the rate charged on underpayments of tax, with compounding beginning on January 1, 1996. Simple interest continues to accrue through 1995. The change imposes compound interest based on the underpayment rate on tax amounts determined under the accumulation distribution rules and the total accrued simple interest for pre-1996 periods. Rules for apportioning accumulated distributions to U.S. citizens or resident beneficiaries and for the period for which interest is charged are also established.

Effective Date: The interest charge provisions apply to distributions after August 20, 1996. The abusive transaction provision is effective August 20, 1996. The loan provision applies to loans of cash or marketable securities made after September 19, 1995.

Recommendation: Adopt the federal change (the interest rate provisions are not applicable for Wisconsin).

Fiscal Effect: Minimal revenue gain.

2. Inbound Foreign Grantor Trusts

Federal Change: To prevent tax avoidance by use of foreign grantor trusts, the Small Business Act provided that the U.S. grantor trust rules generally do not apply to portions of a trust that would otherwise be deemed owned by a foreign person. Rather the rules are generally applied only when they result in income, either directly or indirectly, of a U.S. citizen or resident or a domestic corporation.

Exceptions are provided for: (1) revocable trusts where the power to revoke may be exercised solely by the grantor and is not conditioned on the approval or consent of any other person; (2) trusts where distributions of income or corpus during the grantor's lifetime may only be distributed to the grantor or the grantor's spouse; (3) trusts established to pay compensation for services; (4) revocable trusts owned by the grantor or another person or trusts from which income is distributed or held for distribution only to the grantor or the grantor's spouse (except for trusts held for premiums on life insurance) that are in existence on September 19, 1995. Grantor trust rules apply if the foreign grantor is a controlled foreign corporation.

Effective Date: August 20, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue gain.

3. Outbound Foreign Grantor Trusts

Federal Change: The Small Business Act modified the outbound foreign grantor trust rule. U.S. persons who transfer property to foreign trusts with U.S. beneficiaries are no longer treated as the owners of the trust if the trust pays fair market value to the transferor for the property. Obligations issued by the trust, by any grantor or beneficiary of the trust, or any person related to any grantor or beneficiary are generally not included in this exception, unless the obligations are at arm's length. The rule does not apply to transfers to charitable trusts.

Foreign grantors who become U.S. residents within five years of directly or indirectly transferring property to a foreign trust are treated as transferring the property on the date of the grantor's U.S. residency. The amount considered transferred is the trust portion (including nondistributed earnings) attributable to the property previously transferred. A U.S. citizen or resident who transfers property to a trust that becomes a foreign trust while the individual is alive is treated as transferring the property on the date the trust became a foreign trust. Beneficiaries are not treated as U.S. beneficiaries if they first become U.S. persons more than 5 years after the transfer to the foreign trust.

Effective Date: Transfers of property after February 6, 1995.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

4. Residence of Foreign Trusts

Federal Change: The Small Business Act established a two-part objective test to determine if a trust is a resident of the U.S. A trust is treated as a U.S. person if a U.S. court can exercise primary supervision over the administration of the estate or trust, and if one or more U.S. fiduciaries have the authority to control all substantial decisions of the trust.

Domestic trusts that change situs, becoming foreign trusts, are subject to the 35% excise tax imposed on transfers intended to avoid tax unless an exception to the excise tax applies. The change in situs is treated as a transfer of all trust assets to the foreign trust. The change may also trigger information reporting requirements.

Effective Date: Residence determination provisions apply to tax years beginning after December 31, 1996. A trust may make an irrevocable election to apply the provision to tax years ending after August 20, 1996. The excise tax provision applies on August 20, 1996.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue gain.

C. EMPLOYMENT TAXES

1. Newspaper Distributors and Carriers

Federal Change: The Small Business Act clarified that individuals engaged in delivering or distributing newspapers or shopping news, including such related services as soliciting customers or collecting money, are generally classified as direct sellers. As direct sellers, these persons are treated as independent contractors for withholding and employment-tax purposes.

Effective Date: Services performed after December 31, 1995.

Recommendation: Adopt the federal change. Newspaper distributions and carriers treated as independent contractors would be considered self-employed persons subject to the temporary recycling surcharges.

Fiscal Effect: None, since provision was intended to clarify entity law.

2. Fishing Crew Members

Federal Change: The Small Business Act provided a measuring standard for determining the usual size of the crew of a fishing vessel. This standard is used to determine whether the crew members are classified as employees or as independent contractors.

Effective Date: Remuneration paid after December 31, 1994. Also for remuneration paid after December 31, 1984, and before January 1, 1995, unless the payor treated such treated such payments as subject to FICA taxes.

Recommendation: Adopt the federal change. Fishing crew members treated as independent contractors would be considered self-employed persons subject to the temporary recycling surcharge.

Fiscal Effect: Minimal revenue loss.

