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May 1, 2006

MEMORANDUM

To: Representative Lehman

From: Joseph T. Kreye, Sr. Legislative Attorney, (608) 266-2263

Subject: Technical Memorandum to **2005 AB-873 by DOR** (LRB 05-3994/1)

We received the attached technical memorandum relating to your bill. This copy is for your information and your file. If you wish to discuss this memorandum or the necessity of revising your bill or preparing an amendment, please contact me.

MEMORANDUM

April 10, 2006

TO: Joseph Kreye
Legislative Reference Bureau

FROM: Rebecca Boldt
Department of Revenue

SUBJECT: Technical Memorandum on AB 873: Excess Profits Tax on Integrated Oil Companies

The Department has detailed comments regarding the bill that are attached to this memorandum. The comments provide recommendations by statutory section number when possible. In addition, there are a number of other recommendations for specific language additions or changes to clarify provisions of the bill or aid in administering the bill.

Because combined reporting would entail a complete restructuring of Wisconsin's corporate income and franchise tax system, the Department is likely to have substantial comments on any subsequent legislative drafts that the sponsor may request. As the statutory language develops, the Department may find it necessary to make revisions different from those currently being considered. Further, changes in the language may affect the way corporate tax returns are processed and audited, and that may lead to changes in the estimate of administrative costs contained in the fiscal estimate.

The home heating credit is based on the amount of revenue generated from the excess oil profits tax. Since data is not available to estimate the amount of revenue that may be generated from that tax, the sponsor may wish to delay the credit until the following year and have it based on the previous year's excess oil profits tax revenue. In that way, neither more nor less revenue than is generated will be awarded as a credit.

The proposed legislation makes no provision for the funding of the costs involved in administering the activities required. The Department would incur costs for computer programming, form development, processing of returns and auditor training. The Department estimates that it would need at least two years of lead-time to implement combined reporting. If the author wishes to provide funding, appropriation language could be developed and costs allocated in the following manner:

	Chapter 20	Amount
annual	s. 20.566 (1) (a)	$343,800

If you have any questions regarding this technical memorandum, please contact Rebecca Boldt at 266-6785; for administrative costs contact Jeff Whittow at 266-9759.

cc: Rep. Lehman

ATTACHMENT TO AB 873 TECHNICAL MEMORANDUM

Excess Profits Home Heating Credit:

- Section 71.07(5e)(b) and (d) allows the excess profits home heating credit to be offset against the taxes imposed under s. 71.02. However, the order of computation (s. 71.10(4)(gxx)) places the credit after the alternative minimum tax (s. 71.08). Section 71.07(5e)(b) and (d) should be amended to add a reference to s. 71.08.

- Section 71.07(5e)3 defines "household income." Because household income is not used in the computation of the credit, there does not appear to be a need for this definition.

- It will be difficult to determine the amount paid for fuel and electricity used to heat the claimant's principal dwelling.

  - For example, electricity may be used to heat the dwelling and for hot water, lighting, cooking, etc. It is not clear how the portion for heat would be determined.
  - If more than one household occupies a dwelling, the bill should specify how the heating cost is to be divided among the households. One method would be to allocate the cost based on the number of members of each household.
  - In addition, renters who have the cost of heat included in their rent will not be able to determine what they paid for heat. If it is the intent that renters be eligible for the credit, the bill should require the landlord to furnish each renter with a statement indicating the renter's share of the total cost of heating the rental unit.

- The credit is effective for taxable years beginning on January 1, 2006. The department must determine the percentage used to compute the credit so that the maximum amount of all credits claimed in any taxable year does not exceed the amount collected under the excess profits tax. In order to determine the percentage, the department would need to know the amount potential claimants spent on home heating and the amount of excess profits tax available.

  - The department may not know how much will be collected under the excess profits tax for taxable years beginning in 2006 until after September 15, 2008.
  - The department will not know the amount that potential claimants paid for heating until the claimants actually file their claims.

