

Testimony before the Steering Committee for Symposia on State Income Tax Hearing

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Good morning Chairperson Vos and members of the Steering Committee for Symposia on State Income Tax. Thank you for this opportunity to share my observations and recommendations for changes to the Wisconsin income tax laws.

My name is Hank Jasper; I am a resident of Fort Atkinson, Wisconsin and am licensed in Wisconsin as a CPA. I am a partner in a small local CPA firm in Fort Atkinson specializing in taxation. Our firm works with small businesses, their owners and other individuals to provide a full range of accounting and tax services. We have about 60 small businesses and 120 individuals as clients. Our business clients range in size up to \$40,000,000 in sales. I also provide consulting services to other CPA firms and to Kwik Trip, Inc. regarding various tax matters.

I am a native of the Upper Peninsula of Michigan and practiced in Michigan for several years before moving to Wisconsin in 1984.

I have a Master's of Science in Taxation degree, and previously was a manager in the Madison office of McGladrey & Pullen, the 5th largest CPA firm in the U.S., specializing in state and local taxes. I am a member of both the American Institute of CPAs and the Wisconsin Institute of CPAs, and a member of the WICPA Wisconsin Taxation Committee of the WICPA for 28 years.

Scope of Testimony

My testimony today is focused on individual income taxes, but as part of that I am addressing some issues regarding the computation of business income for sole-proprietors and "flow through" entities. Flow through entities includes S corporations and partnerships where the net income of the business is first determined at the entity level, but then which "flows-through" to be included on the tax returns of the individuals who own the entities. In our practice we have only a handful of regular "C" corporations which pay taxes at the corporation level. A flow through entity is the entity of choice for almost all but the largest of

corporations, because it allows for only one level of taxation at the owner level. A regular C corporation pays tax on its income and then shareholders also pay taxes on income distributed to them in the form of dividends.

In 2009, the following businesses operated in Wisconsin:

Regular ("C") Corporations	48,000	9%
S-Corporation:	66,000	12%
Partnership:	66,000	12%
Sole Proprietorships:	<u>377,000</u>	<u>67%</u>
Total	<u>557,000</u>	<u>100%</u>

Since over 90% of the businesses in Wisconsin are pass-through entities, the computation of business income is integrally connected with many of the individual income tax returns filed in Wisconsin.

What Works Well

Before I speak about what things we need to fix in our tax system, here are several things that we think Wisconsin does well:

- Electronic filing of tax returns and direct deposits for refunds.
 - When electronic filing first started it could take up to 5 days before we would receive confirmation that a return had been accepted by federal and Wisconsin.
 - For 2011 returns, we usually received the acceptance notice within 5 hours.
- I believe that overall Wisconsin has an excellent Dept. of Revenue.
 - It is commonly acknowledged as one of the best in the country.
 - They do a great job informing taxpayers and practitioners about new laws and have many good publications.
 - They aggressively protect the revenue of the state. (In fact a bit too aggressively from the standpoint of many practitioners.)

Complexity of the Current Wisconsin Tax System

Here is some anecdotal evidence of the increase in complexity in the Wisconsin income tax laws over the years:

1. In 1995, Form 1 fit on two pages; in 2011 it is four pages long.
2. In 1995, there were a total of 15 schedules and forms that could be attached to Form 1, of which 5 were for credits.
3. **In 2011, there were 53 schedules and forms** that could be attached to Form 1, of which 29 were for credits. And because there are now too many credits to fit on Form 1, Schedule CR - Other Credits must be included to consolidate many of the available credits.
4. To complicate matters further, the credits that can be claimed fall into three categories.
 - a. Nonrefundable credits claimed before the alternative minimum tax ("AMT").
 - b. Nonrefundable credits claimed after the AMT.
 - c. Refundable credits.
5. On top of that, some credits are "use it or lose it", and some can be carried forward to future years to the extent not used to offset the current year's tax. In other words, "use it or lose it" credits can only be used in the year in which they are generated; if credits exceed the amount of taxes, the excess credits are lost forever.
6. Not only that, but there are 20 credits that must be added back to income in the current year, which reduces the benefit of claiming these credits. To avoid having to add it back, wouldn't it be easier to just allow a smaller credit in the first place?
7. The Wisconsin Tax Guide, authored by Robert A. Kuehn, is an excellent resource for tax preparers which discusses in detail the application of the Wisconsin individual income tax laws. In 1993 his tax guide was 280 pages long; for 2011 it was 456 pages.

The problems that result from too much complexity include:

1. An increase in compliance costs for businesses by having to maintain additional records solely for computing Wisconsin taxable income.