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Tommy G. Thompson
Governor

Cate Zeuske
Secretary of Revenue

MEMORANDUM

April 22, 1997

TO: Senator Brian Burke, Co-chair
Representative Scott Jensen, Co-chair
Joint Committee on Finance

FROM: Cate Zeuske
Secretary of Revenue
Cate Zeuske

SUBJECT: Technical Corrections to SB 77 - Biennial Budget Bill

The Department of Revenue has identified a number of technical errors and omissions in the 1997-99 Biennial Budget Bill. I am submitting a list of these items to you as Co-chairs of the Committee and am also forwarding a copy to Fiscal Bureau Director Lang. I thank you for the recent opportunity to appear before the Joint Finance Committee and look forward to working with you during the budget process and on other matters before the Legislature.

The Department will also be forwarding draft language for the Internal Revenue Code update in order to make changes in Wisconsin tax laws consistent with Federal law changes.

Attached are descriptions of corrections needed for the following items:

1. Individual Income Tax Treatment of Nonresidents and Part-Year Residents (section 9143 (1))
2. Homestead Tax Credit – Definition of Household Income (section 2289)
3. Income Tax Exemption for Premier Resort Center Bonds
4. Development Zone Tax Credits
5. Use Tax of Automobiles Used by Dealers (section 2392)
6. Sales Tax on Telecommunications that Terminate in this State (section 2387)
7. Sales Tax on Telephone Answering Services (sections 2388, 2389 and 9443 (12))
8. Sales and Use Tax Agreements with Direct Marketers (section 2363)
9. Local Exposition District Food and Beverage Tax Exemption (section 2407)
10. Wisconsin Dells Area Premier Resort Center (sections 719, 2211, 2212, 2260, 2273, 2284, 2404 to 2406, 2408 to 2410, 2908, 3286 to 3287)
11. Increase Penalty for Tampering with a Cigarette Meter (section 2968)
12. Alternative Methods of Filing, Paying Taxes (Electronic Funds Transfer)
13. Utility Tax on Personal Communications Services (sections 2378 and 2379)
14. Mining Investment and Local Impact Board
15. Mining Net Proceeds Tax (sections 2237 to 2251)

16. Environmental Remediation Tax Incremental Financing (sections 2216, 2246, 2247 and 2864)
17. Cancellation of Delinquent Property Taxes on Contaminated Property (section 2373)
18. Payment of Taxes by Credit Card (sections 2370 to 2372)
19. Tax Appeals Commission – Filing Fee Increase (sections 2354 and 2355)
20. Lottery Appropriations – Vendor Fees
21. Multijurisdictional Lotteries (section 4737)
22. Lottery: Retailer Compensation and Incentive Bonus (section 4749)
23. Lottery: Transfer Gaming Board Responsibilities to Revenue (sections 4750 to 4752, 4764-4765)

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Attachments

cc: Robert Lang, Legislative Fiscal Bureau

TECHNICAL CORRECTIONS TO SB 77 – BIENNIAL BUDGET BILL

1. Individual Income Tax Treatment of Nonresidents and Part-Year Residents (section 9143 (1))

   The budget bill directs the Department of Revenue to submit drafting instructions to the Legislative Reference Bureau (LRB) to change the proration formula for the income tax treatment of nonresidents and part-year residents. These instructions were submitted to the LRB on March 17, 1997, and are attached (Attachment #1). The draft language will be forwarded to the Fiscal Bureau upon completion.

2. Homestead Tax Credit – Definition of Household Income (section 2289)

   The intent in the budget bill was to eliminate the double counting of scholarship income -- once in the year it is received and again in the following year when it is deemed taxable. However, the bill does not fix the problem. Any portion of scholarship income that is included as household income as part of Wisconsin adjusted gross income should be able to be subtracted if that income had already been included on a previous year's Homestead credit claim.

   Action: Insert the following sentence prior to the last sentence in s. 71.52 (6):

   Scholarship income included in adjusted gross income but added to "income" under this subsection in a previous year may be subtracted from income for the year during which it is included in adjusted gross income.

3. Income Tax Exemption for Premier Resort Center Bonds

   The bill does not specifically address the treatment of the premier resort center bonds relating to a tax-option (subchapter S) corporation's deduction from net income. The result is that the income from these bonds is exempt from income tax at the shareholder level and excluded from the measure of the S corporation's income for franchise tax purposes. Since S corporations are required to include U.S. government interest income in the measure of net income for corporate franchise tax purposes, the exclusion of premier resort center bond interest from net income makes the franchise tax a discriminatory tax, subject to a possible constitutional challenge.

   Action: Amend s. 71.36 (1m) [second sentence] to add obligations issued by "a commission to create a premier resort center under s. 66.30 (3q)."

4. Development Zone Tax Credits

   a. The bill intends to replace the current development zone credits with the new credit for taxable years beginning on or after January 1, 1998; however, there are no changes made to terminate the current tax credits. Claimants may assert that the law change does not prohibit them from claiming the current development zone credits for day care, environmental remediation, investment, jobs, location, sales tax and research. The bill merely eliminates the requirement that the Department of Commerce verify the expenses for these credits.

