



TERRY KATSMAS

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Date: May 9th, 2017
To: Assembly Committee on Ways and Means
From: Representative Terry Katsma
Re: Assembly Bill 259: Taxpayer Fairness Act

Dear Chairman Macco and committee members,

Thank you for convening a hearing on Assembly Bill (AB) 259, a bill that aims to keep making Wisconsin a better place to do business. There are four main parts to this bill.

The first component is federalizing the built-in gains tax. Some for-profit corporations choose, when they are created, to be taxed separately from their owners under Subchapter C of Chapter 1 of the Internal Revenue Code (and are therefore known as “C corporations”). Other corporations instead choose to be “S corporations,” dividing any gains or losses among its shareholders, who are then responsible for paying the income taxes as part of their individual tax returns. A C corporation can choose to convert itself to an S corporation, but the new S corporation must keep paying tax for a period of time (which is commonly called a “built-in gains tax”) as if it were still a regular C corporation. A 2015 federal law permanently reduced this period of time from 10 years to 5 years. AB 259 adopts into state law the new 5-year federal recognition period and provides for state law to adjust automatically to match any future changes in federal law.

The second part of the bill helps level the playing field between government and taxpayer in audit situations. In some tax audits of businesses, the Department of Revenue (DOR) examines whether a business engaged in certain transactions for genuine business purposes—with “economic substance” behind the transaction—or merely to evade tax liability. If DOR alleges that a transaction lacked economic substance, the burden is presently on the taxpayer to provide “clear and convincing” evidence (the law’s highest possible standard of proof) that economic substance did in fact exist. In reality, this is an impossibly high legal threshold for a business to meet; a business has practically no hope of successfully contesting such an allegation. Under this bill, a taxpayer bears the burden of establishing economic substance by a “preponderance of the evidence” rather than “clear and convincing” evidence, thus giving taxpayers a fairer chance in dispute situations than they have today.

Third, AB 259 would withdraw our state from the Multistate Tax Commission (MTC). Presently, the Department of Revenue contracts annually with the MTC to conduct business audits. Many businesses believe that MTC auditors do a poorer job than DOR auditors (who are more familiar with Wisconsin law). Involving third-party contractors in the audit process can compromise the confidentiality of tax information that is more appropriately kept private between taxpayer and government. And contracting for audit services can create an incentive for



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contractors to “find something” worth selling to DOR even where tax liability does not reasonably exist. This bill withdraws Wisconsin from participation in the MTC.

Finally, this bill creates greater certainty for taxpayers after disputes are settled. If DOR reviews a taxpayer’s transactions and finds no tax liability, the taxpayer should be able to rely upon that determination unless the law is changed or DOR publishes new guidance that would alter the determination. This is particularly true when, as in most audit situations, an audit is resolved via a written agreement between DOR and the taxpayer. AB 259 eliminates a possibility for auditors to overreach in new audits by unfairly revisiting issues settled in previous audits or by unreasonably expecting taxpayers to provide more information than DOR actually requests.

Thank you for your time and consideration of AB 259.

WMC

WISCONSIN MANUFACTURERS & COMMERCE

TO: Members of the Assembly Ways and Means Committee

FROM: Jason Culotta
Senior Director of Government Relations

DATE: May 9, 2017

RE: Testimony on Assembly Bill 259

Thank you for the opportunity to share comments with you today in support of Assembly Bill 259, legislation to make compliance with Wisconsin's tax code fairer for taxpayers.

Wisconsin Manufacturers & Commerce (WMC) is the state chamber of commerce and largest general business association in Wisconsin. We were founded more than 100 years ago, and are proud to represent approximately 3,800 member companies of all sizes, and from every sector of our economy. Our mission is to make Wisconsin the most competitive state in the nation in which to do business.

Assembly Bill 259 consists of four elements:

- Treating taxpayers fairly under the legal threshold for challenging assertions of economic substance; the statute adopted by Governor Doyle in 2009 precludes taxpayers from having an even chance at challenging such assertions.
- Ending Wisconsin's participation in a third-party audit group known as the Multi-State Tax Commission. With the addition of new state auditors in the 2015 budget and a proposed further 38 positions in the pending budget, Wisconsin no longer has need for an outside group to conduct additional audits of companies doing business here.
- Extend taxpayer protections for material reviewed during an earlier tax audit.
- Federalize treatment of the built-in gains tax for C corporations that converted to S corporations.

Adopting the provisions of this legislation will help make compliance with Wisconsin's tax code easier for taxpayers. WMC urges support for passage of Assembly Bill 259.



