Legislative Fiscal Bureau

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January 22, 1999

TO: Senator Russell Decker
Room 323 South, State Capitol

FROM: Kelsie Doty, Fiscal Analyst

SUBJECT: Individual Income Tax: Exempt Active Duty Military Pay if Stationed Outside of the U.S.

At your request, I am providing information on a proposal to exempt the active duty military pay of persons stationed outside of the U.S. from the individual income tax. Information is also provided on other states that provide a similar exemption.

Under federal law, payments received as a member of a military service generally are taxable as wages, except for retirement pay, which is taxable as a pension. Allowances generally are not taxable. Military pay taxable as wages includes active duty pay, reserve training pay, reenlistment bonuses and armed services academy pay. Wisconsin currently follows federal practice and taxes active duty military pay.

A proposal to exempt the active duty military pay of Wisconsin residents stationed abroad would reduce individual income tax revenues by an estimated $2.7 million annually. This estimate is based on information from the Statistical Abstract of the United States on the number of military personnel on active duty that are located in foreign countries and on basic active duty pay. Information was also obtained from the U.S. Department of Defense on the proportion of active duty personnel that claim Wisconsin as their home of record.

Two states, Maryland and North Dakota, provided an exemption for military pay for persons stationed abroad in tax year 1997. Maryland excluded up to $15,000 in military income for service outside of the U.S. if total military pay is less than $30,000 for the year. North Dakota excluded the first $1,000 of all military pay, plus an additional $300 for each month the taxpayer was stationed abroad.

I hope this information is helpful. If I can be of further assistance, please contact me.

KD/dls

Wisconsin Department of Revenue
Division of Research and Analysis
February 25, 2000

INTERNAL REVENUE CODE: TAX RELIEF EXTENSION ACT OF 1999

The federal Tax Relief Extension Act of 1999, enacted in Public Law 106-170), extended several federal tax provisions that were scheduled to expire and made a few other changes in the Internal Revenue Code. Because the tax bases for the Wisconsin individual income and corporate income and franchise taxes conform closely to the federal individual and corporate income tax bases, the Legislature must consider whether to adopt these changes for Wisconsin tax purposes. It does so by updating the references in the Wisconsin Statutes to the federal Internal Revenue Code (IRC).

This paper analyzes the changes in the Tax Relief Extension Act that potentially impact Wisconsin tax law. The analysis includes a description of the federal law changes and its effective date, a recommendation on whether the state should adopt the federal change, and an estimate of the fiscal effect of adopting the change.

These changes, if adopted, would result in a net increase in state taxes of $1.1 million in FY01 and in FY02. Provisions with a significant fiscal impact are summarized in the following table.

Federal Provision	Fiscal Effect ($ million)	
	FY01	FY02
Exclusion for Employer-Provided Educational Assistance	-$2.2	-$1.4
Expensing of Environmental Remediation Costs	-0.1	-0.3
Constructive Ownership Transactions	+0.2	+0.2
Pension Assets for Retiree Health Benefits	+0.1	+0.2
Installment Method	+2.9	+2.2
Real Estate Investment Trusts	+0.2	+0.2
Total	+$1.1	+$1.1

Changes in the federal Act that potentially affect state tax law include:

1. Exclusion for Employer-Provided Educational Assistance

   Federal Change: exclusion for employer-provided educational assistance is extended by the Act to cover expenses paid by an employer for courses other than graduate-level courses beginning before January 1, 2002. Previously, the exclusion applied to courses beginning before June 1, 2000. The exclusion is allowed for tuition, fees, books, supplies and equipment, and is limited to $5,250 per year. Expenses for graduate-level courses remain ineligible for the exclusion.

   Recommendation: Adopt the federal change.

   Effective Date: Courses beginning after May 31, 2000.

   Fiscal Effect: -$2.2 million in FY 01; -$1.4 million in FY 02.

2. Subpart F Exemption

   Federal Change: The Act extends Subpart F exceptions for income of a controlled foreign corporation (CFC) derived from active conduct of an insurance, banking, financing or similar business for two years. With this extension, the exceptions apply for tax years of a CFC that begin in 1999, 2000 or 2001 and to tax years of U.S. shareholders within which the tax year of the CFC ends.

   Under IRC Subpart F, shareholders owning at least 10% of a CFC are taxed on their share of the corporation's foreign personal holding company income, foreign base company services income, and insurance income whether or not the income is distributed.