Action: Add language in Chapter 71 to provide that the current development zone credits (day care, environmental remediation, investment, jobs, location, sales tax and research) expire for taxable years beginning on or after January 1, 1998. Claimants may continue to carry forward unused credits from prior taxable years.

b. The new consolidated development zones credit does not require the claimant to attach a copy of the Department of Commerce's verification of the allowable credit to the Wisconsin income or franchise tax return. Although the Department of Revenue has the general authority to request information needed to enforce the franchise and income tax law, the absence of this documentation (required for current development zone credits) will decrease DOR's ability to process and audit the credit claims in an efficient and timely manner. (Sections 2262, 2276 and 2286)

Action: Add the following language at ss. 71.07 (2dx), 71.28 (1dx) and 71.47 (1dx):

No credit may be allowed under this subsection unless the claimant submits with the claimant's return a copy of the claimant's certification for tax benefits under subchapter VI of ch. 560 and a statement from the department of commerce verifying the amount of eligible expenditures and the allowable credit.

5. Use Tax on Automobiles Used by Dealers (section 2392)

The bill allows owners of motor vehicle dealerships who actively participate in the dealership to compute use tax on vehicles used personally in the same manner as employees subject to withholding. A definition is needed for "actively participates" in the dealership. We also suggest changing the word "daily" to "day-to-day" in describing the operation of the dealership (page 1048, line 1).

Action: Define "actively participates" as follows:

"Actively participate," for purposes of this section, means the sole proprietor, partner, subchapter S shareholder, or LLC member performs services for the motor vehicle dealership, such as sales, accounting, management, and consulting, for more than 500 hours in a taxable year for which such person receives compensation. "Actively participate" does not include services performed only in the capacity of an investor such as studying and reviewing financial statements or reports on operation of the business, preparing or compiling summaries or analyses of finances of the business for the investor's own use, or monitoring the finances or operations of the activity in a non-managerial capacity.

6. Sales Tax on Telecommunications Services that Terminate in this State (section 2387)

The budget bill lacks specific language to provide a credit for tax properly paid to another state. The Departments of Administration and Revenue have worked with the Legislative Reference Bureau in developing language, contained in LRB b0014/3, to provide this credit.

7. Sales Tax on Telephone Answering Services (sections 2388, 2389 and 9443 (12))

We believe that a single subdivision can be used to clarify the existing sales tax on mechanical telephone answering services and to impose the tax on other, currently nontaxable answering services. In addition, we are concerned the exception to tax for telephone answering services that are incidental to other services may be construed too broadly. Therefore, we suggest the following changes be made to the budget bill:

1. Amend Section 2388 of the bill, creating s. 77.52 (2)(a)5m, as follows:

   "77.52 (2) (a) 5m. The sale of services that consist of ~~taking~~ <u>recording telecommunications</u> messages ~~by telephone~~ and transmitting them to the purchaser of the service or at that purchaser's direction, but not including those <u>non-mechanical</u> services if they are merely an incidental element of another service <u>not listed under s. 77.52 (2) (a)</u> that is sold to that purchaser."

2. Delete Section 2389 of the bill, which would create s. 77.52 (2)(a)5r.

3. Add a new section to the bill to amend s. 77.51 (5), the definition of "incidental," to include a reference to new s. 77.52 (2)(a)5m.

The phrase, "recording telephone messages," would effectively encompass mechanical and any other capture of messages. By contrast, the phrase it replaces, "taking messages by telephone," may exclude some currently taxable mechanical services, for example, when a device other than a telephone, for example, a computer, is used to take the message. The word, "telecommunications," would help to identify the type of messages whose capture and transmission would be taxable, since the current definition of "telecommunications services" in s. 77.51 (21m) effectively describes telecommunications messages.

With these changes to proposed s. 77.52 (2)(a)5m, a separate subdivision for mechanical answering services is not needed, permitting elimination of Section 2389 of the bill.

This revised language, and the language now in the budget as well, would impose the tax on burglar alarm and similar security monitoring services. If this is not intended, additional changes may be needed. The Department of Administration's estimate of the revenue gain from this item appears to include only taxes on telephone answering services, and not taxes on security monitoring services.

We suggest the exception from taxation for incidental telephone services be clarified so that the exception would apply only when incidental to a service not listed under s. 77.52 (2)(a). For example, one might construe the language appearing in proposed s. 77.52 (2)(a)5m to preclude taxation of telephone answering services when they are only a small portion of the bill for providing local and long distance telephone service; we believe the intent is to tax telephone answering services in this instance.

In addition, the definition of "incidental" in s. 77.51 (5) would be helpful; however, that definition contains references to the statutory sections to which it applies, so reference to the telephone answering services imposition language is necessary.

8. Sales and Use Tax Agreements with Direct Marketers (section 2363)

The bill authorizes the Secretary of Revenue to enter into agreements with direct marketers about the collection of state and local sales and use taxes and about making quarterly payments of those taxes. The agreements under negotiation encompass other areas including audits, nexus requirements for past periods, imposition of tax on gift transactions.

Action: Remove the limiting factors in the authorization language by removing the reference to collection and payment. (The reference to sales and use taxes should be retained).

