Legislative Fiscal Bureau

One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873

October 29, 1997

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Assembly Bill 551/Senate Bill 316: Federal Internal Revenue Code Update

BACKGROUND

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, 1996.

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 of Revenue (DOR) in assuring compliance with tax law. 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.

Historically, the process to update Wisconsin statutes to reflect the new IRC provisions begins early in the calendar year with the Department reviewing the federal tax law changes that were enacted in the prior year. This review process generally takes one to two months to complete and varies according to the number and the extent of the tax changes. As part of the review process, the Department considers which changes are relevant to state tax law and makes recommendations on which items should and should not be adopted. The Department also provides fiscal estimates on any recommended changes. Typically, the changes are incorporated into the budget bill or are introduced as separate legislation during the Spring floor period.

On August 5, 1997, the Taxpayer Relief Act of 1997 was signed into law. The Act differs from prior federal tax law changes for two reasons. First, the Act was passed by Congress earlier in the calendar year than other legislation and, as a result, there are approximately 150 provisions

that are effective for the current 1997 tax year. Second, the number of tax changes is relatively large as compared to prior years; the Act contains over 800 IRC amendments, including 300 new tax provisions.

SUMMARY OF BILLS AND FISCAL EFFECT

SB 316 and AB 551 are identical bills which would update state individual income, corporate income and insurance company tax provisions referenced to the federal IRC to refer to the code in effect on December 31, 1997, except that these provisions would not apply to taxable years that begin on January 1, 1998, and thereafter.

SB 316 has been referred to the Committee on Economic Development, Housing and Government Operations. AB 551 was referred to the Joint Survey Committee on Tax Exemptions. The Joint Survey Committee was also requested to prepare a report on SB 316. A public hearing on AB 551 has been scheduled for October 29, at which time an executive session will also be held.

The majority of items are estimated to have a minimal, unknown or no fiscal effect (these items are listed in an Appendix to this paper). The following table provides a summary of the items that would have an impact on state revenues if adopted for tax year 1997. In total, these provisions would decrease general fund revenues by an estimated $1.6 million in 1997-98.

TABLE 1

Summary of Federal Law Changes That Take Effect in Tax Year 1997 or Earlier If Adopted for State Tax Purposes for Tax Year 1997 (In Millions)

	1997-98
Individual Income Tax	
Employer-Provided Education	-$0.9
Gain on the Sale of a Residence	-2.4
State and Municipal Employes	-0.1
Individual Income Tax Total	-$3.4
Partnerships and S Corporations	
Partnership Interest Sales	$0.2
Distributions of Partnership Property	0.2
Partnership and S Corporation Total	$0.4

TABLE 1 (cont.)

	1997-98
Pensions	
Excess Distribution Tax	-$0.1
Police and Firefighter Employe Plans	-0.1
Pensions Total	-$0.2
Business and Investment	
Appreciated Financial Positions	$1.3
Farmers' Installment Sales	-1.0
Suspense Accounts for Family Farms	0.2
Income Forecast Depreciation	0.1
Environmental Cleanup Costs	-0.2
Pooled Debt Obligations	0.3
Business and Investment Total	$0.7
Corporations and Special Entities	
Controlled Corporation Stock: Gain Recognition	$0.8
Preferred Stock Treated as Boot	0.1
Regulated Investment Companies: 30% Test	-0.1
Corporations and Special Entities Total	$0.8
Health and Life Insurance	
Company-Owned Life Insurance	$0.1
Total All Provisions	-$1.6

Two points should be noted about the figures in Table 1. First, the table includes only those federal provisions which took effect in tax year 1997 and earlier and assumes that these provisions would be adopted at the state level only for tax year 1997. This is consistent with SB 316 and AB 551.