   Effective Date: Tax years beginning after December 31, 1999.

   Recommendation: Sections of the Wisconsin statutes defining the Internal Revenue Code should continue to encompass Subpart F. However, sec. 71.26 (3)(s), Wis. Stats., excludes Subpart F income for Wisconsin tax purposes. Therefore, this provision does not affect Wisconsin law.

   Fiscal Effect: None.

3. Percentage Depletion from Marginal Oil and Gas Wells

   Federal Change: The Act extends the exemption of the 100%-of-net-income limitation for owners of marginal oil and gas wells through December 31, 2001. Generally, percentage depletion deductions used to recover investments in oil and gas may not exceed 100% of the net income from property in that year. Under the special percentage depletion rule, the limitation does not apply to domestic marginal properties.

   Effective Date: Tax years beginning after December 31, 1999.

   Recommendation: Sections of the Wisconsin statutes defining the Internal Revenue Code should continue to refer to the federal percentage depletion language. However, sec. 71.26 (3)(q), Wis. Stats., disallows percentage depletion for Wisconsin purposes. Therefore, this provision does not affect Wisconsin law.

   Fiscal Effect: None.

4. Expensing of Environmental Remediation Costs

   Federal Change: The Act extends through December 31, 2001, the expiration date for an election to deduct certain environmental remediation expenditures that would otherwise be charged to a capital account.

   The election applies to both regular income tax and alternative minimum tax. The expenditure must be incurred in connection with abatement or control of hazardous substances at a qualified contamination site. Generally, a qualified site must (1) be held for use in a trade or business, for production of income or as inventory, (2) be certified by an a state agency as located in a targeted area, and (3) contain a hazardous substance.

Effective Date: December 17, 1999.

Recommendation: Adopt the federal change.

Fiscal Effect: -$0.1 million in FY01, -$0.3 million in FY02.

5. Production Flexibility Contract Payments

Federal Change: Under the Act, federal production flexibility contract payments to farmers are taxed in the year received. Any option to accelerate receipt of payment under a Federal Agriculture Improvement and Reform Act (FAIR) production contract is disregarded in determining the tax year the payment is included in gross income. Thus, the year of receipt determines when the payment is included in income.

Farmers generally receive two payments annually under these contracts, in December or January and in September. The FAIR act was amended to provide additional payment options for recipients, which would ordinarily cause constructive receipt of the payments at the time of the options. This provision broadens an earlier one that disregards the payment options for determining when the contract payments are included in income.

Effective Date: December 17, 1999.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue loss.

6. Income and Loss on Derivatives, Hedges and Supplies

Federal Change: The Act creates three new categories of ordinary income property for losses on derivatives. Property not considered capital assets and thus subject to ordinary gains and loss treatment includes:

- A commodities derivative financial instrument held by a commodities derivative dealer, unless it is clearly identified in the dealer's records before the close of the day on which it is acquired, originated, or entered as having no connection to the activities of the dealer as a dealer;
- A hedging transaction clearly identified as a hedge of specified property before the close of the day on which it was acquired, originated or entered into;
- Supplies of a type regularly consumed by the taxpayer in the ordinary course of its trade or business.

Effective Date: To any instrument held, acquired or entered into, any transaction entered into, and supplies held or acquired on or after December 17, 1999.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal.

7. Constructive Ownership Transactions

Federal Change: Act limits long-term capital gain from constructive ownership transactions involving pass-through entities to net underlying long-term capital gain. Net underlying long-term gain is the amount of net capital gain that would have been recognized had the taxpayer purchased the entity directly for its fair market value and sold it for fair market value on the date the transaction closed. The remaining gain is ordinary gain.

This change applies to financial assets, derivative contracts held with respect to any debt instrument and any stock in a corporation to the extent provided by IRS regulations. Prior to this Act, taxpayers could enter into transactions with securities dealers involving forward contracts, notional principal contracts and other arrangements that effectively convert ordinary income and short-term capital gain into long-term capital gain.

Constructive ownership transactions exist if the taxpayer: (1) holds a long position under a notional principal contract regarding a pass-through entity, (2) enters into a forward or futures contract to acquire a pass-through entity, or (3) holds a call option, and is the grantor of a put option, with respect to the pass through entity and the options have substantially equal strike prices and contemporaneous maturity dates. A constructive ownership transaction does not exist if all the positions are marked to market. The IRS may issue regulations that expand the definition to cover similar transactions.