9. Local Exposition District Food and Beverage Tax Exemption (section 2407)

The budget bill provides an exemption from the local exposition district food and beverage tax if the liability is less than $5 for the year. This provision should be clarified if the proposal for the Wisconsin Dells premier resort center food and beverage tax remains in the bill. If the situation should arise where a taxpayer owes both the local exposition district food and beverage tax and the Wisconsin Dells food and beverage tax, the $5 minimum reporting standard should apply to each tax separately.

10. Wisconsin Dells Area Premier Resort Center (sections 719, 2211, 2212, 2260, 2273, 2284, 2404 to 2406, 2408 to 2410, 2908, 3286 to 3287)

If the proposal for the Wisconsin Dells premier resort center remains in the bill, we would note the following problems:

a) There is no language regarding adoption of the premier resort center tax. The local exposition food and beverage tax required adoption by resolution.
b) There is no notice requirement that the commission created to impose the tax inform the Department of Revenue (DOR) as to the effective date of the tax. This notification is needed so that DOR can inform retailers as to what the tax is imposed upon, rates, filings, etc., and to ensure that DOR has the necessary return and processing system ready. This notification requirement is part of the existing local exposition food and beverage tax.
c) Unlike the local exposition tax, there is no notice requirement that the commission notify DOR when the premier resort center tax has raised sufficient money to fulfill the obligations it was imposed for, and that the tax should cease to be collected.
d) Administration of the tax would be easier if there is a requirement, as in the case of the local exposition tax, that the tax would be effective only on certain dates (e.g., the start of a quarter). As written, the start date of the tax could be any day of any month, which would complicate tax processing and collection.
e. There is no definition of "unit of government." If it is meant to refer to "municipality" (defined in s. 66.30(1)(c)), then "municipality" should be used instead.
f. Proposed s. 66.30(3q)(b)2 provides that each municipality that is a part of the commission established to create the premier resort center must separately impose the tax. This could be interpreted to permit each municipality to impose the tax at different rates (i.e., Wisconsin Dells imposes the tax at 0.4%, Lake Delton imposes the tax at 0.1%, and Baraboo imposes the tax at 0.3%, etc.)
g. The provisions for separate imposition of the tax proposed in s. 66.30 (3q)(b)2 may require that DOR, under proposed s. 77.982(3), separately distribute the tax to each municipality, rather than in one lump sum to the "commission."

11 Excise Tax - Increase Penalty for Tampering with a Cigarette Meter (section 2968)

As part of a larger package on increasing felony penalties, the bill increases the maximum penalty for falsely or fraudulently tampering with a cigarette meter from 10 years to 15 years. Since the use of cigarette meters has been prohibited since July 1, 1994, this provision is unnecessary.

Action: Section 2968 should be removed from the bill: In addition, s. 139.32 (4) and s. 139.44 (1m) related to cigarette meters can be repealed.

12. Alternative Methods of Filing, Paying Taxes, etc. (Electronic Funds Transfer)

a. A definition of "pay", similar to that created under s. 139.01 (5m) (section 2937) should be added to s. 78.005 (Motor Vehicle Fuel Tax) and s. 78.55 (General Aviation Fuel Tax). If this is done, then s. 78.12 (5)(b) should be repealed rather than recreated
b. Add language to change "mailed" to "filed" at s. 78.49 (1)(b) as well as s. 78.58 (1)(b); in the latter case, also delete the words "to the department".
c. Amend s. 139.03 (2x)(d) [intoxicating liquor floor tax late filing fee] in the same manner as s. 139.315 (4) [cigarette floor tax late filing fee]
d. Effective date language for electronic tax filing (section 9443 (7)]: On page 2117, line 4, s. 71.045 should read s. <u>72</u>.045.

13. Utility Tax on Personal Communications Services (sections 2378 and 2379)

a. The bill changes the definition of a cellular provider subject to the transitional adjustment fee to clarify that providers of personal communications services (PCS) are subject to the fee. The language would, however, subject resellers of cellular service to the fee as well. Resale of local exchange service does not trigger the transition fee and the intent was not to subject resale of cellular service to the transition fee.

Action: Amend s. 76.90 (2) so that a provider of cellular services in Wisconsin that is not licensed by the FCC to provide service in Wisconsin (i.e., a reseller) would not be subject to the fee. [Note that resellers pay fees indirectly through the purchase of the services they resell.] A provider of cellular service who is licensed in some Wisconsin markets and resells in others would be subject to the fee on all cellular revenues in the state. (See attachment #2 for suggested language.)

b. Under current law, if the cellular activities of an interexchange company (IXC) or a reseller trigger the transition fee, all of that company's gross revenues from telecommunications services would be subject to the fee, not just the cellular revenues. This clearly was not the intent of 1995 Act 351.

Action: Amend s. 76.91 such that a company who is an IXC, or resold IXC service as of June 6, 1996, would compute the transition fee only on revenues from cellular service and the property used in providing cellular service. (See attachment #2 for suggested language.)

14. Mining Investment and Local Impact Fund Board

Administrative expenses of the Mining Investment and Local Impact Fund Board, including personnel costs for the 0.5 FTE Executive Secretary, are paid from a PR appropriation—s. 20.566 (7)(g). The appropriation is funded from a fee assessed against mining companies in proportion to their "gross proceeds". The budget schedule has $41,800 allocated in each year of the biennium. However, since the only metallic mining operation in the state ceased production in early 1997, there will be no mining companies with "net proceeds" in 1998 to assess the fee for expenses. A GPR sum sufficient supplemental appropriation is needed to assure back-up funding in the years that program revenue is insufficient to fully fund the appropriation.

