B

To: Joint Committee on Finance

From: Bob Lang, Director
Legislative Fiscal Bureau

ISSUE

Sales Tax on University Food Contracts (General Fund Taxes)

CURRENT LAW

Under current law, the sales tax is generally imposed on sales of meals, food, food products and beverages for direct consumption on the premises. However, meals, food, food products and beverages furnished in accordance with any contract or agreement by a public or private institution of higher education are not taxable. The exemption does not apply to beer, other alcoholic beverages, soda and certain other soft drinks.

GOVERNOR

No provision.

DISCUSSION POINTS

1. The exemption for food and beverages sold under university contracts is intended to assist college students in purchasing meals, because students living in dormitories do not have the opportunity to prepare their own meals.

2. The current statutory provision does not limit the exemption to purchases by students, and the Legislative Audit Bureau indicates that UW-Madison and other state universities have made broader use of this provision. For example, at UW-Madison and other state campuses, debit cards may be used by faculty and staff (in addition to students) to purchase tax-free meals at student unions and other campus locations. In addition, the student union at UW-Madison

operates a catering business for events held at Memorial Union, and applies the sales tax exemption to sales of food through this catering business.

Other UW campuses and private colleges have used the exemption for similar purposes and for food contracts with organizations outside the university, such as professional football teams that train on the campuses. Officials for the Wisconsin Technical College System indicate that these schools are currently not making use of the exemption for any sales of meals, food or beverages.

3. It can be argued that, even though they are allowed under current law, the additional uses of the exemption by the UW system campuses and private institutions are contrary to the original intent of the Legislature in creating the exemption. Further, the sales tax exemption could provide a competitive advantage to university catering services over private banquet facilities and catering services.

4. The exemption could be modified to apply only to meals, food, food products and beverages furnished to students who are enrolled at the institution of higher education. This modification would increase sales tax revenues by an estimated $100,000 in 1997-98 and $200,000 in 1998-99. These figures assume an effective date of August 1, 1997, and that the new provision would first apply to contracts entered into on or after that date. The lower fiscal effect in the first year reflects the fact that many of the university food contracts have already been signed. Such a provision would require campuses that currently allow faculty members to purchase food tax-free with debit cards to modify these systems.

5. Another option would be to apply the exemption only to meals, food, food products and beverages furnished for a purpose that is consistent with the institution's educational mission, and to specify that the exemption could not be used for purchases of meals by faculty members. The intent of this alternative would be to allow universities and colleges to make use of the exemption for adult continuing education programs, educational programs for high school students, conferences and other educational services and activities provided to individuals who are not enrolled at the institution. However, the exemption could not be used for meal purchases by faculty members or for other activities that are not related to the institution's educational mission, such as catering weddings or providing meals to professional football teams. This modification would increase sales tax revenues by a minimal amount in 1997-98 and $100,000 in 1998-99. These estimates also assume an effective date of August 1, 1997, and that the new provision would first apply to contracts entered into on or after that date.

ALTERNATIVES TO BILL

1. Modify the current sales tax exemption for meals, food, food products and beverages furnished in accordance with any contract or agreement by a public or private institution of higher education to provide the exemption only if these items are furnished to

students who are enrolled at the institution. Specify that this provision would take effect on the day after publication of the bill, and first apply to contracts entered into on or after that date. This alternative would increase sales tax revenues by an estimated $100,000 in 1997-98 and $200,000 in 1998-99.

Alternative 1	GPR
1997-99 REVENUE (Change to Bill)	$300,000

2. Modify the current sales tax exemption for meals, food, food products and beverages furnished in accordance with any contract or agreement by a public or private institution of higher education to provide the exemption only if these items are furnished for purposes that are consistent with the institution's educational mission. In addition, provide that the exemption could not be used for purchases of meals by faculty members and specify that this provision would take effect on the day after publication of the bill, and first apply to contracts entered into on or after that date. This alternative would increase sales tax revenues by a minimal amount in 1997-98 and an estimated $100,000 in 1998-99.

Alternative 2	GPR
1997-99 REVENUE (Change to Bill)	$100,000

3. Maintain current law.

MO#________________

Prepared by: Rob Reinhardt

BURKE	Y	N	A
DECKER	Y	N	A
GEORGE	Y	N	A
JAUCH	Y	N	A
WINEKE	Y	N	A
SHIBILSKI	Y	N	A
COWLES	Y	N	A
PANZER	Y	N	A
JENSEN	Y	N	A
OURADA	Y	N	A
HARSDORF	Y	N	A
ALBERS	Y	N	A
GARD	Y	N	A
KAUFERT	Y	N	A
LINTON	Y	N	A
COGGS	Y	N	A

AYE _____ NO _____ ABS ___

To: Joint Committee on Finance

From: Bob Lang, Director
Legislative Fiscal Bureau

ISSUE

Reestimate Funding for the Earned Income Tax Credit (General Fund Taxes and Shared-Revenue and Property Tax Relief -- Other Credits)

[LFB Summary: Page 25, #10 and Page 554, #1]

CURRENT LAW

The state earned income tax credit (EITC) is paid from a sum sufficient appropriation. The credit provides a supplement to the wages and self-employment income of lower-income workers with children living with them. The credit is refundable; if the amount of the credit exceeds tax due, a check from the state is issued for the difference. The state credit is calculated as a percentage of the federal EITC. In 1996 and thereafter, the percentages are as follows: 4% for families with one child; 14% for families with two children; and 43% for families with three or more children.

GOVERNOR

The Governor's recommendation would provide an increase of $18,500,000 in 1997-98 and $31,000,000 in 1998-99 for estimated costs of the EITC. Total funding would be $75.5 million in 1997-98 and $88.0 million in 1998-99.

DISCUSSION POINTS

1. The administration indicates that the recommended increase in funding includes $11.0 million in 1997-98 and $18.0 million in 1998-99 to reflect increased participation due to implementation of the Wisconsin Works (W-2) program. The remainder, $7.5 million in 1997-98

and $13.0 million in 1998-99, reflects indexing of the credit at the federal level and normal participation growth over the base.

2. Funding for the EITC has been reestimated to include an increase of $21.7 million in 1997-98 and $31.2 million in 1998-99 from the base to provide total funding of $78.7 million in 1997-98 and $88.2 million in 1998-99. This reestimate would be an increase of $3.2 million in 1997-98 and $200,000 in 1998-99 from the funding provided in the bill.

3. Recent caseload projections indicate that people will be leaving the AFDC and W-2 programs and entering the workforce faster than previously estimated. Based on this data, it is estimated that $13.5 million in 1997-98 and $16.9 million in 1998-99 would be required to provide funding for increased EITC participation due to this factor, which is an increase of $2.5 million in 1997-98 and a decrease of $1.1 million in 1998-99 from funding provided in the bill.

4. In addition, it is estimated that an increase of $8.2 million in 1997-98 and $14.3 million in 1998-99 would be needed to fund normal program growth. These amounts are higher than the amounts provided in the bill by $700,000 in 1997-98 and $1.3 million in 1998-99.

5. There have been two recent federal law changes relating to the EITC for 1996. The first change requires that certain losses be added back to adjusted gross income for taxpayers with earned income above the phase-out income amounts. The second change denies the credit to individuals with certain investment income exceeding a base amount.

Questions have been raised at the federal level regarding the treatment of gains and losses from the sale of business property as it relates to these two law changes. Such property is not considered a capital asset, however, gains or losses from the sale of business property is treated as a gain or loss for both federal and state capital grains treatment purposes. The Internal Revenue Service is currently reviewing this issue and has yet to make a determination. The estimates in this paper assume that gains or losses from the sale of business property will not be counted for purposes of these provisions.

MODIFICATION TO BILL

Reestimate funding for the earned income tax credit at $78.7 million in 1997-98 and $88.2 million in 1998-99. These amounts exceed the base funding level by $21,700,000 in the first year and $31,200,000 in the second year. Compared to the bill, the revised estimates would increase funding by $3,200,000 in 1997-98 and $200,000 in 1998-99.

Reestimate	GPR
1997-99 FUNDING (Change to Bill)	$3,400,000

Prepared by: Kelsie Doty

MO#________________

BURKE	Y	N	A
DECKER	Y	N	A
GEORGE	Y	N	A
JAUCH	Y	N	A
WINEKE	Y	N	A
SHIBILSKI	Y	N	A
COWLES	Y	N	A
PANZER	Y	N	A
JENSEN	Y	N	A
OURADA	Y	N	A
HARSDORF	Y	N	A
ALBERS	Y	N	A
GARD	Y	N	A
KAUFERT	Y	N	A
LINTON	Y	N	A
COGGS	Y	N	A

AYE _____ NO _____ ABS _____

To: Joint Committee on Finance

From: Bob Lang, Director
Legislative Fiscal Bureau

ISSUE

Individual Income Tax Treatment of Nonresidents and Part-Year Residents (General Fund Taxes)

[LFB Summary: Page 26, #11]

CURRENT LAW

Income may be taxed on the basis of where it is earned or on the basis of the taxpayer's legal residence; an individual may only have one legal residence. Individuals who do not have legal residence in Wisconsin but have income from Wisconsin sources (nonresidents) and individuals who have moved into or out of the state (part-year residents) are required to file a special state tax form called the 1NPR Form in Wisconsin. For nonresidents, Wisconsin taxes only the income from Wisconsin sources such as wages, business income or capital gains. Part-year residents pay taxes on income from all sources during the period the individual was a Wisconsin resident and, during the period the individual was not a resident, taxes on income from Wisconsin sources. A full-year resident may file the 1NPR form if the individual has a spouse who is a nonresident or part-year resident.

There is one exception to the general requirement that nonresidents pay taxes on income from Wisconsin sources. Wisconsin has entered into reciprocity agreements with five states: Illinois, Indiana, Kentucky, Michigan and Minnesota. Under these agreements, the taxpayer is only required to file a return and pay taxes in the state of legal residence. Wisconsin does not tax the wage and salary income earned in Wisconsin by residents of these states and collects taxes from income earned in these states by Wisconsin residents. Likewise, these other states do not impose their income tax on the earnings of Wisconsin residents and tax income earned in Wisconsin by their residents. As a result, an individual who is a resident of a neighboring state, such as Illinois, and works in Wisconsin only files a return and pays taxes to Illinois on their Wisconsin wages and is not required to file the 1NPR return in Wisconsin. However, if the same Illinois resident also had non-wage income (such as capital gains) from a Wisconsin source, taxes would have to be paid to Wisconsin on the capital gain income.

In filing the 1NPR form under current law, the taxpayer calculates their federal adjusted gross income (AGI) and compares that amount to their Wisconsin AGI to determine their ratio (called the proration factor) of Wisconsin AGI to federal AGI. The taxpayer then uses their federal AGI to determine their sliding scale standard deduction, which is based on income and filing status, and multiplies that amount by the proration factor to arrive at their Wisconsin standard deduction. The standard deduction is subtracted from Wisconsin AGI to determine Wisconsin taxable income. The tax rates and brackets are applied to taxable income to determine gross tax liability. The dependent credit, senior credit, itemized deduction credit and property tax/rent credit are each multiplied by the proration factor and subtracted from gross tax. The taxpayer then must determine whether the state alternative minimum tax applies. Finally, the married couple credit is calculated (using only earned income taxable to Wisconsin) and subtracted from gross tax to arrive at net tax liability.

GOVERNOR

The bill requires the Department of Revenue (DOR) to provide the Legislative Reference Bureau (LRB) and the Department of Administration (DOA) with drafting instructions sufficient to enable the LRB to include language in the 1997-99 budget bill that changes the proration factor for nonresident and part-year resident individual income taxpayers. The new proration factor would first apply to taxable years beginning on January 1, 1998. The bill contained a nonstatutory provision that outlined requirements for the drafting instructions.

These instructions provided that a 1NPR filer would first determine net tax using income from all sources. This amount would then be multiplied by a proration factor to determine the final amount owed to Wisconsin. The proration factor would be calculated by dividing: (a) the amount of Wisconsin AGI considering only Wisconsin sources of income; by (b) the amount of Wisconsin AGI considering all sources of income.

DISCUSSION POINTS

1. Approximately 2.5 million tax returns were filed in Wisconsin in 1995, of which about 3.9% were Form 1NPR. These taxpayers paid about 2.4% of all taxes in that year.

2. The bill proposal would allow nonresident and part-year resident taxpayers to use losses from activities in other states to reduce their Wisconsin income and Wisconsin tax. In addition, it would complicate the calculation of the Wisconsin alternative minimum tax. Finally, the initial proposal would have required substantial changes to the 1NPR tax form and instructions.

On March 17, 1997, DOR issued drafting instructions to the LRB and DOA. A letter accompanying the instructions indicated that, due to the concerns outlined above, an alternative method was proposed and instructions were issued based on this alternative. Under the proposal, the income tax brackets would be prorated based on the ratio of Wisconsin AGI to federal AGI, as calculated under current law. All other calculations would remain the same as current law.

