Corporate Income/Franchise Tax

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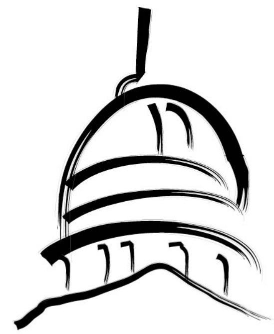

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This paper provides general information regarding the Wisconsin corporate income/ franchise tax. Included in the paper are a general rationale for the tax, a description of the method by which the tax is applied to corporations, and summary and comparative data about the tax.

Theoretical Justification for the Corporate Income Tax

One theoretical justification given for the corporate income tax is based on the view that a corporation is a legal entity with an existence of its own. A corporation can be a significant factor in economic and social decision-making, operated by professional management subject to little control by the average shareholder. Proponents of the corporate income tax believe that, as a separate entity with substantial earnings and economic power, the corporation is properly subject to a separate tax. In addition, proponents believe that, since a corporation can be viewed as a separate income earning entity, it is appropriate to tax a corporation's profits, especially when a substantial amount of the corporation's income is from the sale of goods and services to the state's residents.

Opponents of the corporate income tax believe it depresses the overall level of business investment in the U.S. They argue that although corporations operate as distinct, decision-making units, corporations should not be subject to a distinct tax because, ultimately, corporate taxes are borne by natural persons. Since corporate profits are part of the income of shareholders, some view the corporate income tax as a tax on the income of shareholders. Under this view, the corporation has no independent taxpaying ability but should be seen as a "conduit" through which earnings pass on the way to the shareholders. Those who hold this view criticize the corporate income tax because corporate profits that are distributed are taxed twice--first at the corporate level under the corporate income tax and then under the individual income tax when they are distributed as dividends to shareholders. However, many economists believe that the corporate income tax is borne not only by stockholders but by consumers and wage earners as well. Regardless of the specific incidence, opponents of the corporate income tax argue that it is not a tax on corporate income but rather a tax on the income of people, including shareholders, consumers, and employees.

Another rationale for the corporate income tax is that corporations receive benefits from their form of organization. These benefits include perpetual life, limited liability of shareholders, liquidity of ownership through marketability of shares, growth through retention of earnings, and possibilities of intercorporate affiliations. In addition, corporations derive benefits from certain governmental services which may reduce corporate costs, expand markets, and facilitate financial transactions. Proponents of the corporate income tax believe that it is reasonable that corporations pay for such benefits through the tax. However, opponents argue that the general level of the corporate income tax paid is too high for the benefits received. Moreover, individual corporations receive similar benefits from their status but pay different amounts of taxes. To the extent the tax is for services provided by government, a general business tax or value-added tax would more closely relate to the cost of services that are provided.

A practical justification for the corporate income tax is that it safeguards the individual income tax. If the corporate income tax were abolished, retained earnings would no longer be taxed and individuals could simply leave their wealth within corporations where it would be sheltered from taxes until it was withdrawn. There have been proposals to "integrate" the individual and corporate income taxes to make the income tax more efficient and equitable. However, these proposals have not been adopted on either the federal or state level and would involve substantial administrative problems if enacted.

A final justification for the corporate income tax is that it is a major source of revenue for the federal and state governments. Critics contend that the corporate tax is used because it is politically easier to increase taxes on corporations than to increase taxes on individuals.

Current Wisconsin Corporate Income/Franchise Tax Law

Wisconsin has both a corporate income tax and a corporate franchise tax. The corporate franchise tax is imposed upon corporations for the privilege of doing business or exercising their franchise in the state in a corporate capacity. The corporate income tax is imposed upon corporations which are not subject to the franchise tax and own property in the state or if their business within the state consists of foreign commerce, interstate commerce, or both. The only difference between the corporate franchise and income taxes is that income from obligations of the U.S. government and its instrumentalities is subject to the franchise tax, but not the income tax. Typically, the corporate franchise tax is imposed on corporations subject to taxation in Wisconsin. Since both taxes are similar, they are jointly referred to as the corporate income tax in this paper.