Action: Create a new appropriation as follows:

Investment and local impact fund administrative expense supplement. A sum sufficient to supplement par. (g) for purposes of s. 70.395 if sufficient revenues are not available under s. 70.3965.

			1997-98	1998-99
s. 20.566 (7) (a)	Investment and local impact fund administrative expense supplement	GPR	-0-	41,800

15. Mining Net Proceeds Tax (sections 2237 to 2251)

There are many problems with the language changing the mining net proceeds tax. While the budget language simplifies current law it is inadequate. These changes fail to take account of a number of related provisions that must be revised. (See attachment #3)

16. Environmental Remediation Tax Incremental Financing (sections 2216, 2446, 2447, 2864)

The bill provides that environmental remediation tax incremental financing (ER TIF) districts can be created by cities, villages, towns and counties. Current TIFs can only be created by cities and villages. In the case of a county, the ER TIFs could cross municipal boundaries which would create a multitude of programming and value processing problems.

The joint review board language under s. 66.462 (3) refers to the possibility that more than one school district, technical college or county can tax a parcel. This is incorrect – a parcel can be located in only one of each these taxing jurisdictions.

The bill lacks a requirement for reporting of value change information by municipalities to the Department of Revenue (DOR). Further, DOR has specific deadlines in order to meet its obligation to certify equalized values on August 15 of each year. The ER TIF proposal has no deadlines for applying a base value or for notification to DOR when the period of certification has expired. These omissions would seriously affect DOR's ability to perform its responsibilities in a timely manner. It would make sense to use the same deadlines and informational requirements as are imposed for regular TIFs.

Other specific changes: (i) impose a deadline for notifying DOR that a ER TIF district has terminated per the language in s. 66.46 (8)(b); (ii) require the municipality (or county) to annually submit information, as prescribed by DOR, on or before the second Monday in June.

Finally, the treatment of value increments for environmental remediation under s. 79.03 (3)(b) 3 is inconsistent. The incremental value is included for the county when an ER TIF is created by a town, city or village, while for current TIFs the incremental value is not included.

17. Cancellation of Delinquent Property Taxes on Contaminated Property (section 2373)

The county should also be authorized to cancel delinquent special assessments and special charges in addition to the delinquent property taxes.

18. Payment of Property Taxes by Credit Card (sections 2370 to 2372)

The Department finds that not all credit card companies will permit local government treasurers to recover the card company's fee. Therefore, the proposal should be withdrawn pending further study on the feasibility and mechanics of the proposal.

19. Tax Appeals Commission - Filing Fee (sections 2354-2355)

This item raises the filing fee for most appeals to the Tax Appeals Commission from $5 to $25. The narrative material incorrectly identifies the current filing fee for Homestead Credit cases as being $5. However, Homestead credit appeals, as well as those for the two farmland credits, married persons' credit and community development finance credit are exempted from the filing fee under s. 71.88 (2)(b). The intent is not to impose a fee on these filings.

Action: Amend section 2354 (page 1029, line 16) and section 2355 (page 1030, lines 23-24) to remove the $5 filing fee for Homestead appeals.

20. Lottery Appropriation – Vendor Fees

Change the title of the appropriation under s. 20.566 (8)(v) from "On-line Vendor Fees" to "Vendor Fees". Under current contracts, on-line computer services and instant ticket computer services are being provided by the same vendor. Payment for these services is currently made from two different appropriations [(8)(v) and (8)(q)]. It would make sense to fund them out of a single appropriation.

21. Multijurisdictional Lotteries (section 4737)

The purpose of this provision was to allow the Wisconsin Lottery to participate in games with members of other countries. It is envisioned that the Multi-state Lottery Association, of which Wisconsin is a member, may enter into agreements with lotteries in other countries for joint lottery games. This section should be amended to include other countries, in order to permit participation with Mexico or European nations.

22. Lottery: Retailer Compensation and Incentive Bonus (section 4749)

While the Lottery is interested in developing retailer incentive programs that benefit both ticket sales and the retailers, it is necessary to have some flexibility in determining the effectiveness of those programs in a timely manner. We recommend removing the language about goals and rules submission in favor of letting the Lottery work with its Retailer Advisory Committee in developing incentive programs that are effective.

23. Lottery: Transfer Gaming Board Lottery Responsibilities to Revenue (sections 4750 to 4752, 4764-4765)

   a. The statutory language in section 4750 which defines security responsibilities of the Gaming Board as a regulator of all gaming activities, was brought over from the Gaming Commission (s. 561.06). Since the Department of Revenue now operates the Lottery, rather than regulating it, we suggest deleting this list of responsibilities.

   b. There is an inconsistency in the language on conflicts of interest and restricting gaming activities of Department employees between the Gaming Board under DOA and the Lottery under DOR. The Gaming Board language follows the current law for the Lottery; however, the budget bill amends the provisions as they apply to Revenue employes.