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May 8, 2017

Wisconsin Legislature
Assembly Committee on Ways and Means

Via E-mail

Re: COST's Support for Assembly Bill 259

Dear Chair Macco, Vice-Chair Katsma, and Members of the Committee:

On behalf of the Council On State Taxation (COST), I am writing in support of Assembly Bill 259, which would continue the work of the Wisconsin State Legislature in improving the fairness of the State's tax administration. COST is a nonprofit trade association consisting of approximately 600 multistate corporations engaged in interstate and international business. COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Important Taxpayer Fairness Reform Enacted in 2016

COST recognizes the achievements of the Wisconsin State Legislature last year in addressing a taxpayer fairness issue identified in COST's State Tax Administration "Scorecard." As enacted, 2016 S.B. 503 requires the Department of Revenue to issue a summons, and for the taxpayer to fail to comply with the summons in good faith, before the Department may impose penalties for failure to produce records and documents during an audit. Before this change, the Department's regulations allowed for penalties to be imposed even when the taxpayer timely responded to the Department's records request if the Department deemed the response insufficient. This change was an important recognition that the taxpayer is at a disadvantage when required to clear a higher hurdle than the Department or is penalized at the Department's discretion.

Leveling the Playing Field on "Economic Substance"

Assembly Bill 259 would likewise address a fairness issue by moving toward a level playing field for taxpayers required to defend the economic substance of legitimate business transactions. This issue was included in last year's reform legislation, but was not enacted. Existing law creates a presumption that any intercompany transaction – essentially any business conducted within the corporate group – lacks economic substance, and the taxpayer bears the burden of proving otherwise by clear and convincing evidence. This blanket presumption has no regard for legitimate

transactions and places businesses at a significant disadvantage in defending normal business arrangements.

While Assembly Bill 259 leaves the presumption in place, it changes the burden of proof to a “preponderance of the evidence” standard. In practice, the taxpayer would still be required to provide evidence establishing economic substance for those intercompany transactions challenged by the Department’s auditor – a common audit situation. However, by changing the burden from clear and convincing evidence, the taxpayer would be placed on a more equal footing when the Department requires it to show that its intercompany transactions possess economic substance.

The Department’s Fiscal Estimate acknowledges that the revenue impact of this change is unknown, but presumes without support that the change would result in a loss. On the contrary, providing a more even-handed evidentiary standard could streamline audits and appeals, result in more settlements and accelerate resulting payments to the State. Further, the Department believes that the change “will increase the Department’s administrative expenses,” although fewer disputes could result in less, not more, administrative cost to the State. Puzzlingly, the Department states that the “preponderance of the evidence” standard is “less clear” than a “clear and convincing evidence” standard. The fact that “clear” is in the current statutory language does not make the application of the statute any clearer. Arguably, a greater weight of the evidence, or preponderance, test is clearer than determining what constitutes a level of clear and convincing evidence.

Taxpayer Reliance on DOR Audits

Taxpayers should be able to rely on the results on Department audits. Current law provides such protections, but allows exceptions where the taxpayer did not “give the department employee adequate and accurate information” or if the issue was settled in the prior audit determination. The adequacy and accuracy of information provided by the taxpayer should be determined during the audit – that is the function of audit procedures and the duty of the Department. Of course, intentionally misleading or fraudulent conduct by taxpayers should not be excused, and in fact is punishable under Wisconsin law. Likewise, the Department is free to assess tax based on available information if the taxpayer fails to provide adequate information, and as noted above, the Department can issue summons and impose penalties on uncooperative taxpayers. Moreover, the Department may issue an estimated assessment if a taxpayer fails to provide information needed for the Department to audit the taxpayer.

COST believes the Department’s representation in its Fiscal Estimate that this change would enable taxpayers to “conceal or misrepresent” relevant tax information is entirely outside the scope of the proposed change, and this concern is addressed in current law. In fact, with this amendment the statute will largely codify case law on reasonable reliance that has existed for decades. Contrary to the fiscal note, this change should not impact taxpayer compliance with the Department’s audit activities; rather, it should shield taxpayers from the Department questioning prior audit conclusions, including whether the Department had enough information and whether the Department conducted the audit effectively to determine the accuracy of that information. Likewise, settlements reflect agreements between taxpayers and the Department on which taxpayers should be able to rely. Rather than reduce taxpayer compliance, establishing settled expectations enhances taxpayer compliance and streamlines audits.

Council On State Taxation (COST)
Letter Re: COST's support for Assembly Bill 259

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Thank you for the opportunity to provide this Committee with COST's rationale supporting Assembly Bill 259. I welcome any questions or requests for information I can provide the Committee to aid in its consideration of this measure.

Respectfully,

A handwritten signature in black ink, appearing to read 'F. Hogroian', with a large, sweeping flourish extending to the right.

Ferdinand Hogroian

cc: COST Board of Directors
Douglas L. Lindholm, COST President & Executive Director



State of Wisconsin • DEPARTMENT OF REVENUE

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Scott Walker
Governor

Richard G. Chandler
Secretary of Revenue

May 9, 2017

Testimony to the Assembly Committee on Ways & Means on Assembly Bill 259

Chairman Macco and members of the committee, thank you for the opportunity to testify on Assembly Bill 259, which makes several changes to statutes administered by the Department of Revenue. I'll present information about the fiscal effects and the policy aspects of the provisions in the bill.