3. Since the tax brackets are not prorated under current law, a 1NPR filer generally has a lower effective gross tax rate than full-year residents with the same total income if the percentage of gross tax to Wisconsin AGI is compared. Attachment 1 compares the effective gross tax rates for hypothetical full-year resident taxpayers to the effective gross tax rates of part-year resident and nonresident taxpayers with the same total income. Gross tax is the amount of tax before credits are subtracted.

For example, as shown in Attachment 1, a single full-year resident taxpayer with Wisconsin income of $25,000 would have a gross tax of $1,337 and an effective tax rate of 5.3% ($1,337 / $25,000). A part-year resident with federal AGI of $25,000, of which $15,000 is taxable to Wisconsin, would have a gross tax of $737, which is 4.9% of Wisconsin income. This happens because the 1NPR filer has a greater share of their Wisconsin income being taxed at the lower marginal tax rates than the full-year resident.

If the tax brackets were prorated as proposed, the part-year resident taxpayer in this example would have a gross tax of $802, an increase of $65 compared to current law. The effective tax rate would be 5.3% ($802 / $15,000), which is equal to the effective tax rate of the full-year resident. For this part-year resident individual, the tax bracket would be prorated by multiplying the tax brackets for single taxpayers by the ratio of Wisconsin income to total income ($15,000 divided by $25,000 = 60%). The prorated tax brackets in this case would be as follows:

Current Law Brackets	Multiply by Ratio	Prorated Brackets	Marginal Tax Rates
Less than $7,500	x 60% =	Less than $4,500	4.90%
7,500 to 15,000	x 60% =	4,500 to 9,000	6.55
15,000 and Over	x 60% =	9,000 and Over	6.93

4. Under current law, once taxable income has been determined, 1NPR filers use a table in the instructions to determine gross tax liability, which is similar to how all other taxpayers determine their tax liability. By prorating the tax brackets, a tax table could not be used because the tax brackets would be different for each taxpayer. As a result, 1NPR filers would have to complete a worksheet to determine gross tax. Attachment 2 to this paper contains the steps that would need to be taken for the same hypothetical individual to determine their Wisconsin gross tax liability under the proposal. The $13,140 amount on line 1 of the worksheet is Wisconsin taxable income, which is calculated on the 1NPR form by multiplying the standard

deduction (based on federal AGI) by the 60% proration factor and subtracting that amount from Wisconsin AGI.

Although it is not known at this time, it is presumed that the 17-step worksheet in the attachment would be similar to the worksheet 1NPR filers would need to complete if this provision is enacted. Requiring 1NPR filers to calculate their gross tax liability on a worksheet rather than using a tax table would complicate the tax form. In addition, this change could result in addition errors, which could increase processing time.

5. Prorating the tax brackets would result in the same effective gross tax on full-year residents and 1NPR filers with the same total income. In addition, since all of the tax credits, except the married couple credit, are also multiplied by the proration factor, the effective net tax would be the same for most full-year residents and 1NPR filers. (Net tax is the amount of tax owed after allowable credits are subtracted from gross tax.)

6. The bill estimated that modifying the taxation of 1NPR filers effective January 1, 1998, would increase individual income tax revenues by $4.0 million in 1998-99, based on the proposal outlined in the bill. The bill provision contained a 1998 tax year effective date because it would have required significant time to rewrite the 1NPR form and instructions and make data processing changes, which may not have been ready for the 1997 tax year.

If the modification submitted by DOR is adopted instead, it is estimated to increase revenues by $5.5 million in 1998-99 from current law, or by $1.5 million from the bill provision. Since the alternative proposal to prorate the tax brackets would not require as substantial of a change to the tax form and instructions and data processing, it could be made effective with the 1997 tax year, which would generate an additional $5.2 million in individual income tax revenues in 1997-98.

7. Attachment 3 presents distributional information from the 1995 Wisconsin tax sample regarding 1NPR filers who would be affected by the proposal. The tax sample includes information from over 20,000 individual income tax returns, weighted to reflect all taxpayers in 1995. Changes over time in the number of taxpayers and the kinds and amounts of income, deductions and credits they claim cannot be shown. To the extent possible, changes in the tax laws between 1995 and later years have been included. The amount shown in the attachment and the estimated fiscal effect differ because the attachment reflects 1995 data and the fiscal effect is for the 1997-99 biennium.

8. The following table, based on the 1995 tax sample, shows the distribution of the tax increase by three categories of 1NPR filers: nonresident tax filers, part-year residents who moved into the state and part-year residents who moved out of the state.

	Count	Percent of Count	Amount	Percent of Amount	Average Increase
Nonresidents	21,000	34.6%	$1,722,000	37.6%	$82
New Residents	20,200	33.2	1,538,000	33.5	76
Former Residents	19,600	32.2	1,327,000	28.9	68
	60,800	100.0%	$4,587,000	100.0%	$75

As shown in the table, approximately one-third of 1NPR filers were nonresidents, one-third were new state residents and one-third were former state residents. Nonresident filers would pay slightly more than one-third of the total increase and former residents would pay slightly less than one-third of the increase. If the distribution of the tax increase from the 1995 tax sample is applied to the estimated fiscal effect for 1998-99, nonresident taxpayers would pay 37.5% of the $5.5 million total fiscal estimate, or $2.1 million, new state residents would pay $1.8 million and former residents would pay $1.6 million of the total.

ALTERNATIVES TO BILL

1. Delete the bill provision and adopt DOR's recommendation to prorate the income tax brackets for nonresident and part-year resident taxpayers, based on the ratio of Wisconsin AGI to federal AGI, effective January 1, 1998.

Alternative 1	GPR
1997-99 REVENUE (Change to Bill)	$1,500,000

2. Delete the bill provision and adopt DOR's recommendation to prorate the income tax brackets for nonresident and part-year resident taxpayers, based on the ratio of Wisconsin AGI to federal AGI, effective January 1, 1997.

Alternative 2	GPR
1997-99 REVENUE (Change to Bill)	$6,700,000

3. Maintain current law.

Alternative 3	GPR
1997-99 REVENUE (Change to Bill)	- $4,000,000

Prepared by: Kelsie Doty

MO#________________________

BURKE	Y	N	A
DECKER	Y	N	A
GEORGE	Y	N	A
JAUCH	Y	N	A
WINEKE	Y	N	A
SHIBILSKI	Y	N	A
COWLES	Y	N	A
PANZER	Y	N	A
JENSEN	Y	N	A
OURADA	Y	N	A
HARSDORF	Y	N	A
ALBERS	Y	N	A
GARD	Y	N	A
KAUFERT	Y	N	A
LINTON	Y	N	A
COGGS	Y	N	A

AYE _____ NO _____ ABS _____

ATTACHMENT 1

Comparison of Effective Tax Rates for Hypothetical Taxpayers

	Full-Year Residents			Nonresidents or Part-Year Residents							
							Current Law		Proposal		
	WI AGI	Gross Tax	Effective Tax Rate*	Federal AGI	WI AGI	Proration Factor	Gross Tax	Effective Tax Rate*	Gross Tax	Effective Tax Rate*	Tax Increase
Single											
	$75,000	$5,017	6.7%	$75,000	$50,000	66.7%	$3,284	6.6%	$3,345	6.7%	$60
				$75,000	25,000	33.3%	1,552	6.2%	1,672	6.7%	121
	$50,000	3,277	6.6%	$50,000	30,000	60.0%	1,894	6.3%	1,966	6.6%	72
				$50,000	20,000	40.0%	1,202	6.0%	1,311	6.6%	109
	$25,000	1,337	5.3%	$25,000	15,000	60.0%	737	4.9%	802	5.3%	65
				$25,000	10,000	40.0%	450	4.5%	535	5.3%	85
Married-Joint											
	$75,000	$4,957	6.6%	$75,000	$50,000	66.7%	$3,224	6.4%	3,304	6.6%	$80
				$75,000	25,000	33.3%	1,492	6.0%	1,652	6.6%	160
	$50,000	3,155	6.3%	$50,000	30,000	60.0%	1,797	6.0%	1,893	6.3%	96
				$50,000	20,000	40.0%	1,119	5.6%	1,262	6.3%	143
	$25,000	1,084	4.3%	$25,000	15,000	60.0%	584	3.9%	650	4.3%	66
				$25,000	10,000	40.0%	374	3.7%	434	4.3%	60

* The effective tax rate is the ratio of gross tax to Wisconsin AGI.

ATTACHMENT 2

Example of Form 1NPR Worksheet to Determine Gross Tax Under Proposal

1.	Enter Wisconsin taxable income (from line 32 of Form 1NPR).	$13,140
2.	Enter $7,500 if single or head-of-household, $10,000 if married filing jointly or $5,000 if married filing separately.	7,500
3.	Enter the proration factor (from line 28 of Form 1NPR).	60%
4.	Multiply line 2 by line 3.	4,500
5.	Enter the lesser of line 1 or line 4.	4,500
6.	First bracket tax rate.	4.90%
7.	Multiply line 5 by line 6; enter the amount here and on line 15 below.	220
8.	Subtract line 5 from line 1. If line 5 equals line 1, enter $0 on lines 14 and 16 below, and go on to line 17.	8,640
9.	Enter the lesser of line 8 or line 4.	4,500
10.	Second bracket tax rate.	6.55%
11.	Multiply line 9 by line 10; enter the amount here and on line 16 below.	295
12.	Subtract line 9 from line 8. If line 9 equals line 8, enter $0 on line 14 below, and go to line 17.	4,140
13.	Top bracket tax rate.	6.93%
14.	Multiply line 12 by line 13; enter the amount here.	287
15.	Amount from line 7.	220
16.	Amount from line 11.	295
17.	Add lines 14, 15 and 16. This is gross tax. Enter this amount on line 33 of Form 1NPR.	$802

ATTACHMENT 3

Distribution of Tax Increase Under a Proposal to Prorate the Tax Bracket for 1NPR Filers

Federal Adjusted Gross Income	Count	Percent of Count	Amount of Tax Increase	Percent of Increase	Average Increase
Under $5,000	0	0.0%	$0	0.0%	$0
5,000 to 10,000	0	0.0	0	0.0	0
10,000 to 15,000	2,800	4.6	29,000	0.6	10
15,000 to 20,000	7,900	13.0	220,000	4.8	28
20,000 to 25,000	6,300	10.4	206,000	4.5	33
25,000 to 30,000	4,200	6.9	222,000	4.8	53
30,000 to 40,000	7,600	12.5	565,000	12.3	74
40,000 to 50,000	4,900	8.0	450,000	9.8	92
50,000 to 75,000	11,900	19.6	1,164,000	25.4	98
75,000 to 100,000	3,200	5.3	313,000	6.8	98
100,000 to 200,000	7,200	11.8	852,000	18.6	118
200,000 to 300,000	1,600	2.6	149,000	3.3	93
300,000 and Over	3,200	5.3	417,000	9.1	130
TOTALS	60,800	100.0%	$4,587,000	100.0%	$75

SOURCE: 1995 Wisconsin Tax Sample

- Approximately 60,800 taxpayers would be affected by the proposal. Of the 2.5 million total taxpayers in 1995, the proposal would affect approximately 2%.

- According to sample data, there would be no taxpayers with federal AGI below $10,000 affected by this proposal. Because of their low incomes, these taxpayers would have no tax liability under current law or under the modification.

- Taxpayers with federal AGI between $10,000 and $25,000 would pay 9.9% of the tax increase and make up 28.0% of the taxpayers impacted by the proposal.

- Taxpayers with federal AGI above $100,000 make up 19.7% of the count of affected taxpayers and would pay 31% of the tax increase.

- The average tax increase would be $75. By income level, the average increase would range from $10 for taxpayers with income between $10,000 and $15,000 to $130 for taxpayers with income above $300,000.

To: Joint Committee on Finance

From: Bob Lang, Director
Legislative Fiscal Bureau

ISSUE

Internal Revenue Code Update (General Fund Taxes)

CURRENT LAW

State tax provisions are generally referenced to definitions under federal law. With limited exceptions, changes to federal law take effect for state purposes only after action by the Legislature. Each year, the Legislature reviews the previous year's federal law changes to update state references to the federal Internal Revenue Code (IRC). With exceptions, current state tax provisions reference the code in effect as of December 31, 1995.

GOVERNOR

No provision.

DISCUSSION POINTS

1. In a letter dated April 21, 1997, the Secretary of the Department of Revenue requested that the Committee incorporate an IRC update into the Joint Committee on Finance version of the budget.

The majority of changes in federal law that affect the IRC were part of the Small Business Job Protection Act, the Health Insurance Portability and Accountability Act and the Personal Responsibility and Work Opportunity Reconciliation Act.

2. The Department recommends that, beginning in tax year 1997, state individual income, corporate and franchise income, estate tax and excise tax provisions referenced to the federal IRC would refer to the code in effect on December 31, 1996.