2. It forces many taxpayers to seek professional assistance in the preparation of their tax returns.
3. An increase in tax preparation fees that individuals and businesses must pay because of the additional time spent by tax preparers to comply with all of the additional rules.
4. Taxpayers missing out on tax deductions or credits because they either don't know how to do the computations or are simply not aware that they exist.
5. Non-compliance with the tax laws either unintentionally or intentionally. As an example, sometimes credits or deductions have such little impact on taxpayers that the cost to compute them outweighs the benefits.

Conform with Federal Tax Laws to Simplify Tax Reporting

Wisconsin's Current System for Following Federal Law

Each year the legislature adopts the Internal Revenue Code as in effect on the prior December 31; changes in federal law during the current tax year are not followed. For example, for 2011 Wisconsin adopted the Internal Revenue Code in effect on December 31, 2010. In addition, numerous exceptions are made regarding specific provisions in prior federal tax laws. For example, Wisconsin has not adopted the federal depreciation rules for 12 years.

To reconcile the computation of taxable income between federal and Wisconsin, each year the DOR issues Schedule I on which the adjustments are computed. In some years there were as many as 90 differences that had to be reconciled, even though many of the differences would have had a negligible impact on the revenues of the state. This creates a lot of confusion and extra work for the DOR, taxpayers and tax practitioners.

Even when Wisconsin does recognize the federal changes, the effects of nonconformity in prior years can linger for many following years. For example, Wisconsin adopted the Health Savings Account provisions in 2011 a couple of years after they were introduced into federal law. So for contributions starting in 2011, federal and Wisconsin are in sync. But for contributions made to HSAs before 2011 Wisconsin taxpayers need to fill out a worksheet included with the Schedule I instructions to figure out what they need to do on their Wisconsin returns to account for the prior year differences.

Types of Differences

There are two types of differences between federal and Wisconsin tax laws - permanent differences and timing differences. A permanent difference occurs when Wisconsin either will never recognize income that has been reported as income on federal, or when a federal deduction will never be allowed for Wisconsin. An example is U.S. government interest which is taxable on federal but which Wisconsin is prohibited from taxing.

A timing difference will result in the same amount of income or deductions for both federal and Wisconsin but which will be recognized at different rates over a period of years. The primary example of this is depreciation.

Depreciation Differences

The largest difference in dollar terms between federal and Wisconsin tax laws is the timing of depreciation deductions for businesses of all types. Wisconsin has not changed its depreciation rules since 2000. Over the last several years, federal tax law has allowed for accelerated depreciation in the form of additional first year expensing options including Sec. 179 expensing and first year bonus depreciation. For example, federal has allowed expensing amounts of \$500,000 in 2010 and 2011, and \$139,000 in 2012 for equipment placed in service. Wisconsin has allowed only \$25,000 of expensing and no first year bonus depreciation for every year since 2000.

This adds a significant amount of compliance costs for taxpayers to keep multiple depreciation books, and is a disincentive for businesses because it accelerates the payment of Wisconsin income tax.

Example:

XYZ Company purchases equipment with a cost of \$100,000 in 2011.

For federal purposes, this equipment may be eligible to be expensed in full in the year of acquisition, or at the election of the taxpayer a smaller amount of expensing can be claimed. In this example the taxpayer elects to expense \$50,000 of the cost in 2011, with the remaining cost of \$50,000 to be depreciated over 6 tax years.

Wisconsin has a limit of \$25,000 for first year expensing, with the balance to be recovered over 6 tax years.

The depreciation deductions for this equipment are as follows:

	2011	2012	2013	2014	2015	2016	Total
Federal							
1 st yr exp	\$50,000	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 50,000
Deprec	<u>10,000</u>	<u>16,000</u>	<u>9,600</u>	<u>5,760</u>	<u>5,760</u>	<u>2,880</u>	<u>50,000</u>
Total depr	<u>\$60,000</u>	<u>\$16,000</u>	<u>\$9,600</u>	<u>\$5,760</u>	<u>\$5,760</u>	<u>\$2,880</u>	<u>\$100,000</u>
Wisconsin							
1 st yr exp	\$25,000	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 25,000
Deprec	<u>15,000</u>	<u>24,000</u>	<u>14,400</u>	<u>8,640</u>	<u>8,640</u>	<u>4,320</u>	<u>75,000</u>
Total depr	<u>\$40,000</u>	<u>\$24,000</u>	<u>\$14,400</u>	<u>\$8,640</u>	<u>\$8,640</u>	<u>\$4,320</u>	<u>\$100,000</u>
WI Add (Subtract) Modification	<u>+\$20,000</u>	<u>(\$8,000)</u>	<u>(\$4,800)</u>	<u>(\$4,800)</u>	<u>(\$2,880)</u>	<u>(\$1,440)</u>	<u>\$0</u>

As can be seen from this example, the only year Wisconsin "gains" is in 2011; all of the remaining years result in additional deductions claimed for Wisconsin. But in total the amounts claimed are the same for both federal and Wisconsin; the only difference is the "timing" of the depreciation deductions.

