**Legislative Fiscal Bureau**
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October 19, 2005

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Assembly Bill 21: Adopting Federal Internal Revenue Code Expensing and Depreciation Provisions for Farming

Assembly Bill 21, which would adopt federal expensing and depreciation provisions for farming under the state individual and corporate income and franchise taxes, was introduced on January 20, 2005, and referred to the Assembly Committee on Agriculture. On September 9, 2005, Assembly Amendment 2 was adopted by that committee, by a vote of 12 to 1. The bill, as amended by Assembly Amendment 2, was recommended for passage by the Committee on Agriculture on September 9, by a vote of 12 to 1. Assembly Bill 21, as amended by Assembly Amendment 2, was referred to the Joint Committee on Finance on September 22, 2005.

## CURRENT LAW

State individual and corporate income and franchise tax provisions are generally referenced to definitions under federal law. Changes to federal law take effect for state tax purposes only after action by the Legislature. Generally, the Legislature reviews the previous year's federal law changes each year to update state references to the Internal Revenue Code (IRC). With some exceptions, the current statutes refer to the federal IRC in effect on December 31, 2004. However, state depreciation and amortization provisions are referenced to the IRC in effect on December 31, 2000. State provisions relating to the expensing of certain depreciable assets (Section 179 expensing) are referenced to the IRC in effect on December 31, 2002.

**Depreciation.** The Modified Accelerated Cost Recovery System (MACRS) rules of depreciation apply to most tangible property placed in service after 1986. Generally, the Accelerated Cost Recovery System (ACRS) of depreciation applies to property placed in service

after 1980 and before 1987.

Property, other than MACRS and ACRS property, must be depreciated using general depreciation rules. Under the general rules, the basis to be recovered through depreciation must be charged off over the life of the property using recognized methods of depreciation. MACRS and ACRS property is recovered using statutory percentages that are annually applied to the depreciable basis of the property.

Since its inclusion in the federal tax code in 1913, the depreciation deduction has been periodically revised both by Congress and the Internal Revenue Service (IRS). As a result of these changes, until recent years, taxpayers frequently used one or more of the different systems to depreciate assets for federal tax purposes: (a) the general depreciation system based on salvage value; (b) the Class Life Asset Depreciation Range (ADR) system; (c) the Accelerated Cost Recovery System; and (d) the Modified Accelerated Cost Recovery System. The first two systems generally apply to property placed in service before 1981. As noted, ACRS primarily applies to assets placed in service after 1980 and before 1987. MACRS applies to property placed in service since January 1, 1987.

More recently, the federal Job Creation and Worker Assistance Act of 2002, which was enacted in March, 2002, included provisions that provide taxpayers with an additional first-year depreciation deduction equal to 30% of the adjusted basis of certain property that was acquired after September 10, 2001. The federal Jobs and Growth Tax Relief Reconciliation Act of 2003, enacted in May, 2003, increased the bonus depreciation rate to 50% for property that was acquired after May 5, 2003. The 30% rate generally applies to property acquired after September 10, 2001, and before May 6, 2003, and placed in service before January 1, 2005. The 50% rate generally applies to property acquired after May 5, 2003, and placed in service before January 1, 2005. A taxpayer may elect to continue to claim the 30% rate for property acquired after May 5, 2003, or not claim the allowance for eligible property. The additional first year depreciation allowance (bonus depreciation) may be claimed for: (a) new MACRS property for which the recovery period is 20 years or less (includes most property, except real property); (b) MACRS water utility property; (c) certain depreciable computer software; and (d) qualified leasehold improvement property. Property that must be depreciated under the MACRS alternative (ADS) depreciation system does not qualify. The special depreciation allowance is generally equal to 30% or 50% of the adjusted basis of the property. The adjusted basis of property is generally its cost or other basis multiplied by the percentage of business/investment use, reduced by the amount of any IRC code Section 179 expense allowance, and adjusted for other code or regulation provisions. After reducing the adjusted basis of the property by the bonus depreciation amount and other required adjustments, the remaining depreciable basis of the property is used to figure the regular MACRS deductions over the life of the property.