3. State references to federal law generally provide greater simplicity for taxpayers in preparing returns and reduce the administrative burden and cost for both taxpayers and the Department in assuring compliance with tax laws. The IRC references are used to determine which items of income are subject to taxation prior to specific state modifications. The state uses separate tax rates and brackets and separate provisions regarding standard deductions, itemized deductions and tax credits.

4. The majority of items are estimated to have a minimal, unknown or no fiscal effect. The following table provides a summary of the items that are estimated to have an impact on state revenues. In total, these provisions are estimated to decrease general fund revenues by $5.1 million in 1997-98 and $900,000 in 1998-99.

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

	1997-98	1998-99
Individual Income Tax		
Limit on Damage Awards	$0.4	$0.4
Exclusion for Employer-Provided Educational Assistance	-3.0	0.0
Long Term Care Insurance Payment Exclusion	-4.8	-4.6
Medical Savings Accounts	-1.5	-1.9
Maximum Deductible Contributions to Spousal IRA	-0.5	-0.5
Individual Total	-$9.4	-$6.6
Corporation and Business Taxes		
Energy Subsidies	0.4	0.5
Election to Expense Depreciable Property	-0.7	-1.2
Company-Owned Life Insurance	4.2	5.9
Thrift Savings Associations- Bad Debt Reserve Method	0.7	0.9
SIMPLE Retirement Plans	-0.3	-0.4
Corporate and Business Total	$4.3	$5.7
IRC Update Total	-$5.1	-$0.9

5. The following sections briefly outline the new federal provisions that would have a state fiscal effect. The Appendix provides descriptions of the other federal provisions that would be adopted, but are estimated to have a minimal state fiscal effect or no fiscal effect.

INDIVIDUAL INCOME TAX

Limit on Damages Exclusion

Additional restrictions are placed on the exclusion from income of punitive damages and compensatory damages awarded on account of a nonphysical personal injury or sickness (such as age discrimination and injury to reputation). In general, punitive damages are not excludable from the recipient's income. Damages for emotional distress and other nonphysical injuries or sickness remain excludable to the extent attributable to a physical injury or sickness. Damages for emotional distress would continue to be excludable to the extent of the amount paid for medical care for the distress.

This provision is effective for amounts received after August 20, 1996, and for tax years ending after August 20, 1996. The estimated fiscal effect is an increase in revenues of $400,000 annually.

Exclusion for Employer-Provided Educational Assistance

The exclusion (up to $5,250 per person) for employer-provided educational assistance is extended retroactively from December 31, 1994, to May 31, 1997. For tax year 1997, only expenses paid for courses beginning before July 1, 1997, are excludable. In addition, the exclusion for graduate-level educational expenses for courses beginning after June 30, 1996, is disallowed.

The Department recommends adopting the federal change for tax years beginning on January 1, 1997, for courses beginning before July 1, 1997, and that the state not adopt the retroactive extension since that would require taxpayers to file amended returns for tax years 1995 and 1996. This provision is estimate to reduce revenues by $3.0 million in 1997-98.

Exclusion for Long-Term Care Insurance Payments

Amounts received under a long-term care insurance contract are excluded from income. The maximum amount that can be excluded is $175 per day ($63,875 annually); which will be indexed for inflation. Premiums paid for long-term care insurance by an employer as part of a cafeteria plan are not excludable.

This provision is first effective for contracts issued after December 31, 1996, and is estimated to reduce revenues by $4.8 million in 1997-98 and by $4.6 million in 1998-99.

Medical Savings Accounts

A medical savings account (MSA) pilot program was created, to operate from 1997 through 2000, limited to the first 750,000 participants nationally each year. Eligible participants are limited to self-employed individuals and employes of small businesses (having 50 or fewer employes on average during the two preceding years). After a small employer is qualified, contributions may continue to be made until the year following the first year in which the employer has more than 200 employes. After that, participating employes may take over the contributions as long as they remain employed by the employer; nonparticipating employes may not start new accounts.

Participation in an MSA is conditioned upon coverage under a high deductible health plan, which has the following deductibles and out-of-pocket limitations: (a) for individual coverage, the deductible must range from $1,500, to $2,250, with a maximum out-of-pocket limitation of $3,000; and (b) for family coverage, the deductible must range from $3,000 to $4,500, with a maximum out-of-pocket limitation of $5,500. These amounts will be indexed for inflation after 1998. Eligibility is denied if an individual has separate coverage that fails the high-deductible limits.

Contributions to an MSA by an individual are deductible and contributions made by an employer are excludable from income. Account earnings are not included in taxable income. Contributions are subject to an annual limitation, which is a percentage of the deductible for a high deductible health plan. For individual coverage, the annual contribution limit is 65% of the deductible; the annual contribution is limited to 75% of the deductible for family coverage. The contributions of self-employed individuals are also limited by the income earned from the business; employe contributions are limited by the amount of compensation earned by the employe.

If contributions are made by an employer, the same amount must be contributed for each employe or the same percentage of the deductible must be contributed (part-time employes are treated separately). An excise tax is imposed for noncompliance with this requirement equal to 35% of the aggregate amount contributed by the employer.

Distributions from the account for qualified medical expenses incurred for the benefit of the individual, spouse or dependent are generally excluded from income. Health insurance may not be purchased with distributions, except for continuation coverage required by federal law, qualified long-term care insurance, or a health plan purchased while the individual is receiving unemployment compensation. Distributions from MSAs that are not used for medical expenses are taxed. An additional 15% penalty tax also applies unless the distribution is made after age 65 or upon death or disability.

The value of an MSA is includible in the gross estate of its owner, unless a surviving spouse is specifically named as beneficiary.

Due to the national limit of 750,000 participants, the federal Internal Revenue Service (IRS) will announce a cutoff when the limit is reached. At that point, no new MSAs could be established, but contributions to existing MSAs could continue. For each year of the pilot program, MSA trustees and custodians will be required to report the number of participants as of June 30.

The MSA provision is first effective with tax years beginning after December 31, 1996. The Department recommends adopting the federal change, which is estimated to reduce revenues by $1.5 million in 1997-98 and by $1.9 million in 1998-99.

Wisconsin enacted a MSA program beginning on January 1 of the year in which the federal government enacts a broad-based MSA program, as certified by the Secretary of DOR. The Secretary has not yet determined whether the federal pilot program is sufficient to implement the state MSA program. The Department recommends repealing the state's existing MSA program in order to avoid conflicts with federal law regarding the differences between the two programs.

Spousal IRA Deduction

Nonworking spouses will be allowed to contribute up to $2,000 per year to a deductible individual retirement account (IRA); the aggregate contribution for both spouses cannot exceed $4,000. If the working spouse participates in an employer-sponsored retirement plan and earns over $40,000, the maximum allowable deduction would be reduced proportionately as under current law. Previously, if one spouse had no compensation, a married couple was allowed a maximum annual deductible IRA contribution of $2,250.

This provision is effective with tax years beginning after December 31, 1996, and would reduce general fund revenues by an estimated $500,000 annually.

CORPORATION AND BUSINESS TAXES

Energy Subsidies

The partial exclusion for any subsidy provided by any utility for the purchase or installation of an energy conservation measure on nonresidential property is repealed.

The provision is effective for subsidies received after December 31, 1996, unless received pursuant to a binding written contract in effect on September 13, 1995, or later. It is estimated that the provision would increase state revenues by $400,000 in 1997-98 and $500,000 1998-99.

Election to Expense Depreciable Property

Eligible taxpayers may elect to deduct, rather than depreciate over the useful life of the property, up to $25,000 of the cost of qualified business property in the year that the property is placed in service. Under prior law, the maximum expense deduction was $17,500. The increase in the maximum expense deduction is phased in as follows: $18,000 in 1997; $18,500 in 1998; $19,000 in 1999; $20,000 in 2000; $24,000 in 2001 or 2002; and $25,000 in 2003 and thereafter.

This provision is effective for property placed in service in tax years beginning after December 31, 1996. The estimated state fiscal effect would be a decrease in revenue of $700,000 in 1997-98 and $1.2 million in 1998-99.

Company-Owned Life Insurance

The interest expense deduction for debt incurred on corporate-owned life insurance policies purchased after June 20, 1986, that cover officers, employes, or financially interested individuals is generally repealed. A limited interest deduction is allowed for debt incurred for life insurance policies and annuity or endowment contracts owned by the corporation on key people. The interest is deductible to the extent that the aggregate amount of debt does not exceed $50,000. In addition, the interest rate is capped and interest that exceeds the cap is not deductible. The interest rate cap applies to interest paid or accrued for any month beginning after December 31, 1995.

Officers and 20% owners are considered key persons. However, the total number of key persons is the lesser of 20 individuals or 5% of the total officers and employes of the taxpayer, but cannot exceed five individuals. For corporations a 20% owner is any person who owns directly at least 20% of the outstanding stock or stock possessing 20% or more of the total combined voting power of all stock of the corporation. For noncorporate taxpayers, a 20% owner is any person who owns at least 20% of the capital profits interest in the employer.

Income received under life insurance policies or endowments or annuity contracts on their complete surrender, redemption, or maturity during calendar years 1996, 1997 and 1998 is includible in gross income ratably over four tax years, beginning with the tax year in which the amount would otherwise be includible. This treatment is also provided for full discharge of the obligation under the policy or contract as a refund of the consideration paid, to the extent the amount is includible in income for the tax year in which the discharge occurs.

Unamortized balances of certain deferred policy acquisition expenses attributable to the contract cannot be capitalized. A deduction is allowed for the unamortized balances.

The interest expense deduction is eliminated over a transitional period (after October 13, 1995 and before January 1, 1999) for certain existing indebtedness. Any otherwise deductible interest incurred during the transitional period is allowed to the extent that the rate of interest does not exceed the lesser of the borrowing rate specified in the contract as of October 13, 1995, or the applicable percentage of Moody's rate. During the transition, the applicable Moody's rate for a calendar year equals the following percentage of the rate: 100% for 1996, 90% for 1997, 80% for 1998, and 0% thereafter.

These provisions apply to interest paid or accrued after October 13, 1995. The state fiscal effect is estimated to be an increase in revenues of $4.2 million in 1997-98 and $5.9 million in 1998-99.

Thrift Savings Associations--Bad Debt Reserve Method

The reserve method of accounting for bad debts used by qualified thrift institutions is repealed. Thrift institutions that qualify as small banks can use the experience method of accounting for bad debts. Thrift institutions that are treated as large banks are required to use the specific charge-off method. A thrift institution that is required to change its method of computing bad debts must treat the change as a change in accounting methods and request approval from the Treasury Secretary. Any adjustment required by the change in accounting methods is solely based on the applicable excess reserves of the thrift and is generally taken into account ratably over the six-year period beginning with the first tax year after 1995.

If a thrift institution becomes a large bank, the amount of the institution's applicable excess reserves generally is the excess of the balance of its reserves at the close of its last tax year beginning before January 1, 1996, over the balance of its reserves as of the close of its last tax year beginning before January 1, 1998. Consequently, a thrift institution that is treated as a large bank generally is required to recapture its post-1987 additions to its bad debt reserves whether the additions are made under the percentage of taxable income method or the experience method.

If a thrift institution becomes a small bank, the amount of the institution's applicable excess reserves will be the excess of the balance of its reserves as of the close of its last tax year beginning before January 1, 1996, over the greater of the balance of either its pre-1988 reserves or what the institution's reserves would have been at the close of its last tax year beginning before January 1, 1996, had the thrift always used the experience method. If a thrift institution no longer qualifies as a bank, the balance of the institution's pre-1988 reserve is restored to income ratably over a six-year period, beginning in the year that the thrift institution no longer qualifies as a bank.

A thrift institution that meets the residential loan requirement for a tax year may suspend the recapture of applicable excess reserves that are otherwise required to be considered for a change of accounting method adjustment for the year. A thrift institution meets the residential loan requirement for the tax year, if the principal amount of residential loans made by the institution is not less than its base amount. The base amount generally is the average of the principal amounts of the residential loans made by the thrift during the six most recent tax years beginning before January 1, 1996.

A thrift institution that converts to a credit union because of repeal of the bad debt reserve method will be treated as an institution that is not a bank. Consequently, the adjustment required to be included in gross income is treated as derived from an unrelated trade or business.

The provision is effective for tax years beginning after December 31, 1995. However, amendments to shareholder distribution provisions do not apply to any distribution of preferred stock if the stock is outstanding at all times after October 31, 1995, and the distribution is made before August 21, 1997. The repeal of provisions related to foreclosure on property securing loans is effective for property acquired in tax years beginning after December 31, 1995. Amendments to the treatment of income in excess of daily accruals on residential interests do not apply to any residential interest held by a thrift if the interest has been held for all times after October 31, 1995.