  As a result, the percentage for the credit will be extremely difficult, if not impossible, to establish and promulgate in a rule. Tracking the credits claimed, so they don't exceed the maximum amount allowable, will also be administratively burdensome.

Oil Company Excess Profits Tax:

- Page 5, line 17, of the bill refers to sub. (5) (b). It appears that the reference should be to sub. (4) (b).

- On page 5, beginning at line 23, the bill creates sec. 71.23(4)(a)2, a definition of "income." It is unclear how this definition relates to the other definitions created in sec. 71.23(4).

- ➢ It is unclear if the sponsor intends that the definitions of "excess taxable income," "in-state taxable income," "normal taxable income," and "taxable income" that are created in par. (a) refer to the definition of income in sec. 71.23(4)(a)2.
- ➢ Which expenses, if any, that would be allowed in the computations of "excess taxable income," "in-state taxable income," "normal taxable income," and "taxable income" is not clear. If it is the intent to allow certain expenses, then the bill needs to state which expenses are allowable. For example, the bill could state that only direct expenses related to the extracting, producing, and refining of crude petroleum and to the transporting, distributing, and marketing of crude petroleum and similar petroleum products are allowed. Alternatively, the company's total expenses, prorated based on the ratio of the "income" as defined in sec. 71.23(4)(a)2. to the company's total income, could be allowed.

- On page 6, beginning at line 3, the bill creates sec. 71.23(4)(a)3., a definition of "in-state sales." This definition would not include any revenue of a pipeline company that is part of an integrated oil company, since pipeline companies use a special apportionment formula. If this is not the sponsor's intent, then it appears that the bill should direct the department to promulgate a new single sales factor rule relating to the apportionment of income of a pipeline company so its revenue would be included in sec. 71.25(9)(a).

- Because there have been a significant number of mergers and reorganizations in the petroleum industry, it could be extremely complicated and time consuming for integrated oil companies to propose and for the department to approve an alternative method of computing the company's excess taxable income.

Combined Reporting:

Under current law, businesses use a variety of apportionment formulas. While the phase-in of single sales factor apportionment applies to a majority of businesses, specialized industries use different one-, two-, or three-factor formulas. Unless the Legislature directs the department to promulgate single sales factor apportionment rules for all of the specialized industries, combined reporting would involve extremely complex computations for the specialized industries. It is unknown whether a court would find single sales factor apportionment constitutional for these industries. The following suggested changes assume that the Legislature would not require all businesses to use the single sales factor apportionment formula.

Additionally, although insurance companies are taken into consideration in determining whether a commonly controlled group exists, insurers are being excluded from combined reporting since only certain insurance company income is subject to Wisconsin franchise or income tax.

- Revise sec. 71.255(1)(d)(intro.) to read as follows:

  (1)(d)(intro.) "Commonly controlled group" ~~means~~ <u>includes</u> any of the following~~, but does not include an insurer that is exempt from taxation under s. 71.45 (1)~~:

- For emphasis, revise sec. 71.255(1)(d)2. to read as follows:

  (1)(d)2. Any 2 or more corporations if a common <u>corporate or noncorporate</u> owner directly or indirectly owns stock representing more than 50 percent of the voting power of the corporations or the connected corporations.

- Revise sec. 71.255(1)(i) to read as follows:

  (1)(i) "Intercompany transaction" means a transaction between corporations, partnerships, or limited liability companies that ~~become~~ are members of the same combined reporting group at the time of the transaction or immediately after the transaction.

- Since an entity that meets the requirements may elect whether or not to be treated as a partnership, revise sec. 71.255(1)(im) to read as follows:

  (1)(im) "Partnership" means any entity considered a partnership under section 7701 of the Internal Revenue Code for federal income tax purposes.

- Revise secs. 71.255(1)(j) and (k) to eliminate the references to ss. 71.44 and 71.43, respectively. Although insurance companies are taken into consideration in determining whether a unitary business exists, they may not determine their income under combined reporting or participate in a combined return.