Generally, changes in federal tax law concerning depreciation were effective for Wisconsin individual and corporate income and franchise taxpayers. However, following enactment of the ACRS system by the federal government in 1981, the Legislature adopted a series of state

limitations on federal depreciation provisions that applied for state income and franchise tax purposes. These limits were repealed as a part of the federalization provisions included in 1997 Wisconsin Act 27. As a result of Act 27, state tax provisions related to amortization and depreciation were again automatically referenced to the federal IRC. This provision applied until the bonus depreciation provisions were enacted as part of the federal Job Creation and Worker Assistance Act of 2002. The Legislature then included provisions in 2001 Wisconsin Act 109 that referenced state amortization and depreciation provisions specifically to the federal IRC in effect on December 31, 2000. Consequently, the federal bonus depreciation provisions that were enacted by Congress in 2002 and 2003 were not adopted for state individual corporate income and franchise tax purposes, and the Legislature must take action to reference state amortization and depreciation provisions to federal provisions that take effect after December 31, 2000.

Because state depreciation provisions are fully referenced to the Internal Revenue Code in effect on December 31, 2000, tangible depreciable property currently placed in service is generally subject to MACRS. As noted, under MACRS, the cost of property is recovered by using accelerated methods of cost recovery and statutory recovery periods and conventions. Although most property placed in service after 1986 is depreciated under MACRS, some types of property are excluded from MACRS treatment including certain public utility property, intangible assets, and motion picture films, video tapes, and sound recordings.

**Election to Expense Depreciable Assets.** Under Section 179 of the IRC, a taxpayer may elect to treat all or a portion of the cost of qualifying property, up to a limit, as an expense rather than as a capital expenditure. Such an expense or cost is deductible in the year in which the property is placed in service. The amount claimed as a deduction is referred to as a Section 179 expense allowance. Qualifying property is generally:

a. Tangible personal property.

b. Other tangible property (except buildings and their structural components) used as: (1) an integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services; (2) a research facility used in connection with any of these activities; or (3) a facility used in connection with such activities for the bulk storage of tangible commodities.

c. Single purpose agricultural property (livestock or horticultural structures).

d. Storage facilities (except buildings and their structural components) used in connection with distributing petroleum or any primary product of petroleum.

e. Off-the-shelf computer software (this type of property is not eligible for Section 179 treatment under Wisconsin law).

Under federal law, the Section 179 deduction is the cost of qualifying property up to a maximum limit, and the deductible amount is reduced by the amount by which the total cost of the Section 179 property placed in service in a year exceeds a specified phase-out amount. Under provisions included in the federal Jobs and Growth Tax Relief Reconciliation Act of 2003, a taxpayer may elect to deduct up to $100,000 of the cost of qualifying property placed in service in the year. The maximum deductible amount of $100,000 is reduced (but not below zero) by the amount by which the qualifying property placed in service during the taxable year exceeds $400,000. In addition, off-the-shelf computer software is included as qualifying property. These provisions which applied to tax years beginning after December 31, 2002 and before January 1, 2006, were extended for two more years, for tax years beginning after December 31, 2005 and before January 1, 2008, by the American Jobs Creation Act of 2004.

However, the provisions of the federal Jobs and Growth Tax Relief Reconciliation Act of 2003 were not adopted for state income and franchise tax purposes. Rather, state taxpayers are subject to Section 179 IRC provisions that were in effect for tax years through 2002. As a result, under current Wisconsin law, a taxpayer may elect to deduct up to $25,000 of the cost of qualifying property in the year it is placed in service, rather than taking depreciation deductions over a specified recovery period. In general, qualifying property is depreciable tangible personal property that is purchased for the active conduct of a trade or business. The maximum deductible amount of $25,000 is reduced (but not below zero) by the amount by which the qualifying property placed in service during the taxable year exceeds $200,000. In addition, the amount eligible to be expended for a taxable year may not exceed the taxable income of the taxpayer that is derived from the active conduct of a trade or a business for that year. Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding years and deducted, subject to the total investment and taxable income limits.