The estimated state fiscal effect of the provisions would be an increase of revenues of $700,000 in 1997-98 and $900,000 in 1998-99.

SIMPLE Retirement Plans

Employers with 100 or fewer employes who received at least $5,000 in compensation in the preceding year may adopt the Savings Incentive Match Plan for Employes (SIMPLE) if they do not currently maintain another qualified plan. The plan must be open to every employe who received at least $5,000 in compensation during any two proceeding years and is expected to receive at least $5,000 during the current year. Self-employed individuals may participate. Employers who maintain a plan for at least one year, but lose eligibility may continue to maintain the plan for two years. The SIMPLE plan is not subject to the nondiscrimination rules relating to elective deferrals and employer matching requirements applicable to qualified plans.

The plan allows employes to make elective contributions of up to $6,000 per year. Account assets are not taxed until distributed. An employe's elective contribution will be treated as wages for employment tax purposes; nonelective contributions will not be treated as wages. Employer contributions are generally deductible by the employer and are excluded from the employe's income. Distributions may be rolled-over to another SIMPLE account or IRA without penalty if the employe has participated for at least two years, but distributions may not be rolled over to a qualified plan.

Early withdrawals (before age 59½) are generally subject to the 10% penalty applicable to IRAs, except employes who withdraw within two years from establishing the account will be assessed a 25% penalty.

An employe may elect to participate by making elective deferrals during the 60-day period before the beginning of the year. During this period, the employe may modify contribution amounts. Participation may be terminated by discontinuing contributions at any time during the year. Contributions may be made to a designated trustee or issuer.

SIMPLE plans may be structured as an IRA or as a qualified cash or deferred arrangement [401(k) plan]. Employe contributions are expressed as a percentage of compensation. The $6,000 limit is indexed for inflation in $500 increments. All contributions to the plan are 100% vested.

Employers are generally required to match employe contributions up to 3% of the employe's annual compensation. However, an employer may elect, upon notification to employes, to limit its match to a smaller percentage of no less than 1%, except that the election may not be made in more than two out of every five years. An employer does not have the option to reduce the matching contribution to less than 3% if the SIMPLE is structured as a 401(k).

As an alternative to the matching requirement, an employer may make a nonelective contribution of 2% of compensation for each eligible employe who has earned at least $5,000. However, a $150,000 compensation limit applies to this option, which results in a maximum contribution of $3,000. Employers must notify employes of this election prior to the 60th day before the beginning of the year.

The trustee must provide employers with the following information annually: (a) name and address of the employer and trustee; (b) eligibility requirements; (c) plan benefits; (d) time and method of making salary reduction elections; (e) procedures for and effect of withdrawals; and (f) procedures for and effects of rolling over distributions. The trustee must also provide statements of account activity and balances to each participating individual within 30 days after each calendar year. Finally, the trustee must file an annual report with the Secretary of the Treasury. A trustee who fails to provide the above information is subject to a $50 per day penalty unless due to reasonable cause.

Employers must notify each employe of the right to make salary reduction contributions under the plan and of the contribution alternative elected by the employer. Employers who fail to furnish notice are subject to a penalty of $50 per day, unless due to reasonable cause.

Employers are relieved of fiduciary liability from actions taken by participants or beneficiaries who exercise control over the account. A participant or beneficiary will be treated as exercising control once the account has been established for one year, once an affirmative election regarding the initial investment is made, or a rollover to another SIMPLE or IRA account is executed.

Salary reduction simplified employe pensions (SARSEPs) may not be established after December 31, 1996. Employers may make contributions under pre-1997 rules. Employes hired after December 31, 1996, may participate in SARSEPs established before 1997.

The SIMPLE retirement plans are effective beginning after December 31, 1996. This provision is estimated to reduce general fund revenues by $300,000 in 1997-98 and $400,000 in 1998-99.

6. There are three provisions that DOR recommends not be adopted as part of the IRC update. These include modifications to: (a) the federal work opportunity credit; (b) audit procedures for S corporations; and (c) treatment of certain accumulated earnings and profits of S corporations. The modification regarding the work opportunity credit would change the definition of targeted job members which is used by the Department of Commerce for the state development zones job credit. Commerce has indicated that it would prefer to continue using the definition under prior federal law. The federal audit modifications for S corporations would not be adopted because the state has its own requirements.

The third federal provision reduces accumulated earnings and profits of an S corporation during its first tax year beginning after December 31, 1995, by the earnings and profits accumulated in any tax years beginning before January 1, 1983, during which it was an S corporation. This ensures that an S corporation's accumulated earnings and profits are solely attributable to tax years for which its S corporation election was not in effect. This provision applies to tax years beginning after December 31, 1996. DOR recommends that this provision not be adopted because, with this change, some income would not be taxed either to the corporation or its owners. In addition, S corporations would not be required to keep additional records if this provision is not adopted because differences in state and federal treatment of S corporations prior to 1983 required separate records. If this provision is adopted, there would be a revenue loss. However, the fiscal effect is unknown.

ALTERNATIVES TO BILL

1. Adopt the provisions requested by the Department of Revenue to update state tax references to the federal Internal Revenue Code in effect as of December 31, 1996. In addition, repeal the current statutory provisions regarding the state medical savings account program.

Alternative 1	GPR
1997-99 REVENUE (Change to Bill)	- $6,000,000

2. Modify the provisions requested to be adopted by DOR to update the state tax references to the federal IRC in effect as of December 31, 1996, by not adopting one or more items.

3. Maintain current law.

Prepared by: Ron Shanovich and Kelsie Doty

MO#________________

BURKE	Y	N	A
DECKER	Y	N	A
GEORGE	Y	N	A
JAUCH	Y	N	A
WINEKE	Y	N	A
SHIBILSKI	Y	N	A
COWLES	Y	N	A
PANZER	Y	N	A
JENSEN	Y	N	A
OURADA	Y	N	A
HARSDORF	Y	N	A
ALBERS	Y	N	A
GARD	Y	N	A
KAUFERT	Y	N	A
LINTON	Y	N	A
COGGS	Y	N	A

AYE ____ NO ____ ABS __

APPENDIX

Federal Tax Law Changes With a Minimal or No Fiscal Effect

In addition to the provisions described above, the IRC update would adopt a number of other federal law changes that would affect state taxpayers, but would have a minimal state fiscal effect. These provisions are described below.

INDIVIDUAL INCOME TAX

Exclusion for Employer-Provided Adoption Assistance

An employe's gross income will not include amounts paid by an employer for the employe's qualified adoption expenses as part of an adoption assistance program. The amount excluded cannot exceed $5,000 ($6,000 for a special needs child). The exclusion is phased out for taxpayers with AGI between $75,000 and $115,000. The exclusion is not available for amounts paid or expenses incurred after December 31, 2001, for both special needs and non-special needs adoptions.

Qualified adoption expenses include reasonable and necessary adoption fees, court costs, attorney fees, and other expenses that are directly related to, and for the principal purpose of, the legal adoption of a child, including all expenses required by a state as a condition of adoption. The expenses may not be incurred in violation of state or federal law, or incurred under a surrogate parenting arrangement or the adoption of a spouse's child.

Wisconsin currently provides a deduction for adoption expenses of up to $5,000. The Department recommends adopting the federal provision and limiting the state deduction to amounts included in federal AGI. The provision would first be effective for tax years beginning after December 31, 1996, and is estimated to have a minimal impact on state revenues.

Exclusion for Housing for Medical Research Institution Employes

Employes of certain medical research institutions may exclude from income the value of subsidized campus housing as long as they pay annual rent that is at least 5% of the appraised value of the housing or, if market rents are less than that, the average amount paid for comparable housing. If the rent is inadequate, the employe must include in income the difference between the actual rent paid and the rent threshold amount. Qualified campus housing must be located on the campus of the employer or, in the case of state university systems comprised of many institutions with separate campuses, on the campus of one of the component institutions. This exclusion has been available to university employes since 1986.

An eligible medical research institution must be eligible to receive charitable contributions, receive social security payments for graduate medical training and have as one of its principal purposes the providing and teaching of basic and clinical medical science and research.

The Department recommends adopting the provision for tax years beginning on January 1, 1997. This provision is estimated to result in a minimal revenue loss.

Exclusion for Self-Insured Plans

Amounts received by a self-employed individual for a personal injury or sickness are excludable from income when the payment is from a self-insured accident or health plan, effective for tax years beginning after December 31, 1996. This provision is estimated to result in a minimal revenue loss.

Accelerated Death Benefits

Accelerated death benefits received under a life insurance contract on the life of an insured, terminally or chronically ill individual may be excluded from gross income. In addition, amounts received from a viatical settlement provider are excludable. The exclusion is not applicable to amounts paid to any person other than the insured.

A chronically ill individual only may exclude death benefits if the amount is received under a rider or other provision of a contract which is treated as a qualified long-term insurance contract. Payments made on per diem basis are excludable up to $175 per day ($63,875 annually); the maximum amount will be indexed for inflation beginning in 1998.

A terminally ill individual is a person whom a physician has certified as having a condition that is reasonably expected to result in death within 24 months. A chronically ill individual is a person whom a licensed health care practitioner has certified within the preceding 12 months as being unable to perform at least two activities of daily living for a period of 90 days, having a similar level of disability, or requiring supervision for health and safety reasons due to a cognitive impairment.

A viatical settlement provider includes any person that is engaged in the trade or business of purchasing or accepting assignment of life insurance contracts on the lives of terminally or chronically ill insured. The provider must be licensed in the state in which the insured resides.

This provision is effective January 1, 1997. The state currently exempts amounts received under a viatical settlement contract. The Department recommends adopting the provision and limiting the existing state exemption to amounts included in federal AGI. This provision is estimated to have no fiscal impact.

IRA Distributions for Medical Expenses and Health Insurance Premiums

The 10% tax imposed on early distributions from IRAs will not apply to distributions used to pay medical expenses in excess of 7.5% of AGI.

The 10% tax would also not apply for payment of health insurance premiums after separation from employment if the individual has received unemployment compensation for 12 consecutive weeks and if the distributions are made during the tax year the compensation is paid or during the following tax year. This exception would not apply to distributions made after the individual has been employed for at least 60 days. A self-employed person is considered to have met the unemployment compensation requirements if the individual would have received compensation except for the fact of being self-employed.

This provision is effective for distributions made after December 31, 1996. Generally, under current law, if the federal 10% tax is imposed for each distribution from an IRA, the state imposes a tax equal to 33% of the federal tax. Adopting this provision is estimated to result in a minimal loss of revenues.

Self-Employed Health Insurance Deduction

Under prior federal law, self-employed persons were entitled to deduct 30% of amounts paid for health insurance for themselves, their spouse and their dependents. This deduction will be increased to 40% in tax year 1997 and to 45% in tax years 1998 through 2002. In 2003, the deduction is 50% and is increased by 10% each year, beginning in 2004, until the maximum of 80% is reached for 2006 and thereafter. The self-employed insurance deduction is also expanded to include long-term care insurance premiums.

This provision is effective with tax years beginning after December 31, 1996. The provision allowing self-employed individuals to deduct long-term care insurance premiums would result in a minimal revenue loss. Increasing the federal exclusion for health insurance would have no impact since Wisconsin currently allows self-employed individuals to deduct 100% of health insurance premiums.

Long-Term Care Services and Insurance Premiums

Unreimbursed amounts paid for long-term care services provided to a taxpayer, the taxpayer's spouse or dependents are treated as medical expenses for purposes of the medical expense itemized deduction. Amounts paid for services provided by a relative, either directly or indirectly, are not counted as a deductible medical expense, unless the relative is a licensed professional. Long-term care insurance premiums that do not exceed the following annual limitations are also treated as medical expenses for the deduction (these amounts will be adjusted for inflation after 1997): $200 if age 40 or less, $375 up to age 50, $750 up to age 60, $2,000 up to age 70, and $2,500 if over age 70.

For federal tax purposes, medical expenses are deductible from income to the extent that the expenses exceed 7.5% of AGI and if total itemized deductions exceed the standard deduction.

This provision is effective for tax years beginning after December 31, 1996. The Department recommends adopting this provision for purposes of calculating the state's itemized deduction tax credit. This provision is estimated to result in a minimal loss in revenues.

Alternative Minimum Tax: Residual REMIC Interest

Three rules were provided for determining the alternative minimum taxable income (AMTI) of a taxpayer who holds residual interests in a real estate mortgage investment trust (REMIC). These rules, which do not apply to thrift institutions, would:

a. Prevent a taxpayer from having to include preference items for which no tax benefits were received by computing AMTI without regard to the rule that taxable income cannot be less than the amount of excess inclusions;

b. Prevent nonrefundable credits from reducing the taxpayer's income tax below an amount equal to what the tentative minimum tax would be if computed only on excess inclusions by specifying that the AMTI of a taxpayer cannot be less than the excess inclusions of REMIC.

c. Ensure that net operating losses do not reduce any income attributable to excess inclusions, allowing a taxpayer subject to the alternative minimum tax to pay a tax on excess inclusions at the AMT rate, regardless of whether the taxpayer has a net operating loss.

