



## Legislative Fiscal Bureau

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Joint Committee on Finance

Paper #326

### **Dairy Manufacturing Facility Investment Tax Credit (General Fund Taxes -- Individual and Corporate Income Taxes )**

#### *Bill Agency*

[LFB 2007-09 Budget Summary: Page 168, #19]

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#### **CURRENT LAW**

Under current law, similar 10% tax credits may be claimed for expenses related to modernization and expansion of dairy farms and livestock farms. The dairy farm credit is available for tax years that begin after December 31, 2003, and before January 1, 2010, and the livestock farm credit is available for tax years that begin after December 31, 2005, and before January 1, 2012. The aggregate amount of dairy and livestock farm credits that may be claimed by a taxpayer is \$50,000.

Typically, capital assets used in a trade or business are depreciated. The deduction for depreciation allows taxpayers to recover, over a period of years, the cost of capital assets used in a trade or business or for the production of income. Because state depreciation provisions are fully referenced to the Internal Revenue Code (IRC) in effect on December 31, 2000, tangible depreciable property currently placed in service is generally subject to the federal Modified Accelerated Cost Recovery System (MACRS). Specifically, the cost of eligible property is recovered over a 3-, 5-, 7-, 10-, 15-, 20-, 27.5-, 31.5, 39-, or 50-year period depending upon the type of property involved. Depreciation methods are prescribed for each MACRS class. Generally, personal property is assigned to the three-year class, the five-year class, the seven-year class, or the 10-year class. Real property is assigned to the remaining classes based on the type of property involved. Property included in the three-year, five-year, seven-year, and ten-year classes is depreciated using the double declining balance method, switching to the straight-line method at a time which maximizes the depreciation allowance. Property in the 15-year and

20-year classes is depreciated using the 150% declining balance method, again switching to the straight-line method at a time which maximizes the depreciation allowance.

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. 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.

## **GOVERNOR**

Create a dairy manufacturing facility investment tax credit under the state individual income and corporate income and franchise taxes equal to 10% of the amount paid in a tax year by a claimant for dairy manufacturing modernization or expansion related to the claimant's dairy manufacturing operation. The administration estimates that the dairy manufacturing facility investment tax credit would reduce corporate income and franchise taxes by \$300,000 in 2007-08, and \$400,000 in 2008-09.

## **DISCUSSION POINTS**

1. According to data compiled by the Wisconsin Milk Marketing Board, from the University of Wisconsin, Department of Agriculture and Applied Economics, the dairy industry in Wisconsin contributes \$20.6 billion annually to the state's economy, and is the largest sector of the state's \$51.5 billion agriculture industry. The dairy industry accounts for almost 40% of total agricultural employment, with 160,000 individuals working in the industry. This employment represents approximately 4.6% of total state employment. It is estimated that economic activity in the dairy industry has helped create over 65,500 jobs in other sectors of the state economy, including an estimated 2,600 in construction, 20,260 in services, 21,240 in manufacturing, and 21,640 in trade. The Wisconsin dairy industry exports \$224 million in product annually, or 22% of total U. S. dairy exports.

2. As noted, Wisconsin currently provides a tax credit to dairy producers (dairy farms). The dairy investment tax credit was created by 2003 Wisconsin Act 135. Under current law, a tax credit may be claimed, for tax years that begin after December 31, 2003, and before January 1, 2010, equal to 10% of the amount paid by the claimant during the tax year for dairy farm modernization or expansion related to the operation of the claimant's dairy farm.

Dairy farm modernization or expansion is defined as the construction, improvement, or

acquisition of buildings or facilities, or the acquisition of equipment for dairy animal housing, confinement, animal feeding, milk production, or waste management, including the following, if used exclusively related to dairy animals and if acquired and placed in service in the state during tax years that begin after December 31, 2003, and before January 1, 2010: (a) freestall barns; (b) fences; (c) watering facilities; (d) feed storage and handling equipment; (e) milking parlors; (f) robotic equipment; (g) scales; (h) milk storage and cooling facilities; (i) bulk tanks; (j) manure pumping and storage facilities; (k) digesters; and (l) equipment used to produce energy. Dairy animals include heifers raised as replacement dairy animals. Dairy farm includes a facility used to raise heifers as replacements to dairy animals.

In 2005, 8,478 dairy producers claimed slightly more than \$38 million in dairy investment tax credits. A total of \$11.9 million in credits was used by 6,498 claimants to offset income tax liability. The remaining \$26.2 million was carried forward to offset future tax liabilities.

