STATE OF WISCONSIN

REPORT OF THE JOINT SURVEY COMMITTEE ON TAX EXEMPTIONS

JANUARY 2002 SPECIAL SESSION ASSEMBLY BILL 1

[Introduced by Committee on Assembly Organization, by request of Governor Scott McCallum.]

General Nature of Proposal

Generally, under current law, for Wisconsin income tax purposes, state law makes reference to the Internal Revenue Code. Typically, every biennium Wisconsin statutes relating to the income tax are updated to provide a more current reference to the Internal Revenue Code, as affected by recent federal legislation.

January 2002 Special Session Assembly Bill 1 is the budget reform bill. It affects many aspects of state finance and appropriations. A portion of the bill however, provides the biennial Internal Revenue Code update by incorporating by reference changes to the Internal Revenue Code enacted by Congress in 2000 and 2001. In 2001, the major federal tax law change was the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). In addition, three federal laws were enacted during 2000, but have not been adopted for Wisconsin tax purposes. These are the Federal Sales Corporation Repeal and Extraterritorial Income Exclusion Act (FSCRA), the Community Renewal Tax Relief Act (CRTRA), and the Installment Tax Correction Act (ITCA). The only provision of these federal laws not included in Assembly Bill 1 is the deduction for higher education expenses, enacted in EGTRRA. Wisconsin already provides a deduction targeted to tuition at the state's institutions of higher education.

Legality Involved

There are no questions of legality involved.

Fiscal Effect Upon the State and Its Subdivisions

According to the Department of Revenue, the fiscal effect of the changes recommended in Assembly Bill 1 are estimated to result in a revenue reduction in fiscal year 2002 of $8.55 million and in fiscal year 2003 of $24.35 million.

The federal laws affect numerous provisions of Wisconsin's tax laws, not all of which affect tax exemptions. The following provides a brief description of the major provisions of the federal laws that could be considered to affect a Wisconsin exemption.

- Expansion of Employer Adoption Assistance Exclusion. EGTRRA doubles the maximum amount of the exclusion from income for employer provided adoption assistance to $10,000 per eligible child. The amount will be adjusted annually to reflect inflation beginning in tax year 2003. The starting point for phase-out of the exclusion is increased to $150,000 of modified adjusted gross income. [FY 02 revenue decrease = $.05 million; FY 03 revenue decrease = $.20 million.]

- Increased Contributions to IRAs. EGTRRA increases the maximum annual contribution to an individual retirement account over the next seven years until it reaches $5,000 in 2008, after which the maximum will be adjusted annually for inflation. Individuals who are over age 50 are also allowed to make additional "catch up" contributions to an IRA. [FY 02 revenue decrease = $2.25 million; FY 03 revenue decrease = $5.95 million.]

- Increase in AMT Exemption. EGTRRA increases the alternative minimum tax exemption amounts for individual income tax filers for tax years 2001 through 2004. Under current law, Wisconsin's exemption amounts are the same as the federal amounts. [FY 03 revenue decrease = $.20 million.]

- Qualified Retirement Planning Services. EGTRRA excludes employer-provided qualified retirement planning services for employees and their spouses from the employee's gross wages. [Minimal fiscal effect.]

- Exclusion for Restitution Payments to Victims of Nazi Persecution. Under EGTRRA, certain restitution payments received by eligible individuals, their heirs or estates, are not included in gross income. An eligible individual is defined as any person who was persecuted on the basis of race, religion, physical or mental disability, or sexual orientation by Nazi Germany, any other Axis regime, or any other Nazi-controlled or Nazi-allied country. [Minimal revenue loss.]

- Repeal of Stepped-Up Basis. EGTRRA modifies the basis rules for purposes of the individual income tax due to the estate tax changes in the act. The changes will not take effect until the federal estate tax is eliminated, after 2009. Generally, EGTRRA replaces the step-up rule for the basis of property received from a decedent at death or from a donor with a carryover rule. Under EGTRRA, the basis of property transferred by the donor becomes the basis in the hands of the recipient. In other words, the donor's basis is "carried over" to the recipient. [No fiscal effect in current biennium.]