   Action: Maintain current law for conflict of interest and restrictions of gaming activity by eliminating the repeal and recreating of s. 565.05 (1) (sections 4751-4752) and s. 565.17 (5) (sections 4764-4765).

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ATTACHMENTS

1. Individual Income Tax Treatment of Nonresidents and Part-Year Residents (item #1)
   (Letter and drafting instructions to Peter Dykman, LRB, March 17, 1997)

2. Utility Tax on Personal Communications Services (item #13)
   (Proposed Telecommunications Tax Law Changes)

3. Mining Net Proceeds Tax (item #15)

ATTACHMENT #1

State of Wisconsin • DEPARTMENT OF REVENUE

125 SOUTH WEBSTER STREET • P.O.BOX 8933 • MADISON, WISCONSIN 53708-8933 • 608-266-6466 • FAX 608-266-5718 • http://www.dor.state.wi.us

Tommy G. Thompson
Governor

Cate Zeuske
Secretary of Revenue

March 17, 1997

Mr. Peter Dykman, Acting Director
Legislative Reference Bureau
100 North Hamilton Street
Madison, WI 53701-2037

Dear Mr. Dykman:

Drafting instructions relating to the taxation of nonresidents and part-year residents for the Governor's 1997-99 budget are attached. Section 9143 (1)(a) of Assembly Bill 100/Senate Bill 77, the biennial budget bill, requires the Department of Revenue to submit these instructions to the Legislative Reference Bureau and the Department of Administration by March 17, 1997, or the effective date of the bill, if later, for inclusion in the budget.

I suggest that these drafting instructions be used to guide drafting of an amendment to the budget bill. This amendment should also eliminate the nonstatutory provisions that require these drafting instructions [as noted, Section 9143 (1)(a) of the bill].

Under current law, nonresidents and part-year residents calculate tax, using Form 1NPR, on their Wisconsin income, which includes all income earned in Wisconsin and all unearned income received while a resident of Wisconsin. These filers reduce Wisconsin total income by a standard deduction that is calculated on the basis of total—Wisconsin plus nonWisconsin—income, and prorate this deduction by multiplying it by a fraction equal to the ratio of Wisconsin income to total income, but not more than one. Wisconsin income less this prorated standard deduction equals Wisconsin taxable income, and Wisconsin tax rates are applied to this amount to determine gross tax. The nonresident or part-year tax filer reduces gross tax by the dependent, elderly, itemized deductions and school property tax credits, after these credits have been multiplied by the same proration factor used to reduce the standard deduction. They are also allowed a married couple credit, when both spouses have earnings in Wisconsin, based on the amount of earnings in Wisconsin for the lower-earning spouse.

Under this treatment, nonresidents and part-year residents have lower tax burdens than full-year residents with the same amount of total income, when burden is measured as the ratio of Wisconsin tax to Wisconsin income. This occurs because the tax brackets are not prorated for nonresidents and part-year residents; they are allowed to use the full width of the brackets even though their Wisconsin income is only a portion of their total income.

One way to equalize these tax burdens would be to calculate Wisconsin tax on total income and prorate the amount calculated by the ratio of Wisconsin income to total income. This method would effectively prorate the tax brackets, as well as the standard deduction and the tax credits. The nonstatutory provisions directed the Department to develop drafting instructions based on this method. In developing those instructions, however, the Department determined that this method had at least three unintended results.

First, it would allow nonresidents and part-year residents to use losses from activities in other states to reduce their Wisconsin income and thus their Wisconsin tax.

Second, it would substantially complicate the calculation of Wisconsin tax on Form 1NPR. Calculation of the Wisconsin minimum tax would require a reiterative process: nonresidents and part-year residents would have to repeat several steps of the calculation in order to determine their tax. Accounting for losses incurred in another state would also be complicated. Wisconsin has different loss limitations than those allowed for federal purposes—for example, the amount of capital losses that may be used to offset ordinary income is limited to $3,000 under federal law but only $500 under state law, and Wisconsin has income-based limitations on farm losses while federal law has no such limitations. Under this alternative, nonresidents and part-year residents would have to keep separate records of their nonWisconsin losses for federal and Wisconsin tax purposes.

Third, this method, because it would be a substantial change in the way nonresidents and part-year residents calculate their taxes, would require a complete overhaul of Form 1NPR and its instructions.

Because of these concerns, the Department is advancing drafting instructions that use an alternative method: prorating the tax brackets. The tax calculation would continue to be based on Wisconsin income, rather than total income, so nonWisconsin losses could not be used to reduce tax liability, and nonresidents and part-year residents would not have to keep records of these losses for Wisconsin tax purposes. The alternative minimum tax calculation would not need to be revised. Finally, Form 1NPR would probably not have to be changed, or changed only slightly.

However, this alternative would still complicate tax filing for Form 1NPR filers. Currently, they determine gross tax by looking at a table in the instructions. If tax brackets are prorated, they would calculate tax using a worksheet in the instructions. We have included a preliminary worksheet in our drafting instructions, and it involves seventeen steps.