Second, the federal Act contains a provision that reduces the federal tax rates that are applied to long-term capital gain income. Generally, the maximum capital gains rate is lowered from 28% under current federal law to 20% (lower rates apply to taxpayers in the 15% federal tax bracket), effective for sales after May 6, 1997. It is anticipated that income from the sale of capital assets will increase because investors will take advantage of the lower federal tax rates, which will generate additional individual income tax revenue for the state. This will offset the projected decrease in revenues that would result from the other tax changes. However, the extent of the additional revenue from the capital gain realizations is unknown at this time.

The following sections provide descriptions of the federal tax changes included in SB 316 and AB 551 which would have a state fiscal effect in 1997-98.

Individual Income Tax

Employer-Provided Educational Assistance. The exclusion for employes for employer-provided educational assistance is extended to June 1, 2000. The excludable amount of tuition, fees and related expenses is limited to $5,250 per individual per year. Expenses paid for graduate-level courses remain ineligible for the exclusion.

The provision is effective for tax years beginning after December 31, 1996, and is estimated to reduce revenues by $0.9 million in 1997-98.

Exclusion of Gain on Sale of Principal Residence. Individuals may exclude from income up to $250,000 ($500,000 for married-joint taxpayers) of the gain realized on the sale or exchange of a residence. The individual must have owned and occupied the residence as a principal residence for at least two of the five years before the sale or exchange. This exclusion replaces the rollover of gain provisions and the one-time $125,000 exclusion for taxpayers age 55 or older.

The new exclusion and repeal of the capital gains rollover provisions and one-time $125,000 exclusion apply to sales and exchanges after May 6, 1997. Taxpayers may elect to apply prior law to sales or exchanges: (1) made before August 5, 1997; (2) made after August 5, 1997, pursuant to a binding contract in effect on August 5, 1997; or (3) when the replacement residence was acquired on or before August 5, 1997, and the rollover provision would apply. This provision would reduce revenues by an estimated $2.4 million in 1997-98.

Deduction for State and Municipal Employes. Expenses paid or incurred with respect to services performed by an official as an employe of a state or local government are deductible in computing adjusted gross income. This "above-the-line" deduction applies provided that the official is compensated in whole or in part on a fee basis. These expenses are also deductible for alternative minimum tax (AMT) purposes.

The provision applies retroactively to expenses paid or incurred in tax years beginning after December 31, 1986. This provision is estimated to cost $100,000 in 1997-98.

Partnerships and S Corporations

Partnership Interest Sales -- Treatment of Inventory Items. The substantial appreciation requirement for inventory is removed from the definition of property for purposes of sales or exchanges of partnership interests. The amount received in exchange for the partner's interest that is attributable to unrealized receivables or inventory is treated as ordinary income.

It is no longer necessary for the partnership's inventory to be substantially appreciated in order to give rise to ordinary income following a sale or exchange.

For disproportionate distributions of partnership property, the substantial appreciation requirement remains intact. A disproportionate distribution to a partner will be treated as a sale or exchange of property other than a capital asset only if the inventory deemed to be exchanged is substantially appreciated in value.

These provisions are generally effective for sales, exchanges and distributions after August 5, 1997. This is estimated to increase revenues by $200,000 in 1997-98.

Distributions of Partnership Property -- Allocation of Basis. A partner's substituted basis in distributed partnership property will be allocated among multiple properties based on the fair market value of the distributed properties. Allocations based on the partnership's proportionate basis in the distributed properties will no longer be used. In a substituted basis transaction, distributed properties assume the same basis as the partner's basis in his partnership interest. Substituted basis is used when the partner's interest is liquidated. Substituted basis also applies when a partner receiving a nonliquidating distribution cannot carry over the partnership's basis in the property because the carryover basis exceeds the partner's basis in the partnership.

These provisions apply to distributions after August 5, 1997. This is estimated to increase revenues by $200,000 in 1997-98.

Pensions

Excess Distribution Tax. The Act repeals the 15% excise tax on excess distributions from qualified retirement plans, tax-sheltered annuities and IRAs and the 15% excise tax on excess retirement accumulations. An excess distribution would be one that exceeded $160,000 or five times that amount in the case of a lump-sum distribution. Wisconsin imposes a penalty equal to 33% of the federal tax.