This provision is effective for tax years beginning after December 31, 1986, unless a taxpayer elects to apply the provisions only to tax years beginning after August 20, 1996. This provision is estimated to result in a minimal loss in revenues.

EARNED INCOME TAX CREDIT

Phase-Out Based on Modified Adjusted Gross Income

For credit claimants with an AGI greater than phase-out income, the credit is based on the greater of earned income or AGI. Beginning with tax year 1996, the AGI measure is modified by adding back certain losses: (a) net capital losses if greater than zero; (b) net losses from trusts and estates; (c) net losses from nonbusiness rents and royalties; and (d) 50% of the net losses from business (unless the loss is from the performance of services as an employe).

For claimants receiving the advance federal EITC as of June 26, 1996, this provision is effective for tax years beginning after December 31, 1996. For all other recipients, the effective date is for tax years beginning after December 31, 1995. Since the state credit is calculated as a percentage of the federal EITC, the modified AGI provision is currently part of the base for tax year 1996 and thereafter. Therefore, no additional fiscal effect is estimated.

Definition of Disqualified Income

The credit is denied to individuals with disqualified income in excess of $2,200. Disqualified income is defined as taxable and nontaxable interest income, dividends, net income from rents and royalties not derived in the ordinary course of business, capital gain net income and net passive income (if greater than zero) that is not self-employment income. The $2,200 amount will be indexed for inflation after 1996.

For claimants receiving the advance federal EITC as of June 26, 1996, this provision is effective for tax years beginning after December 31, 1996. For all other recipients, the effective date is for tax years beginning after December 31, 1995. Since the state credit is calculated as a percentage of the federal EITC, the disqualified income provision is currently part of the base for tax year 1996 and thereafter. Therefore, no additional fiscal effect is estimated.

ESTATE AND GIFT TAXES

Special Valuation Rules

Special rules apply 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 as a junior equity interest position are also subject to the rules. In order for the rules to apply, the transfer must be to an applicable family member which includes any lineal descendant of any parent or the transferor or the transferor's spouse. All rights under this provision are valued at zero.

This provision is effective for transfers after October 8, 1990, and is estimated to result in a minimal revenue loss.

Unified Credit Required by Treaty

Federal law clarified that property exempted by treaty from U.S. estate tax is not treated as situated in the U.S. when determining the pro rata unified credit for decedents dying with property in more than one country. This prevents the estate from using exempt property as an advantage when calculating the pro rata unified credit. This provision is effective August 20, 1996, and is estimated to result in a minimal increase in revenues.

ESTATES AND TRUSTS

Foreign Nongrantor Trusts

The Secretary of the Treasury is authorized to issue regulations that apply to estates, trusts and beneficiaries, including rules to prevent abusive transactions. A loan of cash or marketable securities by a foreign nongrantor trust to a U.S. grantor or beneficiary is treated as distributed. Exceptions are provided, including where the loan is structured with arm's-length terms.

The abusive transaction provision is effective August 20, 1996; the loan provision applies after September 19, 1995. These provisions are estimated to result in a minimal increase in revenues.

Inbound Foreign Grantor Trusts

To prevent tax avoidance through the use of foreign grantor trusts, the U.S. grantor trust rules generally do not apply to any portion of a trust that would otherwise be deemed to be owned by a foreign person. Rather, the rules are generally applied when they result in amounts being taken into account in computing the income of a U.S. citizen, resident or corporation.

Exceptions are provided for: (a) revocable trusts where the power to revoke is exercisable solely by the grantor and not conditioned on approval or consent of any person; (b) trusts where distributions of income or corpus during the grantor's lifetime are only distributable to the grantor or spouse; (c) trusts established to pay compensation for services rendered; and (d) trusts owned by the grantor, another person or trusts from which income is distributed or held for distribution only to the grantor or spouse, that are in existence on September 19, 1995.

This provision is effective August 20, 1996, and is expected to result in a minimal increase in revenues.

Outbound Foreign Grantor Trusts

The grantor of a foreign trust with U.S. beneficiaries that received transfers of property by a U.S. person will not be treated as an owner of the trust if the trust paid fair market value to the transferor for the property. Obligations issued by the trust, any grantor or beneficiary, or any related person are generally not taken into account when applying this exception; any obligation that bears arm's-length terms would qualify for the exception. These rules do not apply to transfers to a charitable trust.

A foreign grantor who becomes a U.S. resident within five years of transferring property to a foreign trust is treated as transferring the property on the date of the grantor's residency. A U.S. citizen or resident who transfers property to a trust that becomes a foreign trust is treated as transferring property to a foreign trust on the date it became a foreign trust. Beneficiaries are not treated as a U.S. beneficiary if they first became a U.S. person (described below) more than five years after the date of the transfer.

This provision is first effective for transfers of property after February 6, 1995, and is estimated to have a minimal fiscal effect.

Residence of Foreign Trust

A trust is treated as a U.S. person if: (a) a U.S. court can exercise primary supervision over administration of the estate or trust; and (b) one or more U.S. fiduciaries have the authority to control all substantial decisions of the trust. Currently, no guidance on residency is provided.

If a domestic trust changes its situs and becomes a foreign trust, a 35% excise tax is imposed on transfers intended to avoid tax (because the change in situs transfers all trust assets), unless an exemption applies. Information reporting may also be required.

The residence determination provision applies 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 applies on August 20, 1996. These provisions are estimated to result in a minimal gain in revenues.

EMPLOYMENT TAXES

Fishing Crew Members

A measuring standard is established for determining the usual size of the crew of a fishing vessel, which is used to determine whether the crew members are classified as employes or as independent contractors. This change is effective for remuneration paid after December 31, 1994, and for remuneration paid after December 31, 1984, and before January 1, 1995, unless the payor treated such payments as subject to FICA taxes. This provision would result in a minimal revenue loss.

S CORPORATION SIMPLIFICATION

Permissible Number of Shareholders

The maximum number of eligible shareholders of an S Corporation is increased from 35 to 75. This provision is effective for tax years beginning after December 31, 1996, and is estimated to result in a minimal revenue loss.

Electing Small Business Trusts

A small business trust may be a shareholder in an S corporation if all beneficiaries of the trust are individuals or estates eligible to be S corporation shareholders (except charitable organizations may hold contingent remainder interests). For a small business trust to be eligible, no interest in the trust may be acquired by purchase, but rather by gift, bequest or non-purchase acquisition. Each potential current beneficiary of the trust is counted as a shareholder for the 75 shareholder limitation.

The portion of the trust that consists of stock in one or more S corporations is treated as a separate trust for income tax purposes. Taxable income includes: income, loss or deduction allocated to the trust; gain or loss from the sale of the S corporation stock; any state or local income taxes and administrative expenses of the trust that are properly allocable to the stock; and allowable capital losses to the extent of capital gains. No income tax deduction is allowed for amounts distributed to beneficiaries. This income is not included in the distributable net income of the trust.

When all or a portion of the trust is terminated, any unused loss carryovers or excess deductions are taken by the entire trust. Items included in the S corporation part of the trust are disregarded in determining the tax liability of the remaining part of the trust. The trust's distributable net income does not include any income attributable to the S corporation stock. If a trust is terminated before the end of the S corporation's tax year, the trust must prorate the S corporation items for its final year.

This provision is effective for tax years beginning after December 31, 1996, and is estimated to result in a minimal revenue loss.

Tax-Exempt Organizations

Certain tax-exempt organizations (qualified retirement plans and charitable organizations) are eligible S corporation shareholders. All items of income, loss, credit or deduction are used in computing the unrelated business taxable income of the tax-exempt organization shareholders and will flow through to the tax-exempt shareholder.

Determinations of the long-term capital gain, if charitable contributions of S corporation stock had been sold by the contributor, are made under rules similar to those relating to unrealized receivables and inventory items of a partnership. Rules relating to employe stock ownership plans do not apply to S corporations.

This provision is effective beginning with tax years after December 31, 1996, and is estimated to result in a minimal revenue loss.

Post-Death Holding Period for Trusts

The post-death holding period of S corporation stock of a grantor trust is expanded from 60 days to two years, beginning on the day of the grantor's death. A trust that becomes an S corporation shareholder pursuant to the terms of a will is permitted to be an S corporation shareholder for two years, beginning on the date of transfer.

This provision is effective for tax years beginning after December 31, 1996, and is estimated to result in a minimal revenue loss.

Financial Institutions Allowed as S Corporations

Certain financial institutions that do not use the reserve method of accounting for bad debts may elect to be S corporations. This provision is effective with tax years beginning after December 31, 1996, and is estimated to result in a minimal revenue loss.

Financial Institutions Permitted to Hold Safe Harbor Debt

The definition of straight debt is expanded for purposes of certain safe harbor determinations to include debt held by non-individual creditors that are actively and regularly engaged in the business of lending money, if the straight debt is not treated as a disqualifying second class of stock.

The provision is first effective with tax years beginning after December 31, 1996, and is estimated to result in a minimal revenue loss.

Ownership of Subsidiaries

An S corporation may own 80% or more of the stock of a C corporation. Dividends received by an S corporation from a C corporation subsidiary are not treated as passive investment income to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business. The S corporation cannot file a consolidated return with its affiliated C corporation.

An S corporation is permitted to own a qualified subchapter S subsidiary (QSSS), including any domestic corporation that qualifies as an S corporation and is 100% owned by an S corporation parent. A QSSS is not treated as a separate corporation from the parent.

This provision is effective with tax years beginning after December 31, 1996. The IRC update would include specifying that the election to be treated as a QSSS for federal purposes also applies for state purposes and that if an S corporation parent or subsidiary has nexus in Wisconsin then all related corporations have nexus. This provision is estimated to result in a minimal revenue loss.

Inadvertent Terminations and Invalid Elections

The authority of the IRS to waive the effect of an inadvertent termination is extended to cover additional situations. The effect of an invalid election may be waived if caused by the inadvertent failure to qualify as a small business corporation or to obtain required shareholder consents. Late-filed S corporation elections may be treated as timely for reasonable cause.

This provision is effective for elections for tax years beginning after December 31, 1982, and is estimated to result in a minimal revenue loss.

Agreement to Terminate Year

The election to close the books of an S corporation upon the termination of a shareholder's interest is made by the corporation and all affected shareholders, rather than by all shareholders. If the election is made, the closing of the books only applies to affected shareholders. "Affected shareholders" is defined as any shareholder whose interest is terminated and all shareholders to whom the terminating shareholder has transferred shares during the year.

This provision is effective with tax years beginning after December 31, 1996, and is estimated to result in a minimal revenue loss.

Post-Termination Periods

The post-termination transition period is expanded for a former S corporation to include a 120-day period that begins on a final disposition of a claim for refund by the Secretary of the Treasury and certain other agreements. The change allows distributions by a former S corporation during its post-termination period to be treated as if the termination were made by an S corporation and distributions after the post-termination period are treated as made by a C corporation.

The provision is effective for tax years beginning after December 31, 1996, and is estimated to result in a minimal revenue loss.

Five-Year Retroactive Re-election Period

Any small business corporation that terminated its subchapter S election within the five-year period immediately preceding August 20, 1996, can re-elect subchapter S status without the IRS's consent. This provision is effective for terminations occurring in a tax year beginning before January 1, 1997, and is estimated to result in a minimal revenue loss.

Carryovers into Post-Termination Period

Losses of an S corporation that are suspended pursuant to at-risk rules may be carried forward to the S corporation's post-termination period, effective with tax years beginning after December 31, 1996. This provision is estimated to result in a minimal revenue loss.

Distributions During Loss Years

Basis adjustments for distributions made by an S corporation during the tax year are taken into account before applying the loss limitation. As a result, distributions reduce the adjusted basis for determining the allowable loss for the year, but that loss does not reduce the adjusted basis for purposes of determining the tax status of the distributions. The amount in the accumulated adjustments account is computed without regard to net negative adjustments when determining the tax treatment of distributions which have accumulated earnings and profits. This provision treats the distributions by an S corporation during a loss year the same as for partnerships.

This provision is effective with tax years beginning after December 31, 1996, and is estimated to result in a minimal revenue gain.

Inherited S Corporation Stock

Any person who acquired stock in an S corporation by reason of bequest, devise or inheritance must treat the pro rata share of income of the corporation of the decedent as income acquired directly from the decedent. An estate tax deduction is allowed attributable to the income. The stepped-up basis of the stock acquired from a decedent is reduced to the extent that the value of the stock is attributable to income in respect to the decedent. This provision treats S corporation shareholders the same as partners under partnership rules.

This provision is effective with decedents dying after August 20, 1996, and is estimated to result in a minimal revenue gain.