Effective Date: Transactions entered into after July 11, 1999.

Recommendation: Adopt the federal change.

Fiscal Effect: +$0.2 million in FY01, +$0.2 million in FY02.

8. Pension Assets for Retiree Health Benefits

Federal Change: The Act extends to December 31, 2005, the rule allowing an employer to transfer excess assets from a defined benefit pension plan to an account for retiree health benefits.

The Act also replaces a minimum benefit standard with a minimum cost requirement. The minimum benefit standard required the same level of health benefits in the year of the transfer and the four following years. The minimum cost requirement mandate that a group health plan provide a minimum dollar level of retiree health expenditures for the year of the transfer and the four following years. This minimum dollar level equals the applicable employer cost in the first year or the second year immediately preceding the year of the transfer, whichever is greater. The applicable employer cost is calculated by dividing the employer's current retiree health liabilities by the number of individuals to whom coverage for the applicable health benefits was provided during the tax year.

Effective Date: For qualified transfers occurring after December 17, 1999. Employers making a qualified transfer after this date may satisfy the minimum benefit requirement rather than the new minimum cost requirement during the period that overlaps a five-year maintenance period of a qualified transfer occurring before December 17, 1999.

Recommendation: Adopt the federal change.

Fiscal Effect: +$0.1 million in FY01; +$0.2 million in FY02.

9. Installment Method

Federal Change: The Act repeals the installment method of accounting for accrual method taxpayers that allowed taxpayers to defer recognition of income from the disposition of property until payments were received. The change does not apply to sales of farming property, timeshares or residential lots.

The Act also modifies the pledge rule so that any arrangement that allows a taxpayer to satisfy some or all of an indebtedness with an installment note is treated as the direct pledge of the installment note.

Effective Date: Sales or other dispositions occurring on or after December 17, 1999.

Recommendation: Adopt the federal change.

Fiscal Effect: +$2.9 million in FY01, +$2.2 million in FY02.

10. Split-Dollar Insurance Arrangements

Federal Change: The Act prohibits taxpayers from claiming charitable deductions for transfers associated with "split-dollar insurance arrangements." These arrangements are transfers of money to charity that are then used to pay premiums for life insurance on the life of the transferor or another individual. Exceptions are provided for annuity contracts purchased by a charity to fund charitable gift annuities and for charitable remainder trusts that hold life insurance, annuity or endowment contracts to pay annuity or unitrust amounts. In these cases, the deduction is limited to the value of the charity's interest.

Recommendation: Adopt the federal change.

Effective Date: Transfers made after February 8, 1999

Fiscal Effect: Minimal revenue gain.

11. Distributions of Stock to Corporate Partners

Federal Change: Under the Act, a special basis rule applies when a partnership distributes stock to a partner that is a corporation, which then controls the distributed corporation. If the partnership's adjusted basis in the stock immediately before the distribution exceeds the adjusted basis immediately afterward, then the basis of the property held by the corporation is reduced by the excess basis amount.

If the corporate partner later acquires control, the reduction applies to property held when the partner first has control. Generally, control requires at least 80% of the vote and value of specified classes of stock.

The basis reduction cannot exceed the amount by which the sum of the aggregate adjusted basis of property and the amount of distributed corporation money exceeds the corporate partner's adjusted basis in the stock of the distributed corporation. If the amount of the reduction exceeds the basis of the property, the excess is recognized as long-term gain, increasing the partner's adjusted basis in the stock of the distributed corporation. The reduction cannot decrease the adjusted basis of property below $0.

Effective Date: Generally, for distributions made after July 14, 1999. A transitional rule for corporations that are partners in a partnership as of July 14, 1999, applies the reduction rule to distributions made to the partner after June 30, 2001. Unless the corporate partner elects otherwise, the rule does not apply to distributions after December 17, 1999 and before July 1, 2001.

Recommendation: Adopt the federal change.

Fiscal Effect: Minimal revenue gain.