This provision applies to excess distributions received after December 31, 1996. The repeal of the excess accumulation tax applies to estates of decedents dying after December 31, 1996. This is estimated to reduce general fund revenues by $100,000 in 1997-98.

Police and Fire Employe Plans. The reduction in the annual dollar limitation on retirement benefits for police officers and firemen who retire at age 62 has been removed by the Act. Thus, police officers or firemen who retire at age 62 in 1997 or later will be entitled to a benefit of up to $125,000 (as adjusted for inflation in 1997).

This provision is effective for years beginning after December 31, 1996, and is estimated to reduce revenues by $100,000 in 1997-98.

Business and Investment

Appreciated Financial Positions -- Constructive Sale Treatment. Prior to the Act, certain hedging strategies such as short sales against the box, forward contracts, and notional principal contracts could be used to lock in gains on appreciated financial positions without immediate recognition of income. The term "appreciated financial position" generally means any position with respect to any stock, debt instrument, or partnership interest where there would be gain if such position is sold, assigned, or otherwise terminated at its fair market value. The Act limits an investor's ability to do this by treating certain hedging transactions as constructive sales.

The provision is generally effective for constructive sales entered into after June 8, 1997, and is estimated to increase revenues by $1.3 million in 1997-98.

AMT Inapplicable to Farmers' Installment Sales. Cash-method farmers may use the installment method of accounting to compute income from the disposition of farm property when computing an alternative minimum tax liability. For this purpose, farm property is property used or produced in the trade or business of farming.

This provision applies to dispositions of farm property in tax years beginning after December 31, 1987. However, under a special effective date rule which is apparently necessary to take into account the text of the Code as it stood in 1987, the provision is also effective for tax years beginning in 1987. This provision is estimated to cost $1.0 million in 1997-98.

Suspense Accounts for Family Farm Corporations. When a family farm corporation is required to change from the cash method to the accrual method in the year that its gross receipts exceed $25,000,000, the corporation may no longer establish a suspense account to defer reporting the income that results from the change in its method of accounting. Instead, such corporations are now subject to the same rules as large farming corporations. That is, the income adjustment caused by the change in accounting is spread over a period of 10 years beginning with the year of the change in the method of accounting.

This provision is effective for tax years ending after June 8, 1997, and is estimated to increase revenues by $200,000 in 1997-98.

Income Forecast Depreciation Method. Taxpayers seeking to recover the cost of trade or business property that is not eligible for depreciation under the modified accelerated cost recovery system or that does not qualify as intangible property under Code Sec. 197 may be able to depreciate such property under the income forecast method. Under this method, the depreciation deduction is determined not by reference to a term of years but by multiplying the cost of the property less any salvage value, by a fraction, the numerator of which is the income generated by the property during the tax year and the denominator of which is the total estimated income to be derived from the property during its useful life. Under prior law, controversy existed over the types of property that were depreciable under the income forecast method.

Under the federal Act, the income forecast method of depreciating trade or business assets is limited to film, video tape, sound recordings, copyrights, books, patents and other property to be specified by regulations. The controlling committee report directs that regulations restrict the use of the income forecast method to instances when the economic depreciation of the property cannot be adequately reflected solely by the passage of time or when the income stream from the property is sufficiently unpredictable or uneven so that the application of another method of depreciation would result in a distortion of income. The income forecast method is not available to intangible property depreciable under Internal Revenue Code Section 197.

This provision applies to tax years beginning after August 5, 1997, and would increase state tax revenues by an estimated $100,000 in 1997-98.

Environmental Cleanup Costs. A taxpayer may elect to currently deduct costs paid or incurred for the cleanup (remediation) of certain hazardous substances. If the taxpayer does not make the expense election, the costs are classified as capital costs. This election will not be available for expenses paid or incurred after December 31, 2000.