In general, all corporations over which Wisconsin has taxing jurisdiction are subject to the corporate income tax. However, there are certain types of corporations that are specifically exempt. These include municipal corporations, nonprofit corporations or associations, except those subject to the unrelated business income tax, cooperatives, credit unions, most insurance companies (Wisconsin nonlife, nonmortgage guarantee companies and the nonlife insurance business of Wisconsin life insurance companies are not exempt), and banks under liquidation. In addition, small corporations which elect to be treated as tax-option corporations (Subchapter S corporations) have corporate net income attributed to their shareholders who are taxed under the individual income tax. Similarly, business enterprises such as sole proprietorships, partnerships, and limited liability companies that are treated as partnerships for federal income tax purposes are not subject to the state corporate income tax but, rather, the net income of the business is taxed under the individual income tax.

Jurisdictional Nexus

There are two circumstances which give Wisconsin taxing jurisdiction over corporations. First, corporations which are created and authorized to act in a corporate capacity (incorporated) under Wisconsin law or foreign corporations which are licensed to transact business in the state are subject to the Wisconsin corporate income tax. Such firms are subject to the corporate income tax whether or not they conduct business or own property in the state. However, even though a corporation is subject to the corporate income tax, it may not have a tax liability.

Second, corporations which are organized under the laws of other states or foreign nations are generally subject to the Wisconsin corporate income tax if they exercise a franchise, conduct business, or own property within the state. The Department of Revenue has promulgated administrative rules which describe, for non-Wisconsin firms, what type of business activities are needed to make such firms subject to the state's corporate income tax. Under the administrative rules, a non-Wisconsin (foreign) corporation is considered to have "nexus" with Wisconsin and be subject to taxation if it has one or more of the following "activities" in the state:

1. Maintenance of any business location in Wisconsin, including any kind of office.

2. Ownership of real estate in Wisconsin.

3. Ownership of a stock of goods in a public warehouse or on consignment in Wisconsin.

4. Ownership of a stock of goods in the hands of a distributor or other nonemployee representative in Wisconsin, if used to fill orders for the owner's account.

5. Usual or frequent activity in Wisconsin by employees or representatives soliciting orders with authority to accept them.

6. Usual or frequent activity in Wisconsin by employees or representatives engaged in purchasing activity or in the performance of services, including construction, installation, assembly, or repair of equipment.

7. Operation of mobile stores in Wisconsin, such as trucks with driver-salespersons, regardless of frequency.

8. Miscellaneous other activities by employees or representatives in Wisconsin such as credit investigations, collection of delinquent accounts, conducting training classes or seminars for customer personnel in the operation, repair, and maintenance of the taxpayer's products.

9. Leasing of tangible property and licensing of intangible rights for use in Wisconsin.

10. The sale of other than tangible personal property such as real estate, services, and intangibles in Wisconsin.

11. The performance of construction contracts and personal services contracts in Wisconsin.

An out-of-state corporation is not considered to have "nexus" with Wisconsin and is not subject to the corporate income tax if: (a) the corporation stores tangible personal property, such as inventory or a stock of goods, in or on property in the state that is not owned by the corporation and the tangible personal property is delivered to another corporation in the state for manufacturing, fabricating, processing, or printing in the state; (b) the corporation stores, in or on property not owned by the corporation, finished goods that have been fabricated, processed, manufactured, or printed in the state and the entire amount of such goods is shipped or delivered out-of-state by another corporation in the state; or (c) the corporation is an out-of-state publisher which has finished publications printed and stored in this state in or on property not owned by the publisher whether or not the finished publications are subsequently sold or delivered in this state or shipped outside of it.