- Revise sec. 71.255(1)(m) as follows:

  (1)(m) "Unitary business" includes the business activities or operations of an entity that are of mutual benefit to, integrated with, or dependent upon or that contribute to activities of at least one other entity~~, including transactions that serve an operational function, as determined by the department~~. Two or more businesses are presumed to be a unitary business if the businesses have unity of ownership, operation, and use as indicated by centralized management or a centralized executive force; centralized purchasing, advertising, or accounting; intercorporate sales or leases; intercorporate services; intercorporate debts; intercorporate use of proprietary materials; interlocking directorates; or interlocking corporate officers. The absence of these centralized activities will not necessarily evidence a nonunitary business. If a business conducted in this state is owned by a person that conducts a business activity outside this state that is different from the business conducted in this state, it is presumed that the two business operations are unitary, interrelated, connected, and interdependent unless it can be shown to the contrary.

- Create an exception to secs. 71.255(2)(a) and (b) and 71.255(6), which provides that the net income or loss of the following entities may not be included under combined reporting or in the combined report: any insurance company, tax-option corporation, regulated investment company, real estate mortgage investment conduit, real estate investment trust, or financial asset securitization investment trust. Although these entities are taken into account in determining whether a unitary business exists, due to differences in taxation, they must compute their income on a separate entity basis.

- Revise secs. 71.255(2)(a)(intro.) and 71.255(2)(b) to delete the references to ss. 71.43, 71.45, and 71.47. Insurance companies may not determine their income under combined reporting or participate in a combined return.

- Delete sec. 71.255(2)(a)3., relating to foreign sales corporations. Sections 921 to 927 of the Internal Revenue Code have been repealed, and foreign sales corporations no longer receive special treatment for Wisconsin.

- Revise secs. 71.255(2)(a)5. and 6. to refer to the property factor under s. 71.25(7) of the 2001 Stats. and the payroll factor under s. 71.25(8) of the 2001 Stats.

- Revise sec. 71.255(3)(b) to delete the reference to s. 71.43, relating to insurance companies.
- Revise secs. 71.255(4) and 71.255(5)(b) to delete the references to ss. 71.45 and 71.47, relating to insurance companies.
- Revise sec. 71.255(5)(c)2. to delete the reference to s. 71.44(3), relating to extensions for insurance companies.
- Revise secs. 71.255(5)(d)1. and 71.255(5)(d)2.b. to delete the references to s. 71.45, relating to insurance companies.
- Revise sec. 71.255(6)(a) to delete the references to ss. 71.45. 71.45(2)(a)13., and 71.49(2), relating to insurance companies.
- Delete secs. 71.255(6)(h), (i), and (j). The income and tax liability of each member will be computed in the same manner whether or not a group return is filed.
- Create a new paragraph (h) in sec. 71.255(6) to read as follows:

  (6)(h) From the amount determined under par. (g), subtract each member's net business loss carry-forward as determined under sub. (8). The net business loss carry-forward may not reduce the member's income below zero.

- Revise sec. 71.255(7)(a) 1. and 2. to delete the references to ss. 71.45, 71.43, and 71.45(3), relating to insurance companies.
- Delete secs. 71.255(7)(c) and (d) and replace them with the following:

  (7)(c) Compute the apportionment percentage attributable to this state, as determined under s. 71.25 for each member of the combined reporting group.

  (7)(d) Compute the arithmetic average of the apportionment percentages as determined under par. (c).

  (7)(e) Compute each corporation's apportionment percentage for purposes of sub. (6)(e) by dividing the corporation's percentage as determined under par. (c) by the arithmetic average of the apportionment percentages as determined under par. (d).

- Revise sec. 71.255(8) to read as follows:

  (8) NET BUSINESS LOSS ~~CARRY-OVER~~ CARRY-FORWORD. (a) For taxable years beginning after December 31, ~~2005~~ 2007, any net business loss of a corporation that is a member of a combined reporting group as determined under sub. (6) for the taxable year that is not offset against the net income of the other members of the combined reporting group in the same taxable year may be carried forward as provided under s. 71.26(4), except that any net business loss carried forward to a subsequent taxable year ~~may~~ shall be offset against ~~either~~ the net income of the corporation that incurred the net business loss ~~or~~ and the net income of the other members of the combined reporting group of which the corporation is a member, in the manner prescribed by rule by the department.