These calculations are just for "regular" tax purposes. In addition, for both federal and Wisconsin the company must maintain additional sets of depreciation calculations for federal and Wisconsin alternative minimum tax purposes. And for financial reporting purposes, which follows Generally Accepted Accounting Principles (GAAP), the company must maintain a 5th set of depreciation books.

In our example, this results in the following totals for all 5 books of depreciation:

	2011	2012	2013	2014	2015	2016	Total
Books	<u>\$10,000</u>	<u>\$20,000</u>	<u>\$20,000</u>	<u>\$20,000</u>	<u>\$20,000</u>	<u>\$10,000</u>	<u>\$100,000</u>
Fed Reg Tax	<u>\$60,000</u>	<u>\$16,000</u>	<u>\$9,600</u>	<u>\$5,760</u>	<u>\$5,760</u>	<u>\$2,880</u>	<u>\$100,000</u>
Fed AMT	<u>\$57,500</u>	<u>\$12,750</u>	<u>\$8,925</u>	<u>\$8,330</u>	<u>\$8,330</u>	<u>\$4,165</u>	<u>\$100,000</u>
WI Reg Tax	<u>\$40,000</u>	<u>\$24,000</u>	<u>\$14,400</u>	<u>\$8,640</u>	<u>\$8,640</u>	<u>\$4,320</u>	<u>\$100,000</u>
WI AMT	<u>\$36,250</u>	<u>\$19,125</u>	<u>\$13,388</u>	<u>\$12,495</u>	<u>\$12,495</u>	<u>\$6,247</u>	<u>\$100,000</u>

To illustrate further, a client is in the water softener business with almost 2,000 water softener units it rents out. This is not a big company; each unit averages about \$450 in cost, and the company's total sales in a year are about \$1,000,000. To be able to compute the numbers required for financial, federal tax and Wisconsin tax purposes, 5 sets of depreciation records must be maintained, resulting in almost 10,000 separate entries in the depreciation system.

Each year this company adds about 200 softeners, and also sells about the same number of used units. Each of these additions must be added to the depreciation software program, and the disposals must be recorded as well. Because each asset can have 5 different rates of depreciation, when an asset is sold, 5 separate computations of gain or loss must also be made. Thus in a typical year, there are 1,000 entries in the tax software for additions and a 1,000 entries for the disposals. Because our firm maintains their depreciation books, this adds significantly to the accounting fees each year.

The consequence of having different depreciation systems has a ripple effect on other tax provisions and creates filing restrictions:

- The difference in depreciation creates multiple calculations under the passive activity rules - one set each for Fed regular tax, Fed AMT, WI regular tax and WI AMT.
- Losses in partnerships and S corporations are limited to a shareholder's basis in the entity. Again this requires four separate sets of calculations.
- Sole proprietors report their business income and expenses on Federal Schedule C. When there are depreciation differences, they have to recompute the Schedule C for WI and attach it to their Form 1.

- When an individual disposes of assets with different bases because of depreciation differences, a WI version of Federal Form 4797 must also be attached to the WI return.
- Returns with Wisconsin depreciation differences on Form 4797 cannot be e-filed.

While Wisconsin can't do anything about federal tax law, at least by matching the federal depreciation rules companies will only need to maintain three sets of depreciation records.

I do recognize the tremendous pressure that lawmakers are under when it comes to balancing the biennial budgets, and that adopting the federal first year depreciation deductions can have a negative impact on a particular budget. While that is the case, I still believe that the focus should be on what is in the best interests of the taxpayers of the state in the long run. Because the taxes foregone in the current budget will be recovered in future years, and because it would save taxpayers a tremendous amount of compliance costs, I believe that Wisconsin should adopt all of the federal depreciation changes as enacted.

Eliminate the Wisconsin Alternative Minimum Tax

Out of the 2,831,473 tax returns filed in 2009, only 4,451 included the Wisconsin Alternative Minimum tax. The amount of revenue generated by the AMT was \$5,330,000 which is less than 3/10ths of a percent of the total personal income tax revenue of \$1,930,000,000. In other words, the AMT applied to only one out of about 600 returns filed, and generated less than \$3 of revenue out of every \$1,000 of tax revenues collected by the state.