In order to be a qualified cleanup cost the expense must be: (1) an expense that would otherwise be charged to a capital account; and (2) paid or incurred in connection with the abatement or control of "hazardous substances" at a "qualified contaminated site."

If the cleanup expense does not satisfy the definitions of "hazardous substances" and "qualified contamination site," then the taxpayer is not eligible to elect current deduction.

The term "qualified contaminated site" refers to any area: (1) that is held by the taxpayer for use in a trade or business, for the production of income, or as a stock in trade or inventory; (2) that is within a "targeted area;" and (3) at or on which there has been a release (or threat of release) or disposal of any hazardous substance.

In order to make the cleanup election, the contaminated site must be in a targeted area. The term "targeted area" is generally defined as:

(1) any population census tract with a poverty rate of at least 20 percent;

(2) a population census tract with a population of less than 2,000 if more than 75 percent of the tract is zoned for commercial or industrial use, and the tract is contiguous to one or more other population census tracts that have a poverty rate of at least 20 percent;

(3) any empowerment zone or enterprize community (and any supplemental zone designated on December 31, 1994); and

(4) any site announced before February 1, 1997, as being part of the brownfields pilot project of the EPA.

This provision applies to expenditures paid or incurred after August 5, 1997, in tax years ending after that date. However, the election will not be available for expenses paid or incurred after December 31, 2000. The provision would reduce state tax revenues by an estimated $200,000 in 1997-98.

Pooled Debt Obligations. Real estate mortgage investment conduit (REMIC) interests, mortgages held by REMIC's, and debt instruments whose principal payments may be accelerated are subject to a special rule for computing original issue discount (OID) on the debt. Under this rule, if a borrower can reduce the yield on the debt by prepaying it, the amount of OID on such debt is determined by making a reasonable assumption regarding the portion of the debt that will be prepaid. Under prior law, a taxpayer that held pooled debt instruments, such as a pool of credit card receivables, was not subject to this rule. Thus, the holder was able to assume that all of the debt would be timely paid and avoid accrual of interest income on the debt.

Under the federal Act, the rule for determining original issue discount (OIC) on interests in and mortgages held by real estate mortgage investment conduits (REMICs) and on other debt instruments whose principal payments may be accelerated now applies to pooled debt instruments. Pooled debt instruments are debt instruments whose yield may be affected by prepayments or other events to the extent set forth in regulations.

Under the rule, interest or OID must be accrued on pooled debt based on a reasonable assumption regarding the timing and portion of the debt that will be repaid. According to the House Committee Report, if payments occur soon after the end of the year and before the taxpayer files its tax return for the year, interest may be accrued according to the taxpayer's actual payment experience, rather than on reasonable assumptions.

Specifically, the daily portion of OID on pooled debt, as well as on REMIC interests, REMIC mortgages, and debt on which payment may be accelerated, is determined by allocating to each day in an accrual period the ratable portion of the excess of: (1) the present value of the remaining payments plus payments during the accrual period of amounts included in the state redemption price of the debt instrument; over (2) the adjusted issue price of the debt instrument at the beginning of the period.

This provision applies to tax years beginning after August 5, 1997, and would increase state tax revenues by an estimated $300,000 in 1997-98.

Corporations and Special Entities

Gain Recognition on Distributions of Controlled Corporation Stock. New requirements must be satisfied in order for a corporate "spin-off" to qualify for nonrecognition of gain.

A corporation that distributes its property to shareholders is generally required to recognize gain on the distribution as if the property had been sold for its fair market value. The shareholders who receive a distribution generally treat the receipt of property as a taxable event. This general rule applies to the distribution of the stock of a subsidiary corporation, so that the distribution by a corporation of the stock of a subsidiary would cause the recognition of gain.