3. Under SB 40, the proposed dairy manufacturing facility investment tax credit would be equal to 10% of the amount paid in a tax year by a claimant for dairy manufacturing modernization or expansion related to the claimant's dairy manufacturing operation. The tax credit could be claimed for tax years beginning after December 31, 2006, and before January 1, 2015. The maximum aggregate amount of tax credits that a claimant could claim would be \$200,000, and a credit could not be claimed for expenses that were deducted as trade or business expenses. Unused tax credit amounts could be carried forward up to 15 years to offset future tax liabilities.

"Dairy manufacturing modernization or expansion" would be defined as constructing, improving, or acquiring buildings or facilities, or acquiring equipment, for dairy manufacturing, including the following, if used exclusively for dairy manufacturing, and if acquired and placed in service in Wisconsin during tax years that begin after December 31, 2006, and before January 1, 2015:

- a. Building construction, including storage and warehouse facilities.
- b. Building additions.
- c. Upgrades to utilities, including water, electric, heat, and waste facilities.
- d. Milk intake and storage equipment.
- e. Processing and manufacturing equipment, including pipes, motors, pumps, valves, pasteurizers, homogenizers, vats, evaporators, dryers, concentrators, and churns.
- f. Packaging and handling equipment, including sealing, bagging, boxing, labeling, conveying, and product movement equipment.
- g. Warehouse equipment, including storage racks.
- h. Waste treatment and waste management equipment, including tanks, blowers,

separators, dryers, digesters, and equipment that uses waste to produce energy, fuel, or industrial products.

i. Computer software and hardware used for managing the claimant's dairy manufacturing operation, including software and hardware related to logistics, inventory management, and production plant controls.

"Dairy manufacturing" would mean processing milk into dairy products or processing dairy products for sale commercially. "Used exclusively" would mean used to the exclusion of all other uses, except for use not exceeding 5% of total use.

Partnerships, limited liability companies (LLCs), and tax-option corporations could not claim the tax credit, but eligibility for, and the amount of, the credit would be based on the entity's payment of eligible expenses, subject to the \$200,000 limit on the maximum aggregate amount of tax credits that a single entity could claim. A partnership, LLC, or tax-option corporation would be required to compute the amount of the credit that each of its partners, members, or shareholders could claim and provide that information to them. Partners, members of LLCs, and shareholders of tax-option corporations could claim the credit in proportion to their ownership interest.

If two or more persons own or operate a dairy manufacturing operation, each person could claim the dairy manufacturing facility investment tax credit in proportion to his or her ownership interest, subject to the aggregate total credit limit of \$200,000.

The Department of Revenue (DOR) would administer the dairy manufacturing facility investment tax credit, and would be authorized to take any action, conduct any proceeding, and act as authorized under income and franchise tax provisions relating to timely claims, assessments, refunds, appeals, collection, interest, and penalties.

The administration estimates that the dairy manufacturing facility investment tax credit would reduce corporate income and franchise taxes by \$300,000 in 2007-08, and \$400,000 in 2008-09.

4. In a 2004 report to Congress (*Economic Effects of U.S. Dairy Policy and Alternative Approaches to Milk Pricing*, 2004), the U.S. Department of Agriculture (USDA) reported that at every level of the of dairy processing and manufacturing industry in the U.S., consolidation has resulted in fewer participants and larger unit size. Fewer plants process milk and manufacture dairy products. Advances in technologies associated with milk handling, storage, processing, and manufacturing have led to economies of scale and resulted in an expansion of production facilities to take advantage of those technologies. Improved packaging, better coordination among storage and distribution activities, and transportation costs have reduced costs related to increased plant size. Developments in information technology have also improved coordination of product movement both within and between firms. Pressure from downstream businesses, including high-volume retailers, large restaurant chains, and food processors, have caused dairy processors and manufacturers to grow large enough to serve customers efficiently and to offset the market power of

those entities.

According to the USDA report, declining consumer demand for fluid milk has stimulated changes in product mix, structure, and organization. The number of milk processing plants has declined while the volume processed per plant has increased. Nationally, the number of milk processing firms has contracted as large fluid milk processing companies have consolidated through mergers and acquisitions. Fluid milk processing produces a homogenous product with little opportunity for product differentiation, so lower costs are critical to the plant's ability to compete (Manchester and Blaney, 1997). In addition, fluid milk processors have consolidated to meet the demands of large retail accounts, some created through supermarket mergers (GAO, 2001).

USDA reports that firms that produce cheese and other products used in ethnic, prepared, or restaurant food have experienced a growth in demand. U. S. production of natural cheese doubled between 1980 and 2004, and production shifted from primarily American cheese varieties to other varieties, such as Italian cheeses. Shifting fluid milk usage primarily to cheese production has allowed product to be shipped greater distances and caused greater centralization of cheese manufacturing plants. Between 1980 and 2003, the number cheese manufacturing plants declined by 50%, while average plant size more than tripled (Blayney and Miller 2003).