- Educational Assistance Programs. The exclusion for employer-provided educational assistance is made permanent and is extended to cover expenses paid by an employer for graduate level courses. The exclusion is allowed for tuition, fees, books, supplies, and equipment and is limited to $5,250 per year. [Fiscal effect: FY 02 revenue decrease = $2.70 million; FY 03 revenue decrease = $4.65 million.]

- Qualified State Tuition Programs. Distributions from qualified state tuition programs are tax free beginning in tax year 2002 under provisions of EGTRRA. Generally, Wisconsin already exempts from income tax most interest earnings on a prepaid tuition plan or college savings plan provided that the distributions from the plan are used for qualified educational purposes. [Minimal fiscal effect because of the existing Wisconsin deduction for earnings on certain prepaid tuition and college savings plans.]

- National Health Service Corps and Armed Forces Scholarships. Amounts received from the National Health Service Corps or the Armed Forces scholarship program for tuition, fees, books, supplies, and equipment required in the course of instruction are excluded from the student's gross income. Amounts received as stipends for living expenses, such as room and board, remain taxable. [Minimal fiscal effect.]

- Student Loan Interest Deduction. EGTRRA increases the modified adjusted gross income phase-out ranges for eligibility for the student loan interest deduction and adjusts them annually for inflation after tax year 2002. Additionally, both the 60-month limitation on the number of months during which interest is deductible and the restriction making voluntary interest payments nondeductible are repealed. [FY 02 revenue decrease = $.90 million; FY 03 revenue decrease = $1.55 million.]

- Medical Savings Accounts. The CRTRA extends the medical savings accounts program through 2002 and renames these accounts "Archer Medical Savings Accounts (MSAs)." Generally, under the program, contributions to eligible MSAs made by employers are excluded from gross income and contributions by individuals may be deducted from income. [Minimal revenue decrease.]

- Tax Benefits With Respect to Kidnapped Children. The CRTRA clarifies that a tax filer may claim dependency status for his or her child if law enforcement authorities presume that child has been kidnapped by someone who is not a family member. This provision would allow eligible Wisconsin taxpayers to claim head of household status in certain situations and to claim a personal exemption for the kidnapped child. [Minimal fiscal effect.]

- IRAs for Nonworking Spouses. The CRTRA places limits on IRA contributions for spouses with little or no earnings so that a couple's combined contribution does not exceed their combined earned income. This change ensures that couples with a nonworking or lesser earning spouse cannot make contributions in excess of the couple's combined earned income. [Minimal fiscal effect.]

- Renewal Communities. Under the CRTRA, taxpayers in areas designated as renewal communities may take a "commercial revitalization deduction" equal to either 50% of qualifying expenditures for a taxable year in which a qualified building was placed in service, or all of the qualifying expenditures prorated over a 10-year period. [Minimal fiscal effect.]

- Empowerment Zones. The CRTRA extends the federal empowerment zone program through December 31, 2009, and increases the amount of property placed in service in a zone that may be expended in the year acquired from $20,000 to $35,000, rather than requiring the owner to depreciate the property over several years. [Minimal fiscal effect.]

- Environmental Remediation Costs. The CRTRA extends the expiration date for an election to deduct certain environmental remediation expenditures that would otherwise be charged to a capital account to include expenses paid or incurred before 2004. Additionally, the requirement that expenditures be in a targeted area is eliminated so that most other sites certified by state environmental agencies as containing hazardous substances are eligible for the deduction. [FY 03 revenue decrease = $1.25 million.]

- Corporate Donations of Computer Technology. The CRTRA extends the expiration date for deductions of certain computer equipment donated to elementary and secondary schools through 2003. The deduction is extended to include donations to public libraries, donations of property up to three years after acquisition, rather than two years under prior law, and donations of property reacquired by a computer manufacturer. [FY 03 revenue decrease = $1.10 million.]

- Duplication or Acceleration of Loss Through Assumption of Certain Liabilities. The CRTRA requires that the basis of stock received in certain tax free exchanges be reduced by the amount of any liability assumed in exchange for the stock that does not otherwise reduce the transferor's basis. [FY 03 revenue increase = $.20 million.]