There are certain nonrecognition provisions which permit property to be distributed without incurring gain at the corporate level or by the shareholders receiving the property. One of these exceptions involves certain spin-off type distributions of stock of a controlled corporation. Provided that various requirements are met, including certain restrictions relating to acquisitions and dispositions of stock of the distributing corporation or the controlled corporation prior and subsequent to a distribution, stock can be distributed without the recognition or gain by the corporation or the shareholder under the Internal Revenue Code.

Under the federal Act, new restrictions have been adopted on the acquisition and disposition of the stock of the distributing or controlled corporation. If either the controlled or distributing corporation is acquired pursuant to a plan or arrangement in existence on the date of distribution, gain is generally recognized by the distributing corporation as of the date of the distribution. One of the purposes of these restrictions is to limit the ability of a taxpayer to, in effect, dispose of a portion of its business to new shareholders without the recognition of gain. Under the new rules, the recognition of income can be avoided if the historical shareholders retain more than a 50 percent ownership interest in the distributing and acquiring corporations.

In the case of an acquisition of a controlled or a distributing corporation, the amount of gain recognized by the distributing corporation is the amount of gain that the distributing corporation would have recognized had stock of the controlled corporation been sold for fair market value on the date of distribution. This gain is treated as long-term capital gain. No adjustment to the basis of the stock or assets of either corporation is allowed by reason of the recognition of the gain.

These provisions are generally effective for distributions after April 16, 1997, pursuant to a plan (or a series of related transactions) that involves an acquisition described in a specified IRC provision occurring after that date. However, the greater than 50 percent control requirement immediately after certain distributions will be effective for transfers after August 5, 1997.

Under transition rules, the provisions that would otherwise require gain to be recognized to the distributing or controlled corporation do not apply to any distribution pursuant to a plan (or a series of related transactions) occurring after April 16, 1997, if such acquisitions or transfers are: (1) made pursuant to an agreement which was binding on April 16, 1997, and at all times thereafter; (2) described in a ruling request submitted to the IRS on or before that date; or (3) described on or before that date in a public announcement or in a filing with the Securities and Exchange Commission (SEC) required solely by reason of the acquisition or transfer.

The transaction rules do not apply to any agreement, ruling request, or public announcement or SEC filing unless it identifies the acquirer of the distributing corporation or any controlled corporation, or the transferee, whichever is applicable. The Conference Committee Report points out that the transition rules apply to any contract, ever if not written, that is binding under state law as of April 16, 1997. It is expected that some form of contemporaneous written evidence of the contract would exist.

These provisions would increase state tax revenues by an estimated $800,000 in 1997-98.

Preferred Stock Treated as Boot. Gain or loss is generally not recognized in certain reorganization transactions except to the extent other property, other than stock, is received in the transaction. The term "other property" is often referred to as "boot." Since boot is property other than certain stock, under prior law, preferred stock could be received tax free in such reorganizations.

Under the federal act, in certain reorganization transactions, transfer to a controlled corporation, or from a controlled corporation, gain or loss is generally recognized only if "other property," property other than stock, is received. Subject to certain exceptions, the new amendments treat "nonqualified preferred stock" as boot. Similarly, when nonqualified preferred stock is received in exchange for common stock of the same corporation, certain nonrecognition rules do not apply to the extent of the nonqualified preferred stock received.

Thus, when a taxpayer exchanges property for nonqualified preferred stock in certain transactions gain, but not loss, would be recognized. An exchange of nonqualified preferred stock for nonqualified preferred stock in an acquiring corporation may qualify for tax-free treatment in certain cases. To qualify for nonrecognition, property must be transferred to a corporation solely in exchange for stock by one or more persons who are in control of the corporation. Similarly, for purposes of determining whether the transferor in an otherwise qualifying transfer is in control of the corporation, the stock ownership of an individual who transfers property and only receives nonqualified preferred stock would, presumably, be considered in determining whether the persons making the transfer are in control.