But despite applying to so few taxpayers, every business entity in Wisconsin other than regular corporations must compute depreciation for Wisconsin AMT purposes in order for the individuals who own these businesses to determine if the WI AMT applies. Following is the number of businesses by entity type other than regular "C" corporations:

S-Corporation:	66,000
Partnership:	66,000
Sole Proprietorships:	<u>377,000</u>
Total	<u>509,000</u>

S-corporations can have between 1 and 100 owners and there is no limit on the number of partners in partnerships. Therefore, the actual number of individuals reporting business income in Wisconsin is probably much greater than than 509,000. But even if we assume that

the 509,000 business returns only affect 509,000 individual returns, that means that only 1 business out of 113 are affected by AMT but all 509,000 must compute depreciation for WI AMT purposes.

This is a huge compliance burden for taxpayers for such a little amount of income for the state. It is difficult to calculate the exact cost of complying with the WI AMT, but even if it cost only \$20 per business (which I'm sure is way low), that is a total cost of \$10,180,000, which is about twice the amount of the total WI AMT collected. This is another case where the "many" suffer for the sins of the few.

Allow for a WI AMT Credit if the Tax is not Repealed

If the Wisconsin AMT is not repealed, there is a technical issue that must be addressed to make the Wisconsin AMT less punitive. As pointed out previously, depreciation differences are the most likely cause of incurring the Wisconsin AMT. This happens sometimes when the depreciation claimed for Wisconsin regular tax purposes is significantly higher than it is for AMT purposes.

Since depreciation is a timing issue, the State is going to collect the same amount of revenue over time regardless of when the depreciation is claimed. But that is true only if the Wisconsin AMT does not apply in any year. Unlike federal law, Wisconsin does not provide a mechanism to even out the effects of the AMT.

For federal tax purposes, when an AMT is generated because of timing differences (like depreciation) a taxpayer's current year tax is increased by the amount that the AMT is greater than the regular tax. If that happens, then a Minimum Tax Credit is generated for the AMT attributable to the timing differences, which can be used to offset taxes in subsequent years. Wisconsin, however, does not allow for an AMT credit to be generated if the AMT applies. The result is the loss of the deduction of the extra depreciation generated, which means that business owners get the benefit of less than 100% of the depreciation deductions they would otherwise be entitled to.

When our clients are in this situation, we have them elect to use the WI AMT depreciation rules in computing depreciation for regular tax purposes. By doing so, it preserves depreciation deductions to be utilized in future years.

Consider a Complete Overhaul of the Wisconsin Tax System

1. Base Wisconsin's personal income tax on federal taxable income.
2. Make required subtractions for interest on U.S. obligations which by law Wisconsin is prohibited from taxing.
3. Add back municipal interest on non-Wisconsin bonds.
4. Resist to the greatest extent possible making other add or subtract modifications. [But some are inevitable because some prior tax provisions can't be changed, such as the exclusion of certain retirement benefits for people who retired from some retirement systems years ago, such as teachers who retired before 1964.]
5. Apply the Wisconsin tax rate.
6. Subtract credits.
7. The net result is either a refund or a balance due.

Consolidate all business credits into three credits and make them available to all types of entities:

1. An investment credit for investing in equipment and facilities in Wisconsin.
2. A research credit for all types of taxpayers who conduct qualified research as defined under federal law.
3. An employment credit to encourage increasing employment overall and for increasing employment in targeted groups.
 - a) One form can be used on which the different categories could be given specific amounts of credit. For example, a \$200 credit for each increase in full time equivalent employment, a \$500 credit for hiring disabled veterans, etc.
 - b) Make the definition of full time equivalent employees to mean total hours worked per employee up to 2,080 hours per year, divided by 2,080. Under the current law for the deduction for increasing employment, only employees who work at least 2,080 hours are included in the computation, which means that part time employment doesn't count. So even if a company increases the total number of hours worked by hiring more part-time employees, that is not considered an increase in employment under the current jobs deduction provision.

4. [We do recognize that the State has taken steps in this direction with the implementation of the Job Creation Deduction in 2011, and the Manufacturing and Agriculture Credit first applicable in 2013. Both provisions are broad based.]
5. Make the above credits refundable for the first several years of a company's existence (3 yrs?), and then as a non-refundable credit after that.
 - a. The most critical factor in starting and growing a new business is having enough cash to invest in employees, equipment and inventories.
 - b. Deductions are usually of limited value to new businesses because most will operate at a loss for the first few years in business.
 - c. Making the credits refundable during a company's formative years provides them with cash when they need it the most.
6. Keep the Wisconsin Homestead Credit to provide relief for low income families.
7. Keep the Wisconsin Earned Income tax credit.

Summary

A fair tax structure is one that is simple. This reduces the compliance costs for both the state and the taxpayers. To simplify - federalize to the greatest extent possible.

Again, thank you for this opportunity to share my observations regarding Wisconsin's income tax laws. I would be happy to answer any questions now, or I can be contacted at the following address.

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