In addition, 1999 Wisconsin Act 9 (the 1999-01 biennial budget) included a provision specifying that an out-of-state corporation does not have nexus with Wisconsin and is not subject to the state corporate income/franchise tax if each of the following conditions are met

1. The out-of-state corporation stores tangible personal property in the state on property not owned by the corporation;

2. The tangible personal property is stored

for 90 days or less;

3. The tangible personal property is stored on another person's property in the state and is transferred to the person for manufacturing, processing, fabricating, or printing on the parcel of property in or on which it is stored; and

4. The value of the parcel of property in or on which the tangible personal property is stored and manufactured was between $10 million and $11 million on January 1, 1999.

Federal Restrictions on State Taxation of Corporations

Federal restrictions on state taxing powers are contained in the U.S. Constitution. The states have the power to levy taxes in accordance with their own laws, subject to the restrictions imposed principally by the due process clause of the 14th Amendment and the commerce clause. Under the due process clause, a minimal connection must exist between a corporation's activities and the taxing state and the income attributed to the state for tax purposes must be rationally related to income-generating activities within the taxing state. Under the commerce clause, a state is prohibited from adopting a taxation scheme which discriminates against, or places undue burden on, interstate commerce.

In 1959 the U.S. Congress enacted Public Law 86-272, which provides that a state may not impose its income tax upon a corporation which is organized under the laws of other states and which sells tangible personal property if the corporation's only activities in the state are:

1. Solicitation, by employees, of orders for tangible personal property which are sent out-of-state for approval or rejection. (The orders must be filled from a delivery point outside the state.)

2. Solicitation of sales by nonemployee independent contractors conducted through their own offices or businesses located in the state.

Public Law 86-272 does not apply to corporations which are organized (incorporated) under the laws of the taxing state or a foreign nation. The law also does not apply to corporations which sell services, real property, or intangible personal property in more than one state.

Procedure for Determining Net Corporate Tax Liability

The first step in computing corporate taxes is to determine gross (or total) income. With certain adjustments, Wisconsin uses the federal definition of income as the base for state corporate tax computation purposes. Once gross income is determined, the corporation then subtracts allowable deductions from the total amount. Allowable deductions are also based on federal definitions and include: compensation paid to corporate officers; wages, bonuses and other remuneration; the cost of repairs and maintenance; bad debts and other losses; rent paid on property used to produce net income; certain taxes; interest paid; depletion and amortization; depreciation; advertising; contributions to pensions, profit sharing, and employee benefit plans; charitable contributions; certain dividend income; and certain other expenses.

When allowable deductions are subtracted from total income, the net income of the corporation has been determined. The next step is to subtract total nonapportionable income from net income. Nonapportionable income includes nonbusiness income or loss from rentals or royalties from real estate located outside the state, nonbusiness income from the sale of such property, and certain intangible investment income from nonunitary subsidiaries.

By subtracting total nonapportionable income from net income, the corporation has determined its apportionable income. If the firm is a multijurisdictional firm, it applies its Wisconsin apportionment ratio to apportionable income to arrive at income apportioned to Wisconsin. A multijurisdictional firm next adds income that is allocated to Wisconsin. If the firm is a 100% Wisconsin corporation, no apportionment ratio is applied, since 100% of its income is taxable to Wisconsin. Both multijurisdictional and 100% Wisconsin corporations then subtract any business losses carried forward. (Wisconsin law allows business losses to be carried forward for a period of fifteen years.) The result is Wisconsin net taxable income.

The tax rate of 7.9% is applied to Wisconsin net taxable income to determine gross tax. Finally, to arrive at net tax liability, allowable credits are subtracted. Corporate income tax credits are allowed for Wisconsin sales taxes paid on fuel and electricity used in manufacturing, qualified capital and noncapital research expenses, contributions to the Wisconsin Housing and Economic Development Authority, certain expenses to rehabilitate historical structures, and for certain activities in development, enterprise development, development opportunity, agricultural development, and technology zones. In addition, eligible corporations can claim the farmland preservation and farmland tax relief credits.