Preferred stock is defined as stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent. These amendments, which treat preferred stock as boot, only apply to nonqualified preferred stock which is defined as preferred stock for which: (1) the holder has the right to require the issuer or a related person to redeem or purchase the stock; (2) the issuer or a related person is required to redeem or purchase the stock; (3) the issuer or a related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indicators. According to the House Committee Report, such stock with a varying dividend rate is treated as nonqualified preferred stock regardless of when such varying rate is provided as an express term of the stock (for example, an adjustable rate stock) or as a practical result of other aspects of the stock (for example, auction rate stock).

The amendments are generally effective for transactions after June 8, 1997. However, they do not apply to transactions after that date that are (1) subject to a written agreement binding on June 8, 1997, and at all times thereafter; (2) described in a ruling request submitted to the IRS on or before that date; or (3) described in a public announcement or a Securities and Exchange Commission filing on or before that date.

These provisions would increase state tax revenues by an estimated $100,000 in 1997-98.

Thirty-Percent Gross Income Test. The 30-percent gross income test or "short-short" rule, under which a regulated investment company (RIC) had to derive less than 30 percent of its gross income from the sale or disposition of certain short-term assets held for less than three months has been repealed. These assets included: (1) stock or securities; (2) options, futures, or forward contracts (other than on foreign currencies); and (3) foreign currencies or options, futures, or forward contracts on foreign currencies if such items are not directly related to the company's principal business of investing in stock, securities or options or futures on stock or securities. The repeal of the short-short rule was intended to provide RICs with greater ability to hedge their investments and free them from significant recordkeeping, compliance and administrative costs.

This provision applies to tax years beginning after August 5, 1997, and would decrease state tax revenues by an estimated $100,000 in 1997-98.

Health and Life Insurance

Company-Owned Life Insurance Premium Deduction Limitations. Under prior law, under the company-owned life insurance (COLI) rules, deductions for premiums paid on or interest paid or accrued on indebtedness with respect to life insurance were only denied when the policy covered the life of an officer, employe, or person financially interested in any trade or business carried on by the taxpayer (and the taxpayer was directly or indirectly a beneficiary of the policy). Further, prior law did not restrict the deductions for interest on debt that funded the tax-free buildup of life insurance contracts.

Under the federal Act, no deduction is permitted for premiums paid on any life insurance policy, annuity or endowment contract if the taxpayer is directly or indirectly a policy beneficiary. However, this limitation on company owned life insurance does not apply to premiums paid on annuity contracts for certain qualified pension plans, retirement annuities, individual retirement annuities, and qualified funding assets. Also, it does not apply to annuity contracts held by a person who is not a natural person.

No deduction is allowed for interest paid or accrued on indebtedness with respect to any life insurance policy or annuity contract covering the life of any individual in whom the taxpayer has an insurable interest. In the case of a taxpayer other than a natural person, no deduction is

allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values.

The provisions apply with respect to contracts issued after June 8, 1997, in tax years ending after that date. Any material increase in the death benefit or other material change in the contract causes the contract to be treated as a new contract, but the addition of covered lives is treated as a new contract only with respect to the additional covered lives. An increase in the death benefit of a policy or contract issued in connection with a lapse of the Health Insurance Portability and Accountability Act of 1996 is not treated as a new contract.

Interest Rate Cap. The COLI rule generally does not apply to interest on debt with respect to contracts purchased on or before June 20, 1986. If such a contract has a variable interest rate, it is subject to an interest rate cap. Although one section of the IRC provided that this cap applies to interest paid or accrued after December 31, 1995, another provided that the cap applied to interest paid or accrued after October 13, 1995. A technical correction eliminates the discrepancy and makes it clear that the applicable date is December 31, 1995.

This provision is effective with respect to interest paid or accrued after December 31, 1995.

Contract Lapses. Under the COLI rules, special limitations are imposed on the deductibility of interest with respect to single premium contracts and interest on debt incurred or continued to purchase or carry a life insurance, endowment, or annuity contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in cash value of the contract. This borrowing rule is subject to an exception permitting deductibility of interest on bona fide debt that is part of such a plan if no part of four of the annual premiums due during the first seven years is paid by means of debt (the 4-out-of-7 rule).

