



State of Wisconsin

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STEPHEN R. MILLER
CHIEF

January 11, 2007

MEMORANDUM

To: Representative Wieckert

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

Subject: Technical Memorandum to **2007 (un-introduced)** (LRB 07-0703/1) by **DOR**

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

MEMORANDUM

December 19, 2006

TO: Joseph Kreye
Legislative Reference Bureau

FROM: Rebecca Boldt
Department of Revenue

SUBJECT: Technical Memorandum on LRB-0703/1 – Credit for interest on WHEFA
Educational Facility Bonds

This bill creates a nonrefundable credit equal to the amount of interest received from bonds issued by the Wisconsin Health and Educational Facilities Authority to finance any project undertaken for an educational facility, multiplied by the claimant's marginal tax rate. Part-year residents must prorate the credit based on the ratio of Wisconsin adjusted gross income to federal adjusted gross income.

Partnerships, limited liability companies, and tax-option corporations may not claim the credit but the eligibility for, and the amount of, the credit are based on their receipt of interest. The entity shall compute the amount of interest income that each of its partners, members, or shareholders may claim in proportion to their ownership interest.

A. Computation of Credit

This bill would be complex to administer because the computation of the credit requires circular logic: A taxpayer cannot know the amount of credit until taxable income is known, and a taxpayer cannot know taxable income until the amount of credit is known. This is because the amount of credit must be added to taxable income. This may alter the marginal tax rate, which would in turn affect the credit computation, which would in turn affect the amount included in income, and so on.

Further, if the taxpayer is on the borderline of a tax bracket, the credit computation may require the interest income to be prorated into two different marginal tax rates. Also, although partnerships and tax-option corporations are required to include the amount of credit in their income, they will not always know what that amount is because they will not always know the marginal tax rate for each of their partners or shareholders.

Part-year residents are required to prorate tax rates based on Wisconsin adjusted gross income (AGI) to federal AGI. If the computation of Wisconsin AGI is uncertain because of the

requirement to add back the amount of credit, the computation of credit for a part-year resident is even more uncertain. For this reason, the credit should be allowed to part-year residents based only on interest income from the bonds that is taxable to Wisconsin.

The only remedy for the marginal tax rate allocation problem would be to eliminate the addition to income for the amount of the credit. This would also eliminate the problems relating to partnerships, tax-option corporations, and part-year residents. However, taxpayers would still have to perform additional steps in order to claim the credit.

A simpler approach may be to exempt the interest from Wisconsin tax instead of having a credit. This exemption would also be more advantageous to the taxpayer. The current bill requires a taxpayer to include both the interest and the credit in income. In addition, for those allowed a standard deduction, the standard deduction would also decrease as income is increased. Thus taxpayers would be taxed on the interest, the credit, and the result of the decreased standard deduction while being allowed a credit based only on the interest. This could be a disadvantage to some taxpayers. For example, assume the taxpayer had \$1,000 of interest from the bonds and had a marginal tax rate of 6.5%. The taxpayer's taxable income would increase by \$1,165 (\$1,000 of interest income, \$65 of credit included in income, and \$100 that the standard deduction would decrease because of the additional income). Assuming this was all subject to the 6.5% marginal tax rate, the tax on the \$1,165 would be \$76 and the taxpayer would only receive a \$65 credit.

B. Constitutionality

Since this bill allows a credit for certain state interest income, while no credit is allowed for federal interest income, it is likely to be subject to court challenges that could result in the invalidation of the corporate franchise tax.

C. Effect on Alternative Minimum Tax

Section 71.07(6f)(b) allows the credit to be offset against the taxes imposed under ss. 71.02 and 71.08. However, the order of computation (s. 71.10(4)(cf)) places the credit before the alternative minimum tax. If it is the intent that the credit offset alternative minimum tax, the order of computation should be after s. 71.10(4)(f) and s. 71.08(1)(intro.) should be amended to include s. 71.07(6f) in the list of credits not considered when determining alternative minimum tax. If it is not the intent to offset the credit against alternative minimum tax, the reference to s. 71.08 in s. 71.07(6f)(b) should be deleted.

D. Effective date

The initial applicability language is not needed and should be removed. A bond is defined as a bond or note issued on or after the effective date. The language of the bill provides the credit for interest received on bonds in the taxable year. However, the initial applicability provides that if the various sections take effect after July 31, the bill first applies to taxable years beginning on January 1 of the following year. As a result there could be a 5-month period in which the interest is subject to tax but no credit is available.

If you have any questions regarding this technical memorandum, please contact Michael Oakleaf at 261-5173, or via email at Michael.oakleaf@dor.state.wi.us.