(b) A corporation that is a member of a combined reporting group may not carry forward a net business loss from a taxable year beginning before January 1, ~~2006~~ 2008, if the corporation was not subject to the tax imposed under s. 71.23 ~~or 71.43~~ for the same taxable year.

(c) A corporation that is a member of a combined reporting group and that incurred a Wisconsin net business loss in a taxable year beginning before January 1, ~~2006~~ 2008, that has not been offset against the corporation's net income in subsequent taxable years ~~may~~ shall offset the remaining net business loss against the corporation's net income as determined under sub. (6). If the corporation joins in filing a group return under sub. (5) and the corporation's remaining net business loss exceeds the corporation's net income as determined under sub. (6) for the first taxable year beginning after December 31, ~~2005~~ 2007, that the corporation is subject to this section, the corporation ~~may~~ shall annually offset ~~up to 20 percent of~~ the remaining net business loss as provided in s. 71.26 (4) against ~~the net income of the other members of the combined reporting group that join in filing a group return under sub. (5)~~ its net income. The other members of the combined reporting group that join in filing a group return under sub. (5) may not claim any portion of the corporation's remaining net business loss determined under this paragraph.

- Revise sec. 71.255(10) to read as follows:

(10) NET TAX LIABILITY. (a) ~~A~~ Each corporation ~~that files a separate return under this section~~ shall determine its net tax liability as follows:

1. Multiply the amount determined under sub. (6) ~~(i)~~ (h) for the corporation by the tax rate under s. 71.27~~ or 71.46, as appropriate~~.

2. From the amount determined under subd. 1., subtract the corporation's tax credits under s. 71.28 ~~or 71.47~~ based on the corporation's expenses. The corporation may not offset any of its tax credits, or tax credit carry-forwards, against the tax liability of any other member of the combined reporting group to which the corporation belongs.

(b) A combined reporting group that files a group return under this section shall determine its net tax liability ~~as follows:~~

~~1. Multiply the amount determined under sub. (6) (i) for the combined reporting group by the tax rate under s. 71.27 or 71.46, as appropriate.~~

~~2. From the amount determined under subd. 1., subtract the tax credits under ss. 71.28 and 71.47 for all taxpayer members of the combined reporting group~~ by combining the amounts determined under par. (a) for all members of the combined reporting group that join in filing the group return.

- Revise sec. 71.255(11) to delete the reference to s. 71.48, relating to estimated tax payments for insurance companies.

- Revise sec. 71.255(16) to require a member of a commonly controlled group to furnish to the Department of Revenue documentation from foreign countries and their territories or possessions relating to the sourcing of income to the United States.

- Delete bill section 10, relating to the amendment to s. 71.26(3)(x). This section would adopt the federal consolidated reporting rules. These federal provisions may conflict with certain aspects of combined reporting. Language included in other sections of the bill authorizes the department to promulgate rules, which may include federal regulations where appropriate.

- In bill section 11, amend the first sentence of s. 71.26(4) to provide that a corporation "shall offset" rather than "may offset" against its Wisconsin net business income any Wisconsin net loss sustained. Thus, corporations would be required to use their net business loss carryforwards in the first taxable year in which they have net income.

- Delete bill sections 13, 14, 15, and 16. These sections are not needed because insurance companies will not be permitted to compute their income under the combined reporting method.

Effective Date:

It would take the department a minimum of two years to establish a combined reporting system and promulgate rules. As explained in the last item under the Excess Profits Home Heating Credit, information on how much money will be available to be paid as credits would not be known until all oil companies have filed their tax returns.

Therefore, it is suggested that the excess oil profits tax and combined reporting provisions first apply for taxable years beginning on January 1, 2008, and the excess profits home heating credit first apply for taxable years beginning on January 1, 2010, based on home heating bills paid for 2009.