Subdivided Real Estate

S corporations may qualify for capital gain presumptions that permit capital gain treatment for unimproved subdivided real property held for five years that would otherwise constitute ordinary income property. Previously, this treatment was only available to non-corporate taxpayers. This provision is effective with tax years beginning after December, 31, 1996, and is estimated to result in a minimal revenue loss.

PENSIONS

Tax-Exempt Organizations

Tax-exempt organizations are allowed to established 401(k) plans for their employes. This provision is effective with years beginning after December 31, 1996, and is estimated to result in a minimal revenue loss.

Church Pension Plans

Self-employed ministers and ministers who are employed by organizations that are not tax-exempt entities may participate in church plans. A self-employed minister is treated as a tax-exempt organization. Contributions made by ministers to church plans are deductible. Compensation that is used for purposes of determining contributions for a church plan may not be used in determining contributions for a non-church plan.

No employe will be treated as an officer, shareholder, supervisory employe or highly compensated employe unless that person also satisfies the Employee Retirement Income Security Act (ERISA) definition of highly compensated employe. Church plans are required to use the same definition of highly compensated employes that is applicable to other pension plans.

Contributions made by employers on behalf of foreign missionaries are includible in the missionaries' basis in the plan.

These provisions are effective with years beginning after December 31, 1996, and are estimated to result in a minimal revenue loss.

Simplified Distribution Rules

Lump-Sum Distributions. Five-year forward averaging for lump-sum distributions is repealed for tax years beginning after December 31, 1999. Laws that apply to individuals who attained age 50 before January 1, 1986, are still in effect (these laws allow an individual, trust or estate to elect 10-year forward averaging for a single lump-sum distribution and capital gains treatment for the pre-1974 portion of a lump-sum distribution regardless if the employe is age 59½).

Death Benefits Exclusion. A provision that allowed a beneficiary or estate of a deceased employe to exclude up to $5,000 in benefits paid by or on behalf of an employer by reason of the employe's death is repealed for decedents dying after August 20, 1996.

Annuity Contracts. A simplified method for determining the portion of an annuity distribution plan that represents nontaxable return of basis was provided. The portion of each annuity payment that represents nontaxable return of basis is generally equal to the employe's total investment in the contract as of the annuity starting date, divided by the number of anticipated payments, which are determined by the age of the participant as follows: 360 payments if age 55 or under; 310 payments if age 56 through 60; 260 payments if age 61 through 65; 210 payments if age 66 through 70; and 160 payments if age 71 and over. If the number of payments is fixed in the annuity, that number is used instead.

The investment in the contract is the amount of premiums and other consideration paid minus the amount received before the annuity starting date that was excluded from gross income.

This simplified method does not apply if the primary annuitant has attained age 75 on the annuity starting date unless there are fewer than five years of guaranteed payments under the annuity. 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 the payment.

This provision is effective with annuity starting dates later than 90 days after August 20, 1996.

Determination of Unrecovered Investment in Annuity Contract. The entire investment in an annuity contract with a refund feature may be recovered tax free in the event that annuity payments cease because of the death of the annuitant. Previously, the investment in the contract that could be recovered was reduced by the present value of the refund. This provision applies to individuals whose annuity starting date is after December 31, 1986.

New Required Beginning Date for Distributions. Participants in qualified plans, with the exception of 5% owners and IRA holders, are no longer required to begin receiving distributions after attaining age 70½ if still employed. Distributions must begin by April 1 of the calendar year following the later of the year in which the employe reaches 70½ or retires. The accrued benefit must be actuarialy increased to reflect the value of benefits that would have been received if benefits had begun at age 70½. This provision is effective for years beginning after December 31, 1996.

The simplified distribution rules are estimated to result in a minimal revenue gain.

Nondiscrimination Rules

Highly Compensated Employes and Family Aggregation Rules. An employe is considered highly compensated if the individual was a 5% owner during the current or preceding year or had compensation in excess of $80,000 during the prior year and, if the employer elects, was in the top 20% paid group of the employer. An employer may be able to designate those employes with higher benefit percentages as being non-highly compensated. The $80,000 amount will be indexed for inflation. The rule requiring the highest paid officer to be treated as a highly compensated employe is repealed.

Family aggregation rules are eliminated. These rules required that compensation paid to family members of certain highly compensated employes was treated as paid to or on behalf of the employe.

This provision is effective beginning after December 31, 1996.

Application Participation Requirements. A defined benefit plan must benefit at least the lesser of: (a) 50 employes; or (b) the greater of 40% of all employes or two employes (or one if only one employe). This rule may be applied separately to different lines of business with the same employer. This provision is effective for tax years beginning after December 31, 1996.

401(k) Plan Nondiscrimination Rules. A 401(k) plan satisfies the nondiscrimination rules if it meets a notice requirement and one of two contribution requirements. The notice requirement is met if each eligible employe is given written notice of rights and obligations under the plan. The notice must be within a reasonable period, accurate, comprehensive and understood by the average eligible employe. The contribution requirement is met if: (a) the employer makes a matching contribution of 100% of the employe's elective contribution up to 3% of compensation and 50% of employe's elective contributions that exceed 3% of compensation, not to exceed 5%; or (b) the employer makes nonelective contributions of at least 3% of an employe's compensation to a defined contribution plan on behalf of each non-highly compensated employe, regardless if the employe makes elective contributions. Under the matching rule, the match rate for highly compensated employes cannot exceed the match rate for non-highly compensated employes.

A safe harbor method of satisfying the nondiscrimination test is met if the plan meets the contribution and notice requirements and satisfies a special limitation on matching contributions. The special limitation is met if: (a) matching contributions are not made in excess of 6% of compensation; (b) the rate of an employer's matching contribution does not increase as the rate of employe's contributions increases; and (c) the matching rate for highly compensated employes is not greater than the rate for other employes.

Nondiscrimination testing may be done by reference to prior year data. An employer is allowed to elect to use current year data, but that election can be revoked by the Secretary of the Treasury.

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

These provisions are effective for years beginning after December 31, 1998. However, the provisions regarding the use of prior year data and the distribution of excess contributions are effective for years beginning after December 31, 1996.

Compensation for Limits on Contributions and Benefits. For purposes of limits on contributions and benefits under defined contribution plans, the definition of compensation is amended to include: (a) elective deferrals to 401(k) plans and other similar arrangements; (b) elective contributions to nonqualified deferred compensation plans; and (c) salary reduction contributions made to a cafeteria plan. This provision is effective for years beginning after December 31, 1997.

Social Security Retirement Age. Qualified plans are permitted to continue to base benefits on the Social Security retirement age without failing nondiscrimination tests. This provision applies to years beginning after December 31, 1996.

Alternative Nondiscrimination Rules. A 401(k) plan may elect to disregard non-highly compensated employes before they complete one year of service and reach age 21. To make this election, the plan must satisfy the minimum coverage rules taking into account only those employes who have not met the minimum age and service requirements.

A plan can adopt a single actual deferral percentage test that compares deferrals of highly and non-highly compensated eligible employes. A similar rule applies for a actual contribution percentage test.

These provisions are effective for plan years beginning after December 31, 1998. The provisions regarding nondiscrimination rules are estimated to result in a minimal revenue loss.

State and Local Government Deferred Compensation Plans

A state or local deferred compensation plan may allow participants with accounts of $3,500 or less to elect an in-service cash-out distribution without subjecting the total account to tax. The amount can only be distributed two years after the last deferral and the participant must have not received any other distributions.

A participant may make one election to defer commencement of distributions if made before distributions begin and after the participant attains age 70½, separates from service or experiences an unforeseeable emergency. The maximum deferral amount is the lesser of $7,500 or one-third of compensation. The amount will be adjusted for inflation in $500 increments

This provision is effective with tax years beginning after December 31, 1996, and is estimated to result in a minimal revenue loss.

Limits on Compensation and Benefits of Governmental Plans

The rule limiting a defined benefit plan distribution to 100% of a participant's average compensation for the three highest years is inapplicable to governmental plans; these distributions are limited to $120,000 per year, indexed for inflation. Nongovernmental distributions remain limited to the lesser of $120,000 or 100% of average compensation.

State and local governments may maintain qualified excess benefits plans, subject to the same rules as private employer excess benefit plans. However, participants under such plans may not participate in deferred compensation plans. Certain limits do not apply to disability and survivor benefits and a deadline for revocation of a grandfather rule election is established.

This provision is effective beginning after December 31, 1994, except the deadline for revocation of a grandfather rule election is effective for revocations adopted after August 20, 1996. This provision is estimated to result in a minimal revenue loss.

State and Local Governments Length of Service Awards

Requirements for deferred compensation plans for state and local governments do not apply to plans paying awards, based solely on length of service, to bona fide volunteers, such as firefighters, emergency medical and ambulance service personnel, or their beneficiaries. The same rules apply to vacation leave. The length of service award does not qualify for this treatment if the total award exceeds $3,000 for the year. Exempted amounts are not considered wages for social security taxes.

This provision is effective after December 31, 1995, for accruals of length of service. The exemption from social security taxes applies to remuneration paid after December 31, 1996. This provision is estimated to result in a minimal revenue loss.

Vesting Rules for Multiemployer Plan

Multiemployer plans are subject to the same vesting rules that apply to single-employer plans. Multiemployer plans must provide that a participant's accrued benefits are fully vested after five years; previously, accrued benefits were vested after 10 years for employes covered under a collective bargaining agreement. This provision is effective 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 no later than January 1, 1999. This provision is estimated to result in a minimal revenue loss.

Football Coaches Plan

A qualified football coaches plan will be treated as a multiemployer collectively bargained plan and may include a qualified cash or deferred arrangement. This allows the American

Football Coaches Association to establish 401(k) plans for its members. This provision is effective for years beginning after December 22, 1987, and is estimated to result in a minimal revenue loss.

Multiple Salary Reduction Agreements

A law that barred tax-sheltered annuity participants from entering into more than one salary reduction agreement is repealed, allowing such participants to be treated as 401(k) participants. This provision is effective for tax years beginning after December 31, 1995, and is estimated to result in a minimal revenue loss.

Indian Tribal Government Plans

Any tax-sheltered annuity contract purchased in plan years beginning before 1995 by an Indian tribal government is treated as purchased by an entity permitted to maintain a tax-sheltered annuity plan. Rollovers may be made to 401(k) plans maintained by the tribal government. This provision is effective August 20, 1996, and is estimated to result in a minimal revenue loss.

Distributions Under Rural Cooperative Plans

A rural cooperative plan that includes a cash or deferred arrangement (CODA) may permit distributions to plan participants after they reach age 59½ or on account of hardship, allowing such plans to be treated the same as other CORAs. The definition of a rural cooperative is expanded to include certain public utility districts that provide electric service.

The distribution provision is effective for distributions made after August 20, 1996; the definition change is effective for plan years beginning after December 31, 1996. These provisions are estimated to result in a minimal revenues loss.

Combined Plan Limit

The overall limit is repealed on annual contributions made on behalf of an employe who participates in both a defined contribution plan and a defined benefit plan. The 15% excise tax on excess distributions, those exceeding $155,000 per year or lump sums exceeding $775,000, is suspended until the repeal of the limit takes effect.

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. This provision is estimated to result in a minimal revenue loss.

Actuarial Assumptions in Computing Maximum Benefits

If a benefit is payable before age 62 in a lump sum, the interest rate used to reduce the dollar limit on benefits 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 effective date of the new interest rate and mortality assumptions that are used to calculate the limits on benefits and contributions is conformed to the effective date of the provision relating to the calculation of lump sum distributions. Transition rules are provided for plans adopted and in effect before December 8, 1994.

This provision is effective for plan years and limitation years beginning after December 31, 1994, and is estimated to result in a minimal revenue loss.

Contributions on Behalf of Disabled Employes

An employer is no longer required to make a special election in order to continue making deductible contributions to a defined contribution plan on behalf of an employe who is permanently and totally disabled. However, the plan must provide for the continuation of contributions for all participants who are permanently and totally disabled. This provision is effective with years beginning after December 31, 1996, and is estimated to result in a minimal revenue loss.

Definition of Leased Employes

An employer will not be required to treat an individual as a leased employe unless the individual's services are performed under the "primary direction or control" of the recipient employer. The prior test that the individual perform services that were "historically performed" by employes is repealed. Leased employes are eligible for benefits provided by an employer, and the revised definition reduces the risk that an individual for whom the employer contracts for services will be eligible for benefits.

This provision is effective for years beginning after December 31, 1996, and is estimated to result in a minimal revenue loss.

Reemployment Rights of Veterans

Qualified retirement plans may allow veterans returning to employment from military service to make up employe contributions and elective deferrals that were not made during the employe's military service without risking disqualification for violating contribution and deferral limits. Employers may make matching contributions at the rate that would have applied. Plans must permit reemployed veterans to make elective deferrals for the lesser of five years or the period of military service multiplied by three, beginning with the date of reemployment.