As noted, the USDA indicates that concentration measures have risen for all segments of the dairy industry. This has reduced the number of participants in the market and encouraged contracts or other forms of prearranged transactions. With fewer buyers and sellers, participants have begun to produce customized products, rather than those that are traded on markets.

5. According to staff of the Value Added Dairy Initiative, the dairy product processing and manufacturing industry in Wisconsin is less concentrated than on the national level. (The Value Added Initiative includes the Wisconsin Milk Marketing Board, Department of Commerce, Dairy 2020 Program, UW Center for Dairy Profitability, the Dairy Business Innovation Center and other public and private partners.) Staff indicate that there are approximately 350 licensed dairy plants in Wisconsin. Of the total, about 100, are small retail cheese firms that basically cut, wrap, and sell finished cheeses. Another 100 companies are sometimes referred to as further processors. These businesses purchase finished cheeses and then use industrial processes to increase the value of the product by actions such as shredding, slicing, or making cheese spread. Sargento Foods, Inc. would be an example of this type of firm. Thirty of the remaining licensed dairy plants produce dairy products other than cheese, such as butter and ice cream. About 120 firms make cheese from milk. Many of these businesses produce specialized cheeses. Finally, there are about six to eight milk processors in the state. About 90% of the milk produced by dairy farms in Wisconsin is used to make cheeses.

6. According to economic theory, a business will evaluate alternative new investments based on the profitability of the marginal investment in each. From this perspective, tax incentives, at the margin, can influence investment decisions. The value to the firm of a tax incentive is the amount it adds to the profitability of a new investment. Profitability is measured as returns on investment usually calculated as increased cash flow or an increased internal rate of return. As a

result, government could influence business investment decisions by changing the after-tax profitability of operations.

The proposed tax credit would reduce investment costs for capital investments for eligible dairy manufacturing firms. Because of the decentralized nature of the state's dairy product manufacturing industry, the tax credit could be of benefit to many Wisconsin businesses. Many of the firms are shifting from general commodity production to more specialized products. As a result, these firms must purchase newer equipment, or renovate or convert existing equipment and/or facilities. The tax credit would reduce associated investment costs. In turn, a more specialized Wisconsin dairy products industry would be more competitive with the larger general commodity producers in other states. (The small retail firms would likely not be eligible for the proposed tax credit.)

However, economic theory would posit that dairy product businesses would undertake such investments in the absence of tax incentives, if the investment increased profitability. In some cases, this appears to be already occurring. For example, data produced by the Value Added Initiative show that, between 2003 and 2007, over 30 dairy product manufacturers in the state invested an estimated \$200 million in their Wisconsin manufacturing and processing facilities. As a result the state's production capacity increased by more than 50 million pounds.

7. Under the bill, the dairy manufacturing facility investment tax credit is estimated to reduce corporate income and franchise taxes by \$300,000 in 2007-08, and \$400,000 in 2008-09. However, based on aggregate corporate income tax data on the dairy products industry in the state, it is estimated that the tax credit would reduce income and franchise tax revenues by an additional \$300,000 each year. As a result, the estimated fiscal effect of the dairy manufacturing facility tax credit would be a reduction in corporate income and franchise tax revenues of \$600,000 in 2007-08 and \$700,000 in 2008-09.

8. The provisions in the bill specifying the allocation of the credit if two or more persons own and operate a dairy manufacturing facility contain a reference to dairy farm. The provision should be modified to clarify that the credit is for a manufacturing facility.

## **ALTERNATIVES TO BILL**

1. Adopt the Governor's recommendation to create a dairy manufacturing facility investment tax credit under the state individual income and corporate income and franchise taxes equal to 10% of the amount paid in a tax year by a claimant for dairy manufacturing modernization or expansion related to the claimant's dairy manufacturing operation. Provide that the credit could be claimed for tax years beginning after December 31, 2006, and before January 1, 2015. Reestimate the tax credit to be a reduction in corporate income and franchise tax liabilities of \$600,000 in 2007-08 and \$700,000 in 2008-09. Make a technical change to clarify that the tax credit is for manufacturing facilities.

<b>ALT 1</b>	<b>Change to Bill Revenue</b>	<b>Change to Base Revenue</b>
GPR	- \$600,000	- \$1,300,000

2. Delete provision.

<b>ALT 2</b>	<b>Change to Bill Revenue</b>	<b>Change to Base Revenue</b>
GPR	\$700,000	\$0

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