- Foreign Sales Corporations. The FSCRA repeals the present foreign sales corporation rules and replaces them with an exclusion for extraterritorial income. This law change is apparently in response to a decision by the World Trade Organization that prior rules breach the World Trade Organization rules by providing subsidies to assist U.S. exports, thus, giving U.S. companies an unfair advantage in international trade. [FY 03 revenue decrease = $2.80 million.]

- Increase in Contribution Limits. EGTRRA increases the dollar limits on defined contribution plans, elective deferrals and compensation limits. Generally, for 401k plans, 403b annuities and Section 408k salary reduction simplified employee pension plans, the maximum elective deferral is increased to $11,000 from $10,500. The limit is increased by $1,000 annually thereafter until the limit reaches $15,000 in 2006. Thereafter the limit is indexed annually for inflation. The same limits are provided for deferrals for Section 457 tax-exempt plans. [FY 02 revenue decrease = $.40 million; FY 03 revenue decrease = $1.50 million.]

- Catch-Up Contributions. EGTRRA increases the dollar limits on elective deferrals under several types of plans for persons age 50 or older before the end of the plan year. The additional amount of elective contribution equals the lesser of the applicable dollar amount which varies by type of plan, or the participant's compensation for the year, less any other elective deferrals he or she has made. [FY 02 revenue decrease = $.50 million; FY 03 revenue decrease = $1.20 million.]

- Increases in Defined Contribution Plan Limit. EGTRRA increases the contribution limit to 100% of compensation for defined contribution plans, tax-sheltered annuities and Section 457 state and local government plans to make these limits consistent with those of other plans. [FY 02 revenue decrease = $.20 million; FY 03 revenue decrease = $.40 million.]

- Increase in Employer Deduction Limits. EGTRRA increases the amount of deductible contributions employers may make to retirement plans. For defined contribution in simplified employee pension plans, the limit is increased from 15% to 25% of compensation. For money purchase plans, the deduction is the greater of 25% of the compensation or the amount the employer is required to contribute under a 401k. The provision also expands the definition of compensation for purposes of the above limits. [Minimal fiscal effect in FY 02; FY 03 revenue decrease = $.10 million.]

- Exclusion of Elective Deferrals in Determination of Deduction Limits. EGTRRA provides that certain elective deferral contributions are no longer deemed employer contributions and, thus, not subject to the limitations on employer deductions. [FY 02 revenue decrease = $.20 million, FY 03 revenue decrease = $.40 million.]

- Treatment of Elective Deferrals as Roth Contributions. EGTRRA permits Section 401k and 403b plans to provide a Roth contribution program in which participants may elect to have all or a portion of their elective deferrals designated as after tax contributions. Earnings and distributions from accounts under such a program would be tax free, as under Roth IRAs. [No fiscal effect in current biennium.]

- Rollover Provisions. EGTRRA makes a number of changes with respect to how certain rollovers in retirement plans are treated. For example, EGTRRA allows an employee participating in a Section 457 governmental deferred compensation plan to rollover, tax free, a distribution to plans to which tax free rollovers were previously not permitted. In addition, EGTRRA permits the surviving spouse of a deceased participant in a qualified plan to make a tax free rollover of an eligible rollover distribution from the plan to another qualified plan, a tax-sheltered annuity, or a governmental plan in which the surviving spouse participates. Also, EGTRRA permits a tax free rollover of an eligible distribution from an IRA to a qualified employer plan, tax-sheltered annuity or governmental or tax exempt organization deferred compensation plan. Finally, EGTRRA permits a tax free rollover of the entire amount of distribution from one qualified plan into another qualified plan or individual retirement account. [FY 02 revenue increase = $.10 million; minimal fiscal effect in FY 03.]

- Reinvestment of Employee Stock Ownership Plan Dividends. EGTRRA allows corporations to deduct, at the election of plan participants or their beneficiaries, dividends paid to an employee stock ownership plan and reinvested in qualified employer securities. The act also expands IRS authority to disallow deductions claimed for the purpose of avoiding or evading tax. [FY 02 revenue decrease = $.10 million; FY 03 revenue decrease = $.25 million.]

Public Policy Involved

The provisions of the bill relating to tax exemptions are good public policy.