## SUMMARY OF BILL

Assembly Bill 21 would authorize a person who was actively engaged in farming to compute amortization and depreciation on property used in farming using the federal 30% bonus depreciation provisions included in the federal Job Creation and Worker Assistance Act of 2002, and the 50% bonus depreciation provisions included in the federal Jobs and Growth Tax Relief Reconciliation Act of 2003, for state income and franchise tax purposes. The provisions would apply retroactively to tax years for which the federal provisions were effective.

Assembly Bill 21 would also adopt, under the state individual and corporate income and franchise taxes, the increase to $100,000, included in the federal Jobs and Growth Tax Relief Reconciliation Act of 2003, in the amount of depreciable property that could be expensed for property used in farming by a person actively engaged in farming. This provision would apply retroactively to the tax years (2004 and 2005) for which the federal provision was effective.

The definition of "farming" would be referenced to the IRC, and would mean the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity including the raising, shearing, feeding, caring for, training, and management of animals. Trees (other than trees bearing fruit or nuts) are not treated as an agricultural or horticultural commodity.

The definition of "actively engaged in farming" is referenced to the federal administrative code and means that the individual or entity makes a significant contribution to a farming operation of: (a) capital, equipment, or land, or a combination of such factors; and (b) active personal labor or active personal management, or a combination of both. In determining if the individual or entity is actively contributing a significant amount of active personal labor or active personal management the following factors are considered: (a) the types of crops and livestock produced by the farming operation; (b) the normal and customary farming practices of the area; and (c) the total amount of labor and management necessary for such a farming operation in the area. In order to be considered to be actively engaged in farming the individual or entity must have: (a) a share of the profits or losses from the farming operation commensurate with the individual's or entity's contribution to the operation; and (b) contributions to the farming operation that are at risk.

## ASSEMBLY AMENDMENT 2

Assembly Amendment 2 to AB 21 would eliminate the retroactive adoption under the state individual and corporate income and franchise taxes of the 30% and 50% bonus depreciation provisions for property used in farming, but would adopt any federal changes enacted to those provisions after December 31, 2005, for property acquired and placed in service in tax years beginning on or after January 1, 2006. AA 2 would adopt, for state income and franchise tax purposes, the increase to $100,000 under the IRC in the amount of depreciable property that could be expensed for property used in farming by a person actively engaged in farming, for property acquired and placed in service in tax years beginning after December 31, 2005, and before January 1, 2008. The amendment would also adopt, for state income and franchise tax purposes, any subsequent change in the IRC Section 179 expensing provision for property acquired and placed in service beginning on or after January 1, 2008.

## FISCAL EFFECT

**Assembly Bill 21**. Assembly Bill 21 would retroactively adopt federal IRC 30% and 50% bonus depreciation provisions for farming property for state individual and corporate income and franchise tax purposes. Although these expired under federal law on January 1, 2005, state taxpayers could file amended returns for past years and claim the bonus expensing deduction. It is estimated that this would result in a one-time income and franchise tax revenue decrease of $25 million in 2005-06. In addition, the bill would adopt the increase in the IRS Section 179 expensing amount to $100,000 for property used in farming, for tax years 2003 through 2005, under the state income and franchise taxes. It is estimated that this would reduce state individual and corporate

income and franchise tax revenues by $1.6 million in 2005-06 for tax year 2005. There would also be a one-time decrease in income and franchise tax revenues of $3.2 million due to amended returns filed for tax years 2003 and 2004. In later years, tax revenues would increase because depreciation deductions would be lower.

**Assembly Amendment 2.** Assembly Amendment 2 would adopt, under the state individual and corporate income and franchise taxes, any changes made to federal IRC bonus depreciation provisions for property used in farming that are enacted after December 31, 2005. This would have no fiscal effect unless subsequent federal changes are adopted. The amendment would also reference state income and franchise tax provisions to the increase in the IRS Section 179 expensing amount for property used in farming that is acquired for tax years beginning after December 31, 2005 and before January 1, 2008. Subsequent changes that are enacted to the IRC Section 179 expensing increase provisions would be adopted for state income and franchise tax purposes. These provisions would reduce state income and franchise tax revenues by an estimated $1.6 million in 2006-07.

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