Figure I provides an illustration of how, in general, the net tax liability of a multijurisdictional corporation is computed.

Components Used to Determine Corporate Income Tax Liability

In general, state definitions of income and deductions are referenced to federal law. As a result, the Wisconsin corporate tax is determined using federal provisions to determine income and deductions and then apportioning the net income of a multistate corporation, applying the tax rate, and allowing for any credits. Under current Wisconsin corporate income tax law, each separate corporation, including a member of an affiliated group of corporations, is taxed as a separate entity. Each individual corporation reports its own income, its own deductions, and its own net tax due.

Total Income

Gross business income is income that is generated by a taxpayer in the active conduct of a trade or business. For tax purposes, each corporation first calculates federal total income which includes gross profit, dividends, interest, rents, royalties, capital gains or losses, and other income.

Gross business income equals the net amount realized from sales (gross receipts less sales returns and allowances) minus the cost of goods sold plus incidental and other types of business income. Incidental and other miscellaneous types of business income include items such as income from scrap sales, bartering transactions, recovered bad debts, and interest on notes and accounts receivable.

Cost of goods sold is an adjustment made to gross receipts or sales to arrive at gross profit. The adjustment measures the cost of producing inventory or the cost of producing or acquiring property or merchandise for sale or resale. In general, the cost of goods sold is determined by adding related purchases and costs to the value of inventory at the beginning of the year and subtracting the value of inventory at the year's end.

The dollar value of inventory is determined by an inventory method that consists of two elements: (a) identification of the goods included in inventory; and (b) assignment of cost or other value to the goods identified as belonging to inventory.

FIGURE I

Computation of Wisconsin Net Tax Liability for a Multijurisdictional Corporation

1. Determine Total Income

   a. Gross Sales - Cost of Goods Sold = Gross Profit
   b. Gross Profit + Other Income or Loss (Dividends, Interest, etc.) = Total Income

2. Determine Apportionable Income

   a. Total Income - Deductions (Wages, Depreciation, Interest Paid, etc.) = Net Income
   b. Net Income - Total Nonapportionable Income = Total Apportionable Income

3. Determine Wisconsin Net Income

   a. Apportionment Percentage =

$$\left[\left[\frac{\text{Property in WI}}{\text{Total Property}}\right] + \left[\frac{\text{Payroll in WI}}{\text{Total Payroll}}\right] + 2\left[\frac{\text{Sales by WI Destination}}{\text{Total Sales}}\right]\right] \div 4$$

   b. Total Apportionable Income x Wisconsin Apportionment Ratio = Income Apportioned to Wisconsin
   c. Apportioned Income + Income Allocated to Wisconsin - Wisconsin Net Business Loss = Wisconsin Net Income

4. Determine Wisconsin Net Tax

   a. Wisconsin Net Income x 7.9% = Gross Tax
   b. Gross Tax - Tax Credits (Sales Tax on Fuel and Electricity, Noncapital and Capital Research Expenditures, etc.) = Wisconsin Net Tax

The most common, acceptable methods for identifying units included in closing inventory consist of the following methods: (a) actual cost or specific identification; (b) byproduct and allocated costs; (c) first-in first-out [FIFO]; (d) last-in first-out [LIFO]; (e) perpetual inventories; (f) process costs; and (g) specific methods applicable to securities dealers and farmers and livestock raisers.

Specific identification of the items in inventory is usually considered the most accurate and acceptable method of determining the business' ending inventory. The LIFO method is also an acceptable method. Under this method, the last goods that have been acquired or produced are treated as the first to be sold. Whenever specific identification is not possible and the LIFO method has not been elected, the taxpayer may use the FIFO method of identifying inventory. Under this method, items in ending inventory are considered to be those that were most recently purchased or produced.