12. Real Estate Investment Trusts

Federal Change: The Act makes several changes in the treatment of real estate investment trusts (REITs):

- A REIT may own, in whole or in part, a taxable REIT subsidiary, if the REIT and subsidiary jointly elect this treatment. The election can be revoked only if both agree to do so. This election is intended to allow greater flexibility for REITs in allowing them to provide services to tenants without receiving rents that would otherwise disqualify them from REIT tax treatment. The Act also modifies the rules regarding tests relating to the source of income for these subsidiaries. Further, it limits the deductible amount of interest paid or accrued by a taxable REIT subsidiary to its REIT parent under the interest stripping rules so that a REIT subsidiary cannot deduct interest in any year that would exceed 50% of its adjusted gross income. These changes are effective for tax years beginning after December 31, 2000.

- The Act allows health care REITs to treat certain property acquired due to termination of a lease as foreclosure property for up to six years, with IRS consent. There is an exception when the property is acquired by default or imminent default. A licensed health care facility would qualify if it provides medical, nursing or ancillary services and was operated prior to the REIT acquisition by a provider of those services that was eligible to participate in the Medicare program. Qualified health care property is treated as foreclosure property until the close of the second year after the REIT acquires it, unless the IRS extends the grace period. The IRS may extend the period until the close of the sixth year if the REIT can establish that additional time is necessary to liquidate or lease its property interest. These changes are effective for tax years beginning after December 31, 2000.

- The Act decreases the amount a REIT must distribute to its shareholders from at least 95% to at least 90% of its income. The Act also limits a REIT's investment in a single issuer to no more than 10% of its the value, and its investment in a taxable REIT subsidiary to no more than 20% of the REIT's total assets. These changes are effective for tax years beginning after December 31, 2000.

- The Act requires distributions necessary to purge non-RIC or non-REIT earnings and profits to be made on a first-in, first-out basis. This change conforms RIC distribution treatment with that of REITs.

Effective Date: The REIT provisions are generally effective for taxable years after December 31, 2000.

Recommendation: Adopt the federal changes.

Fiscal Effect: +$0.2 million in FY01, +$0.2 million in FY02.

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Tax Ex.

WISCONSIN STATE SENATE

P. O. Box 7882 Madison, WI 53707-7882

TO: Senate Committee Clerks

FROM: Donald J. Schneider, Senate Chief Clerk

SUBJECT: Final Disposition of Committee Materials

Date: November 9, 2000

Pursuant to Wisconsin statute section 13.16, all "documents and papers in the possession of the legislature" will be deposited in the Office of the Secretary of State at the close of the 1999-2000 legislative session.

We are asking all committee clerks to gather bill histories, committee reports, hearings notices, minutes, hearing slips, subcommittee reports and any other committee materials. Storage boxes or accordion folders for these materials are available in the Document/Supply Room, Lower Level, One East Main Street. Please label all folders and/or boxes and send them to the Chief Clerk's office by Friday, December 15, 2000. You may send them any time prior to that date.

Executive Appointments: Records concerning pending gubernatorial appointments and the appointment jackets should be returned to the Chief Clerk's office before the end of 2000. Executive Appointments do carry over into the next Legislative Session, however, they must be referred to the 2001-2002 Senate committees

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Clearinghouse Rules: If the deadline for action has passed without action by your committee, please complete the necessary reports and send them to the office of the Senate Chief Clerk as soon as possible. Clearinghouse Rules continuing into the next session should be returned to the Chief Clerk's office with gubernatorial appointments. Pending Clearinghouse Rules will be referred to the 2001-2002 Senate standing committees.

Senate Petitions: Petition jackets should be returned to the Chief Clerk's office with other committee materials.

If you have any questions regarding the disposition of committee materials, or any other Committee matters, please contact Donna Doyle at 266-1803 for assistance.

SALES TAX EXEMPTION FOR NONPROFIT ORGANIZATIONS

A nonprofit organization is required to charge WI sales tax on sales of tangible (that can be valued monetarily) personal property and taxable services, unless such sales are exempt occasional sales or are otherwise exempt.

A non-profit organization includes: neighborhood association, church, civic group, garden club, social club . . . NOT organized for profit where no part of the net earnings inures (attached) to the benefit of any private shareholder or individual.

What standards must be met by a nonprofit organization for its sales to qualify as exempt occasional sales?

As of January 1, 1989 - 3 Standards:

1. *Organization is not engaged in a trade or a business.*

2. *Entertainment is not involved.*

3. *Organization does not have or is not required to have a seller's permit except for conducting bingo events.*

1. *THE ORGANIZATION IS NOT ENGAGED IN A "TRADE OR BUSINESS."*

Two standards are used to determine whether a nonprofit organization is considered to be engaged in a "trade or business."