Please let me know if you have any questions about our drafting instructions or the alternative we are proposing.

Sincerely,

Cate Zeuske

Cate Zeuske
Secretary of Revenue

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Attachment

Wisconsin Department of Revenue
Division of Research and Analysis
Bureau of State Tax Policy

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March 11, 1997

TITLE: Proration of Individual Income Tax Brackets for Nonresidents and Part-Year Residents

DESCRIPTION OF CURRENT LAW AND PROBLEM:

Wisconsin imposes its individual income tax on income earned in Wisconsin by nonresidents and part-year residents, and on other income received by part-year residents while they lived in the state. In calculating their tax, nonresidents and part-year residents determine the standard deduction based on their total income, and multiply the resulting deduction amount by the ratio of Wisconsin income to total income. Similarly, they multiply their dependent, elderly, itemized deductions and school property tax credits by this proration factor. Since this proration factor is typically less than 1, and may not exceed 1 in those instances when Wisconsin income exceeds total income due to losses in other states, it generally reduces the standard deduction and credits.

While the standard deduction and several tax credits are prorated, the tax brackets are not. As a result, nonresidents and part-year residents have smaller tax burdens, measured by the ratio of Wisconsin tax to Wisconsin income, than full-year residents with the same amount of total income. By prorating the tax brackets, these tax burdens would be equalized.

RECOMMENDATION FOR ACTION:

Require nonresidents and part-year residents to prorate their tax brackets by the ratio of their Wisconsin income to total income when calculating their Wisconsin individual income tax.

FISCAL/ADMINISTRATIVE IMPACT:

Currently, nonresidents and part-year residents, who file Wisconsin Form 1NPR, determine gross tax by looking at a tax table that provides the appropriate amount of tax for the particular filing status and taxable income level. Prorating the tax brackets would preclude use of a table in determining gross tax; rather, Form 1NPR filers would need to complete a worksheet to determine their tax. Presumably, this worksheet could be contained in the instructions for Form 1NPR, but would not need to appear on the tax form.

The worksheet would require an extensive calculation. The following table indicates the steps that would be needed for a married couple filing jointly with total income of $45,750, Wisconsin income of $28,420, and a proration factor of 0.6212. This couple would have a standard deduction of $1,136, and Wisconsin taxable income would equal $27,284.

1.	Enter Wisconsin taxable income (from line 32 of Form 1NPR).	27,284
2.	Enter $7,500 if single or head of household, $10,000 in married filing jointly or $5,000 if married filing separately.	10,000
3.	Enter the proration factor (from line 28 of Form 1NPR).	0.6212
4.	Multiply line 2 by line 3.	6,212
5.	Enter the lesser of line 1 or line 4.	6,212
6.	First bracket tax rate.	4.90%
7.	Multiply line 5 by line 6; enter the amount here and on line 15 below.	304
8.	Subtract line 5 from line 1. If line 5 equals line 1, enter 0 on lines 14 and 16 below, and go to line 17.	21,072
9.	Enter the lesser of line 8 or line 4.	6,212
10.	Second bracket tax rate.	6.55%
11.	Multiply line 9 by line 10; enter the amount here and on line 16 below.	407
12.	Subtract line 9 from line 8. If line 9 equals line 8, enter $0 on line 14 below, and go to line 17.	14,860
13.	Top bracket tax rate.	6.93%
14.	Multiply line 12 by line 13; enter the amount here.	1,030
15.	Amount from line 7.	304
16.	Amount from line 11.	407
17.	Add lines 14, 15 and 16. This is gross tax. Enter this amount on line 33 of Form 1NPR.	1,741

This change would increase income tax revenues by $4 million in FY 1999.

DRAFTING INSTRUCTIONS:

Create a new subsection in s. 71.06, Wis. Stats., to provide that the tax brackets for nonresidents and part-year residents equal the tax brackets provided in s. 71.06 (1) and (2) multiplied by the ratio of Wisconsin income to total income. This language should be similar to that providing for proration of the standard deduction in s. 71.05 (22)(g) and (h).

EFFECTIVE DATE OR INITIAL APPLICABILITY:

Tax years beginning on January 1, 1998.

PERSON TO CONTACT: Dennis Collier, 266-5773
Director, Bureau of State Tax Policy

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ATTACHMENT #2

Wisconsin Department of Revenue
Division of Research and Analysis
March 26, 1997

PROPOSED TELECOMMUNICATIONS TAX LAW CHANGES

Repeal and recreate 76.90(2) to read:

> 76.90(2) "Commercial mobile service" has the meaning given in 47 USC 332(d). For purposes of this section, one-way radio paging is not a commercial mobile service.
>
> *For reference, s. 76.90(2) currently reads: "Cellular mobile radio telecommunications utility" has the meaning given in s. 196.202 (1).*

Amend s. 76.91 to read:

> **76.91 Imposition.** For 1999 and 2000, there is imposed on each ~~cellular mobile radio telecommunications utility~~ person licensed by the federal communications commission to provide ~~that provides~~ commercial mobile service in this state and on each person that, on June 6, 1996, provides basic local exchange service a transitional adjustment fee. Taxpayers shall pay the tax during May 1998, November 1998, May 1999, November 1999 and May 2000. For each month that a fee is due under this subchapter, the taxpayer shall pay to the department an amount calculated as follows:

(1) Determine the amount that the taxpayer would pay during that month, taking into account the reconciliation of the previous year's estimated payments, if the taxpayer were assessed the tax under s. 76.38, 1993 stats., at a rate of 5.77%.