Generally, if property included in inventory consists of property produced by the taxpayer or property acquired for resale, federal uniform capitalization rules must be used to value the inventory. The uniform capitalization rules require that taxpayers allocate specified direct and indirect costs to inventories. However, taxpayers whose average annual gross receipts for the preceding three tax years do not exceed $10 million are not required to apply uniform capitalization rules to personal property acquired for resale. Such taxpayers use federal rules to value inventory at cost. For these taxpayers, the cost of goods purchased during the year is ordinarily their invoice price less trade or other discounts plus freight, delivery, and other necessary costs of acquiring possession. Also, specific methods of valuation are authorized for certain securities and commodities dealers, farming businesses, and foreign taxpayers.

Under federal uniform capitalization provisions, producers and sellers are required to capitalize all direct costs and certain indirect costs properly allocable to property that is produced or to property that is acquired for resale. This means that certain expenses that are incurred during the year must be included in the basis of the property that is produced or acquired in inventory costs rather than be claimed as a current deduction. The expenses are recovered through depreciation, amortization, or calculation of cost of goods sold as the property is used, sold, or disposed of in some manner.

Resellers are required to capitalize the direct acquisition costs of property acquired for resale. Cost means the invoice price minus trade and other discounts.

Producers are required to capitalize direct material costs and direct labor costs. Direct material costs include the cost of those materials that become an integral part of the asset plus the cost of materials that are used in the ordinary course of the production of the asset. Direct labor costs include the cost of labor that can be identified or associated with particular units or groups of units of specific property produced. This includes all types of compensation (basic, overtime, sick, vacation) plus payroll taxes and payments to an unemployment benefit plan.

Indirect costs that directly benefit or are incurred by reason of a production or resale activity must be capitalized. Costs that benefit production or resale activities and other operations must be reasonably allocated to each related production or resale activity. Capitalized indirect costs include: officer's compensation; pension and other related expenses; employee benefit expenses; purchasing costs; handling costs; storage costs; rent; taxes; insurance; utilities; repairs and maintenance; and other similar expenses.

Businesses do not have to determine cost of goods sold if the sale of merchandise is not an income-producing factor for their business. In these instances, gross profits are the same as net receipts. Most businesses and professions that sell services rather than products can figure profits in this manner.

Total income also includes income other than that generated from the sales of goods and services. The amount of a distribution representing a dividend is included in total income, subject to dividends received deductions for corporate recipients. A dividend is defined as any distribution made by a corporation out of its earnings or profits to its shareholders, whether in money or in property. Generally, all interest received or credited to the taxpayer is includable in gross income. (For federal income tax purposes, interest on U.S. obligations is defined as income but interest on state and local obligations is excluded. However, interest on state and local obligations is taxable under the Wisconsin franchise tax. Also, with limited exceptions, state and local interest is taxable under the state corporate income tax.) Profit from the sale or exchange of property is taxable income. Such profits are taxable if they are treated either as ordinary income or capital gains. Rent received from property is income. Royalties are also included in income. Finally, other types of business income such as recoveries of bad debt adjustments due to a change in accounting, refunds of taxes deducted in prior years, and recapture of certain previously-claimed deductions are included in gross income.

Deductions

Deductions are subtractions made from gross income in arriving at net or taxable income. In part, deductions are based on the proposition that certain components of income are not available for the taxpayer's own free use. For example, taxes are viewed as involuntary reductions in the amount of available income. In addition, deductions can affect taxpayer behavior and are sometimes used as incentives to encourage certain types of activities. Accelerated methods of depreciation are designed, in part, to encourage capital investment. Since the corporate income tax is a tax on business, many of the deductions allowed are, in general, related to the expenses incurred in operating a business. In order to be deductible as a business expense, an expense must be an ordinary and necessary expense of the taxpayer's trade or business paid or incurred during the taxable year in which it is deducted and connected with the trade or business conducted by the taxpayer. The general categories of deductions under the corporate income tax are the following (state modifications to these general categories are described in a succeeding section):