A technical correction makes it clear that under the transition relief provision, the 4-out-of-7 rule and the single premium rule of present law are not to apply solely by reason of a lapse occurring after October 13, 1995, by reason of no additional premiums being received under the contract.

The provision is effective with respect to interest paid or accrued after October 13, 1995, generally.

Former Officers, Employes or Interests. No deduction is allowed for interest paid on indebtedness with respect to life insurance policies or annuity or endowment contracts purchased by businesses on the lives of officers or employes of the business, or individuals with a financial interest in the business [the company-owned life insurance provision].

A technical correction makes it clear that the COLI rule applies not only to individuals who are currently officers or employes, or who currently have a financial interest in the business,

but also to anyone who was an officer or employe or formerly had a financial interest in the business. The correction thus clarifies the treatment of interest on debt with respect to contracts covering former employes of the taxpayer and with respect to a business formerly conducted by the taxpayer and transferred to an affiliate of the taxpayer.

The provision is effective with respect to interest paid or accrued after October 13, 1995, generally.

Variable Rate Contracts. The COLI provision, denying interest deduction on company-owned life insurance, generally does not apply to interest on debt with respect to contracts purchased before June 21, 1986. If such a contract provides for a variable interest rate, the amount of interest that is deductible after December 31, 1995 is limited. The deduction is allowable only to the extent that the rate of interest for each fixed period selected by the taxpayer does not exceed Moody's Corporate Bond Yield Average -- Monthly Average Corporates, for the third month preceding the first month of the fixed period. The fixed period may not exceed 12 months.

A technical correction now requires that the election of a fixed period during which the applicable interest rate limitation will apply can be made no later than the 90th day after August 5, 1997 (November 3, 1997) and if made applies to the taxpayer's first tax year ending on or after October 13, 1995, and all subsequent tax years, unless revoked with the consent of the Secretary. If no election is made, the applicable period is the policy year. The policy year is the 12-month period beginning on the anniversary date of the policy.

The provision is effective with respect to interest paid or accrued after October 13, 1995, generally.

Definition of 20% Owner. There is an exception to the COLI rule for interest on indebtedness with respect to life insurance policies covering up to 20 key persons. A "key person" is an individual who is either an officer or a 20% owner of the taxpayer. Prior law provided that in the case of a taxpayer that was not a corporation, a 20% owner was an individual who owned 20% or more of the capital or profits interest of the employer. The technical correction clarifies this definition by changing the word employer to taxpayer.

The provision is effective with respect to interest paid or accrued after October 13, 1995, generally.

The COLI provisions would increase state tax revenues by an estimated $100,000 in 1997-98.

Prepared by: Kelsie Doty and Ron Shanovich

MO# SB 316/AB551
adoption as amended

2 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)
1 JENSEN	(Y)	N	A
OURADA	(Y)	N	A
HARSDORF	(Y)	N	A
ALBERS	(Y)	N	A
PORTER	(Y)	N	A
KAUFERT	(Y)	N	A
LINTON	Y	N	(A)
COGGS	(Y)	N	A

AYE 14 NO 0 ABS 2

APPENDIX

Federal Law Changes That Take Effect in Tax Year 1997 That Have a Minimal, Unknown or No Fiscal Effect

Individual Income Tax
- Deduction for Contributions of Appreciated Stock to Private Foundations
- Traveling Expenses of Federal Employes Engaged in Criminal Investigations
- Employer-Provided Adoption Assistance
- Earned Income Tax Credit -- Compliance Provisions
- Disability Benefits of Police and Firefighters
- Slain Police Officers -- Survivor Annuities
- Expanded Exclusion for Student Loans
- Terminations of Certain Property
- Rollover of Gain on Small Business Stock