(2) Subtract from the amount under sub. (1) the taxpayer's payment during that month of the tax under Subch. IV.

(3) If a person licensed by the federal communications commission to provide commercial mobile service in this state is a telephone company under s. 76.02(9u), 1993 stats., on June 6, 1996, the calculation of the fee under this subchapter shall be limited to that person's activities as a provider of commercial mobile service in this state.

ATTACHMENT #3

17. Mining Net Proceeds Tax

The proposed changes to the mining net proceeds tax and certain mining-related payments were intended to simplify the mining tax law. However, they are incomplete in that they fail to take account of a number of other related provisions that must also be revised for the proposed changes to work.

Following are the necessary revisions and additional changes:

Indexing affects the tax brackets for the net proceeds tax and the following mining-related grant payments: first dollar payments, county additional payments, Native American community payments, and construction payments. The budget proposal fails to rebenchmark the tax brackets and grant amounts to reflect inflation over the 1982-1997 period amounting to over 50%. The proposal also fails to cumulate the effects of inflation after 1997.

Indexing the tax brackets is relatively easy. For the grant payments it is more complex because of the following inconsistencies in the underlying statutes which the budget proposal fails to acknowledge:

1. The term first dollar payment is used ambiguously in section 70.395. In (1)(a) 1. and 3., first dollar payment means the sum of the individual "first dollar payments", and these payments can be less than $100,000 indexed. Elsewhere, first dollar payment means $100,000 indexed.
2. The payment to Native American communities under (2)(d)2m. is stated as $100,000 indexed rather than as a first dollar payment.
3. "Municipality" is defined in s. 70.395(1)(c) to include counties and school districts as well as cities, villages and towns. A comprehensive revision of ss. 70.395 and 70.396 is needed to address ambiguities created by this definition.

Proposal.

Amend s. 70.375(5)(a) to (f) as follows to rebenchmark the tax brackets:

(a) On the amount from ~~$250,001 to $5,000,000,~~ $375,001 to $7,500,000. at a rate of 3%.
(b) On the amount from ~~$5,000,001 to $10,000,000~~, $7,500,001 to $15,000,000, at a rate of 7%.
(c) On the amount from ~~$10,000,001 to $15,000,000~~, $15,000,001 to $22,500,000, at a rate of 10%.
(d) On the amount from ~~$15,000,001 to $20,000,000~~, $22,500,001 to $30,000,000, at a rate of 13%.
(e) On the amount from ~~$20,000,001 to $25,000,000~~, $30,000,001 to $37,500,000, at a rate of 14%.
(f) On the amount exceeding ~~$25,000,000,~~ $37,500.000. at a rate of 15%.

Section 2238. Repeal and recreate s.70.375(6) as follows:

(6) INDEXING (a) For tax years beginning in 1999, the dollar amounts in sub. (5) shall be changed to reflect the percentage change between the gross domestic product deflator for the second quarter of the tax year and the gross domestic product deflator for the second quarter of the previous year, as

year, but not more than 10%. The revised amounts shall be rounded to the nearest whole number divisible by 100. The revised amounts shall constitute the base for the adjustment under this paragraph in the following year.

(b) For payments in 2001, the dollar denominated amounts under s.70.395(1), (2)(d)1m and 5.c. shall be adjusted by the percentage change under (a) for the 1999 tax year. For payments in 2002 and thereafter under s.70.395(1), (2)(d)1m and 5.c., the dollar denominated amounts as adjusted under this paragraph for the prior year shall be adjusted by the percentage change under (a) for the tax year two years prior to the year of the payment.

Section 2241 should be revised as follows:

Change $100,000 to $150,000 to reflect rebenchmarking.
Add a concluding sentence such as this: If the transfer under (1e) in any year is insufficient to make first dollar payments under (2)(d), first dollar payment in that year means the amount of the transfer under (1e) divided by the number of municipalities, counties and Native American communities eligible to receive payment in that year.

Section 2248 should be revised as follows:

Strike the words beginning "minus any payment" to the period.
Strike the final sentence.

Amend s. 70.395(2)(d)1m to change $250,000 to $375,000 to reflect rebenchmarking.

Amend s. 70.395(2)(d)2m as follows:

2m. To any Native American community that has tribal lands within a municipality qualified to receive a payment under this section, <u>the first dollar payment.</u> ~~an amount equal to $100,000 minus any payments during that year under par. (d) (intro.) or subd. 5. Annually, the dollar amount in this subdivision shall be adjusted as specified under s.70.375(6).~~

Section 2249. The reference to subds. 1. and 2. should be to 1., 2., and 2m.

Section 2250 . The reference to subds. 1., 2, and 2m., should be to (d)1., 2., and 2m.

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