1. Built-in Gains

Federal and Wisconsin law require a corporation that converts to an S corporation (i.e., pass-through entity) to pay a corporate tax on gains resulting from the sale of corporate assets if the assets are sold within a certain number of years from the date of the conversion. This is known as the recognition period. Currently, Wisconsin requires a ten year recognition period whereas the federal government requires a five year recognition period. This provision federalizes the length of the recognition period for built-in gains tax. DOR has no concerns with this provision. Based on the federal fiscal estimate for the federal built-in gains recognition period change, this provision would result in a loss of income and franchise tax revenue of an estimated \$950,000 in FY18 and similar amounts thereafter.

2. Economic Substance

The language in current Wisconsin statutes says that business transactions will only be recognized for purposes of tax deductions if they have economic substance. There has to be an economic or business reason to engage in a transaction, not just a tax avoidance reason. The vast majority of states disallow deductions for transactions that lack economic substance, as does the federal government. Wisconsin's current language parallels the federal internal revenue code and

a majority of states. The statutes were revised in 2016 to make sure that Wisconsin language would parallel federal law.

This bill relaxes the standard of proof a taxpayer must meet to establish that a transaction has economic substance for income and franchise tax purposes. Currently, Wisconsin tax law uses a "clear and convincing evidence" standard of proof. This bill reduces that standard for economic substance to a "preponderance of the evidence" which is a less strict standard.

DOR believes that the current burden of proof standard is reasonable. If a valid transaction occurs, it will be recognized as valid. If DOR is making an unreasonable economic substance determination, the taxpayer can always appeal that decision. Lowering the evidentiary standards for burden of proof may allow taxpayers to pursue tax avoidance strategies.

To remain consistent with other provisions of Wisconsin tax law and avoid any fiscal effect, the state would have to maintain the current burden of proof. The burden of proof change in the bill would result in a loss of income and franchise tax of an unknown amount. Assuming the change in evidentiary standard results in a reduction of 10% in the revenue from large-case auditors, corporate income and franchise tax revenue would be reduced by an estimated \$6 million annually.

3. Multistate Tax Commission Audit Program

Under current law, DOR is authorized to enter into a contract to participate in the Multi-State Tax Commission (MTC) audit program. Participating in the MTC audit program leads to efficiencies for both businesses and DOR. Under the bill, that authority would be repealed.

The MTC conducts audits of companies as a representative of many states. There are currently 27 states that participate in the MTC audit program. Many people feel that it makes sense for states to pool their resources in auditing companies that do business in multiple states. Many multi-state businesses prefer to have one audit with one point of contact rather than multiple state audits and

points of contact. This reduces time and expenses for businesses by having less staff devoted to multiple state tax audits. States can also avoid duplication of effort and save money by reducing the amount of time and expenses the Department would have incurred from sending DOR auditors outside the state to perform the audit.

Concerns have been raised that MTC auditors sometimes are not as expert in Wisconsin tax law as Wisconsin auditors. It is important to note that even if Wisconsin withdraws from the MTC, Wisconsin companies may still be audited by the MTC on behalf of other states. The only effect this change will make is losing Wisconsin's share of audited revenue from businesses in other states.

If the authority to participate in MTC is repealed, there is a net fiscal effect of \$1.25 million annually.

4. Reliance on Past Audits

Under current law, taxpayers can rely on determinations by DOR in past audits. Taxpayers can rely on past audits until DOR's position is changed in writing, the law changes, or a court-ruling requires a change. However, currently this provision does not apply if a taxpayer did not provide DOR with complete and accurate records regarding the issues or if the issue was settled in compromise negotiations. In 2013 the Department of Revenue worked with taxpayers and legislators to add this provision to the statutes. We agree that enabling clarity for taxpayers to rely on past audit determinations is a good business practice. If both the audited taxpayer or business and the Department are dealing with the same set of accurate and complete facts, we agree that the taxpayer should be able to use past audit determinations to comply with the law in the future.

The provision on reliance of past audits before you today changes the law to say that DOR is bound by a past determination even if the taxpayer provided incomplete or inaccurate records, or if the past determination was simply a result of splitting the difference between the two parties.

The concern with this bill is that it could encourage tax fraud. There would be no penalty for providing false information to the Department. This bill encourages and rewards taxpayers that intentionally withhold information from DOR and would result in taxpayers having an incentive to provide inaccurate information. If passed this bill could discourage compromise settlements and prolong cases, costing the state and taxpayers more in the long run. The specific fiscal effect of this provision will depend on the degree to which taxpayers reduce their compliance with DOR audit activities. As an example, if the provision reduces the revenue impact of audits by 5% it would reduce total revenue by about \$14.1 million annually.

Thank you again for the opportunity to discuss AB 259.