This provision is effective December 12, 1994, and is estimated to result in a minimal revenue loss.

CORPORATE AND BUSINESS TAXES

Involuntary Conversion Rules for Presidentially-Declared Disasters

Expand the involuntary conversion rules to allow business or investment property that is converted compulsorily or involuntarily as a result of a post-1994 Presidentially-declared disaster to be treated as similar or related in service or use to any tangible personal property of a type held for productive use in a trade or business. Under this rule, a taxpayer may elect not to recognize gain with respect to the involuntarily converted property if the tangible business or investment property is acquired within a certain time period.

The provision applies to tax years ending after Presidential declarations of disasters made after December 31, 1994, and would reduce state revenues by an estimated minimal amount.

Involuntary Conversion Basis Rules--Stock Purchases

Modify the involuntary conversion basis rules. When a taxpayer acquires control of a corporation owning property that is intended to replace the taxpayer's involuntarily converted property, and this taxpayer is required to reduce the basis of the acquired corporation's stock, the corporation must also reduce the adjusted basis of its assets by the same amount. The taxpayer's basis is decreased by the amount of any unrecognized gain from the involuntary conversion.

The adjusted basis of the corporation's assets will not be reduced, in the aggregate, below the taxpayer's basis in the stock, as determined after the appropriate stock basis adjustment. In addition, the basis of any individual asset will not be reduced below zero. The basis reduction is first applied to property that is similar or related in service or use to the involuntarily converted property, in proportion to the adjusted basis of the assets in this group. The reduction is then applied to other depreciable property, in a similar manner, and, finally, it is applied to any remaining property in the same manner.

The provision is effective for involuntary conversions occurring after August 20, 1996. The estimated state fiscal effect would be a minimal revenue gain.

Priority for Earnings Strippings Limits on Interest Deductions

A corporation must apply earnings strippings limits to interest expense deductions before applying at-risk and passive activity limits. Earnings strippings rules apply when a corporation has paid or accrued interest to certain related exempt persons. This provision nullifies a proposed

IRS regulation that would have applied earnings strippings rules after the at-risk and passive activity limits.

The provision is effective for interest paid or accrued in tax years beginning after July 10, 1989. It is estimated that it would result in a minimal state revenue loss.

Dues Paid to Agricultural or Horticultural Organizations

Annual dues not exceeding $100 that are paid to a tax-exempt agricultural or horticultural organization are exempt from the unrelated business income tax. The $100 amount will be indexed for inflation in tax years beginning in a calendar year after 1995.

The provision applies retroactively for tax years beginning after December 31, 1986. A transitional rule also excludes dues paid in any tax year beginning before January 1, 1987, from treatment as unrelated business taxable income if the organization to which the dues were paid did not treat any portion of its membership dues as derived in an unrelated trade or business, and it had a reasonable basis for doing so. The provision is estimated to result in a minimal state revenue loss.

Insurance Income of Controlled Foreign Corporations

A new look-through rule applies in characterizing certain insurance income of a controlled foreign corporation for unrelated business income tax (UBIT) purposes. Insurance income earned by a controlled foreign corporation and includible in the income of a U.S. shareholder is not automatically characterized as dividends for UBIT purposes when the shareholder is a tax-exempt organization. Instead, the insurance income is treated as income from an unrelated trade or business to the extent that it would be characterized that way if the tax-exempt organization had received the income directly.

The new look-through rule does not apply to the insurance income that is attributable to the insurance risks of the tax-exempt organization itself, certain tax-exempt affiliates, or an individual who performs services for these affiliates, provided that the insurance covers primarily risks associated with the performance of these services. When a controlled foreign corporation insures the risks of more than one shareholder, one or more of which is a tax-exempt organization, exceptions from the look-through rule are applied on a shareholder-by-shareholder basis.

This provision is effective for amounts includible in gross income for tax years beginning after December 31, 1995. It is estimated that the provision would result in a minimal state revenue loss.

Common Trust Funds

Assets may be transferred from a bank's common trust fund to a regulated investment company (RIC) on a tax-free basis. If a common trust fund transfers substantially all of its assets to one or more RICs solely in exchange for their shares, and then distributes the RIC shares to the fund's participants in exchange for their interests in the fund, no gain or loss is recognized by the fund or its participants. It is intended that the transfer of assets by the common trust fund to one or more RICs and the distribution of RIC shares to participants be made contemporaneously or pursuant to a single plan. Assumption of fund liability by an RIC and property transferred by a fund that is subject to liability are disregarded in determining whether a fund transfer is solely in exchange for RIC shares.

Generally, the RICs receive a carry-over basis on any assets transferred from the common trust fund. However, to the extent that the RIC assumes liabilities of the trust fund in excess of the fund's aggregate basis, the fund will recognize gain in the amount of the excess, and the RIC's basis will be increased by the amount of the recognized gain. The basis of RIC stock for fund participants is the same as the basis in the common trust fund immediately before the transfer but adjusted for recognized gain. If the assets of the fund are transferred to more than one RIC, any increase in basis is allocated in proportion of the fair market values of the assets received by each RIC.

The nonrecognition rule applies to a common trust fund that does not have more than 25% of the value of its total assets invested the stock or securities of one issuer, and does not have more than 50% of the value of its total assets invested in stock or securities of five or fewer issuers. Government securities are not considered securities of an issuer and are excluded in determining total assets.

The provision is effective for transfers by common trust funds after December 31, 1995. The estimated state fiscal effect would be a minimal revenue loss.

Water Utilities Contributions in Aid of Construction

A regulated public utility that provides water or sewage disposal services is permitted to treat any amount of money or property received from any person as a tax-free contribution to its capital if it: (a) is a contribution in aid of construction; (b) is not included in the taxpayer's rate base for rate-making purposes; and (c) is property, other than water or sewage disposal facilities, that meets an expenditure rule.

A contribution meets the expenditure rule and will not be includible in the utility's gross income if: (a) an amount equal to the amount of the contribution is spent for the acquisition or construction of tangible property used predominantly in the trade or business of furnishing water or sewage disposal services; (b) the expenditure occurs before the end of the second tax year after the year in which the contribution was received; and (c) certain records are kept concerning the contribution and expenditure.

The statute of limitations for assessing deficiencies attributable to contributions extends for three years from the date the IRS is properly notified of the expenditures. The basis of any property acquired with a contribution in aid of construction is $0.

The provision is effective for amounts received after June 12, 1996. The state fiscal effect would be an estimated minimal revenue loss.

Definition of Section 179 Property

Certain property that was previously eligible for expensing in the year it was placed in service is no longer eligible for such treatment. Generally, this property includes property used outside the U.S., property used in connection with furnishing lodging, property used by tax exempt organizations, governments and foreign persons, and air conditioning or heating units.

The provision is effective for property placed in service in tax years beginning after December 31, 1990. It is estimated that there would be a minimal revenue gain if the provision is adopted for state tax purposes.

Gasoline Convenience Store Depreciation

For depreciation purposes, depreciable real property that is a retail motor fuels outlet is 15-year property and, for the purposes of the alternative depreciation system, a retail motor fuels outlet has a twenty-year class life. Real property qualifies as a retail motor fuels outlet if either 50% or more of the gross revenues are generated from petroleum sales or 50% or more of the floor space is devoted to petroleum marketing sales. Determination of whether either of the tests are met is based on an IRS Coordinated Issue Paper. The paper gives guidance on whether gas station convenience store buildings and truck stop structures are property that can be depreciated over 15 years, or whether the property is nonresidential real property that should be depreciated over 31.5 years.

For property that is placed in service in tax years that end after the effective date of this provision, determination of whether the property meets one of the 50% tests generally is made in the year the property is placed in service. If the property is placed in service near the end of the tax year and the use of the property during this period is not representative of the subsequent use of the property, then the test may be applied in the subsequent year. For property placed in service in a tax year before enactment, the determination is based on the IRS paper, but with the test established by the federal Act rather than the paper. If, before enactment, a taxpayer has treated a motor fuel outlet as 15-year property, the taxpayer will be treated as if a valid election was made.

The provision applies to property placed in service on or after August 20, 1996, and to which the Accelerated Cost Recovery System (ACRS) of depreciation, as amended by the federal Tax Reform Act of 1986, applies. Taxpayers may elect to have the amendments apply to any ACRS property placed in service before the effective date. The provision would have an estimated state fiscal effect of a minimal revenue loss.

Income-Forecast Depreciation Method

A number of changes have been made to the way depreciation is computed using the income-forecast method. This method is used to compute depreciation on property that cannot be depreciated under either the Modified Accelerated Cost Recovery System (MACRS) or the intangible amortization provisions of the IRC. The method is used for property such as motion picture films and video tapes, television films, book manuscript rights, patents, master sound recordings, video game machines and other property of a similar character. New rules are provided for determining: (a) the amount of estimated income; (b) the adjusted basis of the depreciated property; (c) the final year's allowable depreciation deduction; and (d) the payment of interest based on the recomputation of depreciation under a look-back method based on actual income verses estimated income.

Determining Income Under The Forecast Method. Under the income-forecast method, depreciation is determined by multiplying the cost of the property (less the estimated salvage value) by a fraction, the numerator of which is the income generated by the property during the year and the denominator is the total estimated income (forecasted income) derived from the property during its useful life. Because the types of revenue that are treated as estimated income from films is expanded, the cost of the films will not be recovered as rapidly as in the past. The income that is taken into account to determine allowable depreciation under the income forecast method is equal to the amount of income earned before the close of the 10th tax year following the year in which the property is placed in service. Consequently, there are 11 tax years taken into account. Generally taxpayers do not have to consider income expected to be generated after the 11th year. Income from films, TV shows and similar property that is taken into account includes income from foreign and domestic sources, theatrical releases, television releases and syndications, and video tape releases, sales, rentals and syndications. When the depreciable property is TV and motion picture films, income must generally include amounts derived from the financial exploitation of characters, designs, scripts, scores, and other incidental income associated with films.

Adjusted Basis of Depreciated Property. The adjusted basis of property under the income forecast method of depreciation only includes amounts that satisfy the economic performance standard of the IRC. If a taxpayer incurs a noncontingent liability to acquire property from another person, economic performance will be deemed to occur when the property is provided to the taxpayer. Certain costs are treated as separate property and may result in excluded income for the purposes of applying the income forecast method to the original property. Any costs incurred after the property is placed in service and before the close of the 11-year depreciation period are treated as separate property, if the costs are significant and give rise to a significant increase in the income from the property that was not included in the estimated income from the property. Also, any costs incurred after the close of the 11-year period will be treated as separate property and these costs may be written off and deducted as they are generated.

Final Depreciation Deduction at the End of the 11-Year Period. The depreciation deduction under the income forecast method for the last year of the 11-year depreciation period is equal to the adjusted basis of the property as of the beginning of the tax year.

Interest Computed Under the Look-Back Method. Taxpayers that claim depreciation deductions under the income forecast method pay (or are entitled to receive) interest based on the recalculation of depreciation under a look-back method for any recomputation year. The look-back method does not apply to property that has a basis of $100,000 or less when placed in service. Generally, the recomputation years are the third and tenth tax years after the tax year in which the property was placed in service, unless the actual income from the property for the period before the close of those years was within 10% of the estimated income from the property for that period. The IRS has authority to permit a taxpayer to delay initial application of the look-back method when the taxpayer is expected to have significant income from the property in the third year after the property is placed in service.

The look-back method is applied in any recomputation year by first determining the depreciation deductions using the income forecast method that would have been allowed in the prior tax years if the recomputation had been made using the sum of: (a) the actual income (including income from the disposition of the property) from the property for periods before the close of the recomputation year; and (b) an estimate of future income for periods after the recomputation year and before the close of the 11-year depreciation period. Next the overpayment or underpayment of tax for each prior year that would result solely from the use of recalculated depreciation is determined. Finally, interest is computed on the overpayment or underpayment using a specified rate. A simplified look-back method is used for pass-through entities.

In applying the look-back method, any cost that is incurred after the property is placed in service, if it is not treated as separate property, is discounted to its value as of the date the property was placed in service. Discounting is done by using the federal mid-term interest rate at the time the costs were incurred. The taxpayer may elect not to discount any property.

Interest required to be paid by the taxpayer for any recomputation year is treated as an increase in tax for payment and collection purposes but not for estimated tax payments. Because the new rules apply to property placed in service in tax years that ended before the date of enactment, no estimated tax penalty or penalty for the substantial understatement of income tax will be made for any tax year ending before the date of enactment, to the extent the underpayment was created or increased by the new rules pertaining to the income forecast method of depreciation.

The provisions generally would apply to property placed in service after September 13, 1995. However, they would not apply to any property produced or acquired pursuant to a written contract that was binding on September 13, 1995. The estimated state fiscal effect of these provisions would be a minimal revenue gain.