- *If it exceeds a 20-day standard,*
- *If it exceeds a $15,000 receipts standard*

A nonprofit organization is NOT considered to be engaged in a "trade or business" if:

a. *Its SALES of otherwise taxable tangible personal property or services or its events occur on 20 days or less during the calendar year, regardless of the dollar amount of sales. For events involving the sales of tickets, only the actual days of the events are counted, not the days of ticket sales, or*

b. *Its "RECEIPTS" for the calendar year are $15,000 or less, regardless of the number of days on which its sales or events occur. (For this purpose, "receipts" means the gross receipts from all sales in WI of otherwise taxable tangible personal property and services after subtracting allowable exemptions.)*

Example 1:

A church sells cookies and cakes at a bake sale. Since the sale of cookies and cakes for off-premises consumption is exempt from sales tax, the sale of these items is not counted as receipts for purposes of the $15,000 receipts test.

Example 2:

A nonprofit organization, which sells hundreds of Christmas trees, sells five Christmas trees for $100 to a public school. Although Christmas trees are taxable tangible personal property, a public school can purchase tangible personal property exempt from sales tax. As a result, this $100 exempt sale to the school is not counted as receipts for purposes of the $15,000 receipts test.

2. *ENTERAINMENT IS NOT INVOLVED AT AN EVENT FOR WHICH CHARGES CONSTITUTE ADMISSIONS.*

a. *For this purpose, "entertainment" means entertainment provided at an "admission" event by all persons or groups (e.g., band or singers) who are paid in the aggregate $300 or more per event by all persons for performing, for reimbursement of expenses, or prize money see "2.b. for definition of "admissions."*

$500

Example 1:

Four different bands are paid $100 each to perform at various times during a 3-day event. There is an admission charge for access to the event. Since the total payment for entertainment ($400) exceeds $300, entertainment is deemed to be involved. As a result, receipts from the event are taxable.

Example 2:

Two nonprofit organizations co-sponsor an admission event at which a band is hired to perform. Each organization pays the band $200. Since the total payment for entertainment ($400) exceeds $300, entertainment is deemed to be involved. As a result, receipts from the event are taxable.

b. *"Admissions," for purposes of 2.a. are involved if access to the event involving entertainment is generally restricted to only those who pay a required fee, make a required "donation," or who must made a purchase of some kind (e.g., meal, raffle ticket).*

Example 1:

A nonprofit organization sponsors a dinner and dance in the high school gymnasium. The dance band is paid in excess of $300. There is no separate admission charge, however, access to the dance is restricted to those who have purchases the meal. The "meal" charge constitutes an admission charge to an event involving entertainment, therefore, sales by the nonprofit organization at this event are taxable.

Example 2:

A nonprofit organization holds a pig roast at the city park and hires a band to play at the park gazebo, so that patrons, if they so wish, can be entertained while they eat. There is no admission charge and access to the band is open to anyone, whether they purchase the meal or not. The sales by the nonprofit organization may still qualify as exempt occasional sales.

c. Temporary Seller's Permit

A nonprofit organization that would otherwise qualify for exempt occasional sales, except for the involvement of entertainment, may obtain a temporary seller's permit from the Department of Revenue for the day or days involving entertainment, pay the sales tax on that event, and still have exempt occasional sales on days not covered by the temporary permit.

NOTE: Days and receipts from events involving admissions to entertainment for which a temporary seller's permit was obtained are included with all other sales in determining the 20 day test and the $15,000 taxable receipts test in standard 1.

Example:

A nonprofit organization plans 5 events covering 3 days each for 1990 (total of 15 days). Entertainment will be involved at one event only. The sales by the nonprofit organization would qualify as exempt occasional sales, except for the involvement of entertainment at the one event. The nonprofit organization may obtain a temporary seller's permit for the one event involving entertainment; thus, allowing the other 4 events to qualify as exempt occasional sales.

3. *THE ORGANIZATION IS NOT OTHERWISE REQUIRED TO HAVE A SELLER'S PERMIT.*

A nonprofit organization is not required to hold a seller's permit if its sales are exempt from sales and use taxation (i.e., it meets standards 1 and 2.)

Note: An organization required to hold a seller's permit solely for the purpose of conducting bingo games may still qualify for exempt occasional sales (on nonbingo sales) if it otherwise qualifies under standards 1 and 2.