Income Taxation of Estates, Beneficiaries and Trusts
- Revocable Trusts to be Treated as Part of Estate
- Separate Share Rule Applicable to Estates
- Definition of Related Persons -- Estate and Beneficiary
- Beneficiaries of Trusts and Estates Subject to Consistency Reporting Requirements
- Throwback Rules for Domestic Trusts
- Charitable Remainder Trusts -- New Payout and Value of Remainder Interest Requirements
- Transfers by Charitable Remainder Trusts to Employe Stock Option Plans
- Taxation of Earnings of Pre-Need Funeral Trusts

Business and Investment
- Safe Harbor for Short-Term Hedges
- Livestock Sold on Account of Weather-Related Conditions
- Appreciated Financial Positions -- Special Rules and Transition Rules
- Work Opportunity Credit (for State Development Zones Job Credit)
- Lessee Construction Allowance
- Depreciation Limits for Clean Fuel Vehicles
- Accelerated Depreciation -- Definition of Indian Reservation
- Replacement Property from Unrelated Persons
- Foreign Replacement Property
- Long-Term Contract Method of Computing Income
- Inventory Shrinkage
- Mark-to-Market Election for Certain Traders and Dealers
- Assignment of Worker's Compensation Liability
- Refunding Rules for Virgin Islands Government Bonds
- Empowerment Zones Provisions
- Extraordinary Dividends
- Stock Redemptions Involving Related Companies
- Definition of Investment Company
- Interest on Disqualified Corporate Debt
- Definition of Related Parties
- Real Estate Investment Trust Modifications

- Debt Reserves of Thrift Institutions
- Unrelated Business Income from Subsidiaries

Partnerships and S Corporations
- Precontribution Gain -- Recognition Period Extended to Seven Years
- Residence of Partnership -- Regulations Defining Foreign and Domestic Partnerships
- Electing Small Business Trusts
- Former S Corporation Post-Termination Transition Period
- Qualified Subchapter S Subsidiaries

Pensions
- Reduction in Benefits Due to Breach of Duty or Criminal Act
- Involuntary Cash-Outs
- Minimum Funding Requirements for Bus Company Plans
- SIMPLE IRAs -- Matching Contributions for Self-Employed Individuals
- SIMPLE IRAs -- Maximum Dollar Limitation
- SIMPLE IRAs -- Exclusive Plan Requirements
- SIMPLE 401(k)s -- Employer Deduction Amounts
- SIMPLE 401(k)s -- Cost-of-Living Adjustments
- SIMPLE 401(k)s -- Top-Heavy Exemption
- Government Plans -- Nondiscrimination Rules
- Government Plans -- Portability of Permissive Service Credit
- Indian Tribal Government Plans -- Rollover from 403(b) to 401(k)
- New Employes May Participate in Salary Reduction Simplified Employe Plans
- Correction of GATT Interest and Mortality Rate Provisions

Health and Life Insurance
- Medical Savings Accounts -- Coverage Under Medicare Supplemental Policies
- Medical Savings Accounts -- Taxation of Distributions
- Long-Term Care Insurance Contracts -- Daily Living Requirement
- Long-Term Care Insurance Contracts -- Employer-Provided Long-Term Care Insurance
- Long-Term Care Insurance Contracts -- Consumer Protection
- Church Plan Exception to Discrimination Prohibition Based on Health

Foreign Taxpayers and Investments
- Expatriates -- Gain Recognition on Certain Exchanges
- Controlled Foreign Corporations -- Gain on Stock Sales
- Controlled Foreign Corporations -- Foreign Personal Holding Company Income
- Controlled Foreign Corporations -- Investment of Earnings in U.S. Property
- Transfers to Foreign Entities -- Repeal of Excise Tax
- Transfers to Foreign Entities -- Transfers of Intangibles
- Transfers to Foreign Entities -- Residency of Trusts
- Transfers to Foreign Entities -- Transfers to Foreign Grantor Trusts
- Treaty Benefits for Income from Hybrid Entities