Leasehold Improvements

A lessor that disposes of or abandons a leasehold improvement, made by the lessor for the lessee, upon termination of the lease may use the adjusted basis of the improvement at the time of disposition or abandonment to determine gain or loss. This basis may be used even if there is no disposition of the underlying building. The provision does not apply to the extent that capitalization of demolition costs and losses apply to the demolition of a structure.

The provision is effective for improvements disposed of or abandoned after June 12, 1996. The provision would result in a minimal state revenue loss.

Depreciation of Water Utility Property

Water utility property is depreciated using a 25-year recovery period and the straight-line method for regular tax purposes. Water utility property is defined as: (a) property that is an integral part of the gathering, treatment, or commercial distribution of water and that would otherwise have had a 20-year recovery period; and (b) any municipal sewer.

The provision is effective for property placed in service after June 12, 1996, other than property placed in service under a binding contract in effect before June 10, 1996 or later. The estimated state fiscal effect would be a minimal revenue gain.

ESOP Loan Interest

The interest income exclusion for loans to employe stock ownership plans (ESOP) is repealed. Consequently, banks, insurance companies, regulated investment companies (such as mutual funds), and corporations actively engaged in the business of lending money may no longer exclude 50% of the interest received on loans to ESOPs or to employer corporations for acquiring employer securities from gross income.

The 50% interest exclusion continues to apply to loans made after August 20, 1996, to refinance loans made on or before August 20, 1996, or to loans made pursuant to a binding contract in effect if the refinancing loan meets requirements in effect before the exclusion was repealed, the outstanding principal of the loan is not increased immediately after the refinancing, and the term of the refinancing loan does not extend beyond the term of the original loan.

The repeal is effective for loans made after August 20, 1996. The provision would increase state revenues by a minimal amount.

Modified Guaranteed Contracts of Life Insurance Companies

Life insurance companies are required to mark-to-market, at the end of each tax year, assets held as part of a segregated account under modified guaranteed contracts. The resulting gain or loss is used in determining a company's net increase or decrease in reserves in arriving at a corresponding income inclusion or deduction. Life insurance reserves include reserves for modified guaranteed contracts that are computed based on rate of interest determined by reference to a market rate of interest. A modified guaranteed contract provides for a guaranteed interest rate for a specified period of time and a market value adjustment in the event that the owner surrenders the contract for cash prior to the end of the guaranteed interest period. A contract is a modified guaranteed contract if it is not a variable contract under provisions of the IRC. In addition, the contract must meet the following requirements: (a) all or part of the amounts received under the contract are required by state law or regulation to be segregated from the company's general asset account and valued at market value; (b) the reserves for the contract must be valued at market value for annual statement purposes; and (c) the contract must provide for a net surrender value or for a policyholder's fund as defined under the IRC.

The provision would be effective for tax years beginning after December 31, 1995. The estimated state fiscal effect would be a minimal revenue gain.

Special Deduction for Certain Health Organizations

Health insurance providers organized under, and governed by, state laws applicable only to not-for-profit health insurance or health service type organizations are allowed to deduct 25% of claims and expenses incurred during the year, less adjusted surplus. These rules under the IRC that benefit Blue Cross and Blue Shield organizations are extended to organizations that are not Blue Cross or Blue Shield organizations but that otherwise meet the requirements. The provision does not apply to health maintenance organizations.

The provision is effective for tax years ending after December 31, 1996. It is estimated that it would result in a minimum state revenue loss.

Contributions of Appreciated Stock

The deduction for contributions of stock to private foundations is extended for contributions made during the period between July 1, 1996 and May 31, 1997. The deduction is equal to the fair market value of qualified appreciated stock. Qualified appreciated stock is publicly traded stock that is capital gain property. The deduction applies only to the extent that total donations of stock in a particular corporation do not exceed 10% of the outstanding stock of the corporation. For purposes of the 10% limit, an individual is treated as making all contributions that are made by any member of the individual's family. The deduction does not apply to contributions made after December 31, 1994, and before July 1, 1996.

The provision is effective for contributions made after June 30, 1996, and before June 1, 1997. The estimated state fiscal effect would be a minimal revenue loss.

Research Credit

The credit for increased research activities is extended for the period between July 1, 1996, through May 31, 1997. The credit expired on June 30, 1995, and it was not retroactively extended so that expenditures paid or incurred from July 1, 1995 through June 30, 1996 are not eligible for the credit. However, a taxpayer that elects the alternative incremental credit regime for its first tax year beginning after June 30, 1996, and before July 1, 1997, may apply the credit to amounts paid or incurred during the first 11 months of that tax year. If the credit is not extended after May 31, 1997, the credit base amount for a tax year affected by the modified credit is reduced to account for the credit's expiration.

The definition of start-up company is expanded to include firms that have both gross receipts and qualified research expenses for the first time in a tax year that begins after 1983. Under prior law, to qualify as a start-up company, a taxpayer had to have fewer than three tax years beginning after December 31, 1983, and before January 1, 1989, in which the taxpayer had both gross receipts and qualified research expenses. A taxpayer can qualify as a start-up company under either definition.

A taxpayer may elect, for its first tax year beginning after June 30, 1996, an alternative method of computing the research credit that uses three tiers of reduced fixed base percentages and credit rates. The election applies to the tax year in which it is made and to all subsequent tax years, unless revoked with the consent of the IRS. Under the alternative computation, a taxpayer's credit is equal to the sum of three tiers of credits:

Tier 1 credit: 1.65% of qualified research expenses for the tax year in excess of a base amount computed using a fixed base percentage of 1%, but not in excess of a base amount computed using a fixed base percentage of 1.5%;

Tier 2 credit: 2.2% of qualified research expenses for the tax year in excess of a base amount computed using a fixed base percentage of 1.5%, but not in excess of a base amount computed using a fixed base percentage of 2%; and

Tier 3 credit: 2.75% of qualified research expenses for the tax year in excess of a base amount computed using a fixed base percentage of 2%.

The alternative computation would allow companies that spend more on research and development now than they did during the 1984-88 base period to claim the credit. The alternative computation may also increase the credit for companies that can claim the research credit using the standard computation.

Taxpayers that conduct research through qualified research consortia are allowed to treat 75% of amounts paid or incurred for qualified research expenses as eligible for the research credit. Prior law rules allowing 65% of contract research expenses paid or incurred for qualified research to be eligible for the research credit continue to apply to amounts not paid to a qualified research consortium. A qualified research consortium is a tax-exempt organization, other than a private foundation, a business league, chamber of commerce or other similar entity, that is organized and operated primarily to conduct scientific research.

Extension of the credit and the new definition of start-up company apply to tax years ending after June 30, 1996. The alternative research credit rules may be elected only for a first tax year beginning after June 30, 1996. The special rule for payments to qualified research consortia applies to tax years beginning after June 30, 1996. The provision would result in an estimated minimal state revenue decrease.

MISCELLANEOUS PROVISIONS

Financial Asset Securitization Investment Trusts

A new entity is created, called a financial asset securitization investment trust (FASIT). A FASIT is used to hold a portfolio of qualified debt obligations, such as credit card receivables, home equity loans and auto loans. However, a FASIT can not engage independently in lending. A FASIT issues asset-backed securities that are treated as debt for federal income tax purposes. FASITs are owned by a single taxable C corporation.

The FASIT offers an advantage to traditional vehicles for securitizing loans, such as revolving trusts. These trusts have certain administrative and financial commitment requirements to ensure that certificates issued by the trust will earn debt status for IRS purposes. In addition, revolving trusts have certain costs associated with earning a rating agency grade, requiring the trust's sponsor to retain a large equity stake in the pool and may necessitate over collateralization.

To qualify as a FASIT, an entity must: (a) make an election to be treated as a FASIT for the current year and all subsequent years; (b) have assets that are substantially permitted assets; (c) issue only nonownership security instruments that meet the requirements for regular interests; (d) have a single ownership interest which is held by a domestic bank or C corporation; and (e) not qualify as a regulated investment company (mutual fund).

The asset test must be met on the 90th day after formation and at all times thereafter. Permitted assets include:

a. Cash and cash equivalents.

b. Debt instruments which are considered debt for federal income tax purposes and bear either a fixed or variable rate of interest tied to a predictable index. Debt may include trade receivables, regular interests in real estate mortgage investment conduits or another FASIT. Debt may not be obligations that were issued by the owner of the FASIT or related person.

c. Certain foreclosure property if the property would be foreclosure property for a real estate investment trust or for such property if not for leases entered into or construction performed while the property is held by a FASIT.

d. Interest rate or foreign currency notional principal contracts, letters of credit, insurance, guarantees against payment defaults or similar instruments which are reasonably required to guarantee or hedge against the FASIT's risk.

e. Securities issued by the FASIT that are treated as debt for federal income tax purposes. Allowable securities include: (1) regular interests yielding no more than five percentage points above the applicable federal rate; and (2) high-yield, high-risk, instruments that may be held only by a domestic C corporation or by a dealer who acquired the security for resale.

f. A regular interest in another FASIT that is an asset-backed security that has fixed terms and meets five requirements: (1) the instrument unconditionally entitles the holder to receive a specified principal amount; (2) the instrument pays either fixed interest or interest that is indexed to a predicable schedule based on rates that measure current variations in the cost of newly borrowed funds; (3) the instrument has a term to maturity of no more than 30 years; (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 of no more than five percentage points above the applicable federal rate.

Holders of regular interest in a FASIT must account for the income earned using an accrual method of accounting. Holders of high-yield instruments may not use net operating losses to offset any income derived from high-yield debt; operating loss carryover will be computed by disregarding any income from the disallowed loss.

A dealer may acquire a high-yield debt instrument issued by a FASIT only for the purpose of resale. An excise tax is imposed at the highest corporate rate (35%) if there is a change in dealer status. A safe-harbor rule allows a dealer to hold a high-yield instrument for a 31-day grace period before the instrument is treated as held for investment purposes.

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 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 ownership interest with any other losses. Any net operating loss carryover of the owner is computed without income from the disallowed loss. The alternative minimum taxable income of an 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 first acquired by the owner. Any assets of the owner or related person used to support the FASIT's obligations 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 pools 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.

To discourage FASITs from engaging in prohibited activities, an excise tax of 100% is imposed on all net income derived from: (a) nonpermissable assets; (b) disposition of an asset other than a permitted asset; (c) income attributable to loans issued by a FASIT; and (d) 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.

This provision is effective September 1, 1997. A transitional rule provides guidance for entities created prior to that date. This provision is estimated to result in a minimal revenue loss.

Insurance Contract on Retired Lives

The term "variable contract" may include contracts that provide for the funding of group term life or group accident and health insurance on retired lives. The contract must provide for the allocation of all or part of the amounts received to a segregated account. Payments in or out must reflect the investment return and the market value of the segregated account. This provision is effective with tax years beginning after December 31, 1995, and is estimated to result in a minimal revenue loss.

Charitable Risk Pools

Qualified charitable risk pools are exempt from tax only if no substantial part of their activities consists of providing commercial-type insurance. Insurance provided at substantially below cost to a class of charitable recipients is not commercial-type insurance. A qualified charitable risk pool is defined as an organization organized and operated solely to pool the insurable risks of its members and to provide information to its members.

To qualify for tax-exempt status, a charitable risk pool must be organized as a nonprofit organization; be exempt from state income tax; obtain at least $1 million in start-up capital from nonmember charitable organizations; be controlled by a board of directors elected by its members; and provide in its organizational documents that members must be tax-exempt charitable organizations. If a member loses its tax-exempt status it must notify the pool immediately.

This provision is effective for tax years beginning after August 20, 1996, and is estimated to result in minimal revenue loss.

State-Sponsored High-Risk Health Insurance Pools

State-sponsored membership organizations that provide high-risk individuals with health coverage are exempt from income tax. In order to be exempt, an organization must be established exclusively for the purpose of providing medical care to high-risk individuals on a not-for-profit basis through either insurance issued by the organization or a health maintenance organization. Only state residents may receive coverage.

This provision is effective for tax years beginning after December 31, 1996, and is estimated to result in a minimal revenue loss.

State-Sponsored Workmen's Compensation Reinsurance Organizations

State-sponsored workmen's compensation reinsurance organizations established by a state before June 1, 1996, exclusively for the purpose of reimbursing their members for losses arising under workmen's compensation acts are exempt from income tax. An organization will qualify if the state requires that the organization's membership consist of persons who issue insurance covering workmen's compensation losses in the state and all persons and governmental entities who self-insure against such losses. The organizations must operate as a nonprofit organization.

This provision is effective with tax years ending after August 21, 1996, and is estimated to result in a minimal revenue loss.

PROVISIONS WITH NO FISCAL IMPACT AND INAPPLICABLE FEDERAL PROVISIONS

In addition to the items listed above, the IRC update would adopt a number of technical modifications and clarifications to federal law that would have no state fiscal effect. Also, a number of provisions of federal law are not applicable to state taxes because the state has its own statutory provisions.