1. Compensation of Officers. Salaries, wages, and other forms of remuneration to officers of the business are deductible expenses. However, a publicly-held corporation cannot deduct compensation (remuneration) in excess of $1 million per tax year that is paid or accrued to certain executives. A publicly-held corporation is any corporation that issues a class of securities required to be registered under the federal Securities Exchange Act of 1934. Generally, this includes a corporation with its securities listed on a national securities exchange or which has $5 million or more of assets and 500 or more shareholders. The limitation applies to compensation to the chief executive officer (CEO) or any of the four highest compensated officers for that year other than the CEO. Compensation (remuneration) subject to the limitation includes cash and noncash benefits paid for services except for certain specified types of remuneration. The $1 million limit on deductible compensation is reduced by the amount of excess golden parachute payments that are not deductible under the provisions of the Internal Revenue Code (IRC).

2. Salaries and Wages. A deduction is provided for a reasonable salary allowance or other compensation for services actually rendered by employees. The form of compensation payment--

fixed salary, percentage of gross or net income, commissions, bonuses, contributions to pensions or profit sharing plans--is not controlling as to deductibility. To be deductible, the compensation must be: (a) an ordinary and necessary expense; (b) reasonable in amount; (c) based on actual services rendered; and (d) actually paid or incurred.

3. Repairs. A deduction is allowed for the cost of incidental repairs and maintenance, such as labor and supplies, that do not add materially to the value of property or appreciably prolong its life but rather keep the property in ordinarily efficient operating condition.

4. Taxes. A tax is defined as an exaction by a government, imposed by some rule of apportionment according to which the persons or property taxed share a public burden. To qualify for the deduction, the expense must be a tax imposed by a government that is paid into the government treasury for public purposes. Charges for specific services or special purposes (user fees) are often not considered taxes and are not deductible as such. However, these charges might be deductible under another provision--for example, as business expenses.

Under federal law, a deduction is allowed for the following types of taxes generally for the year in which they are incurred or paid: (a) one-half of the federal self-employment tax; (b) state, local, and foreign real property taxes; (c) state and local personal property taxes; (d) state, local, and foreign income, war profits, and excess profits taxes; (e) the generation-skipping transfer tax imposed on income distributions; and (f) the federal environmental tax. In addition, any state, local, and foreign taxes paid or accrued in carrying on a trade or business or in connection with the production of income (such as sales taxes on production inputs) are deductible.

Taxes which are not deductible under federal law include: (a) federal income taxes; (b) foreign income taxes if the foreign tax credit is claimed; (c) taxes not imposed on the corporation; and (d) taxes, including state or local sales taxes, that are paid or incurred with an acquisition or disposition of property. (These taxes must be treated as a part of the cost of the acquired property or, in the case of a disposition, as a reduction in the amount realized on the disposition.)

Under the Wisconsin corporate income and franchise tax, the following taxes, which are deductible under the federal corporate income tax, are not deductible: (a) state and local income and franchise taxes that are value-added taxes, single business taxes, or taxes on or measured by net income, gross income, gross receipts, or capital stock; (b) the federal environmental and windfall profits taxes; and (c) the state recycling surcharge. (Wisconsin gross receipts utility taxes and net proceeds taxes on metallic mineral mining taxes are deductible for state corporate income and franchise tax purposes.) Foreign taxes are deductible only if the income on which the foreign taxes are based is taxable under the state corporate income and franchise tax.

5. Interest. A deduction is allowed for interest on indebtedness incurred in the operation of a trade or business. Interest is defined as compensation for the use or forbearance of money. Only interest on actual indebtedness is deductible. There must be both a legal and an economic obligation for the debt.

In most cases, the time when interest is deducted is determined by the taxpayer's method of accounting. Generally, the interest is deductible when it accrues or is paid in accordance with the interest provisions of the loan. However, in certain cases, interest must be accounted for using specific rules. For example, this occurs when the loan agreement (debt instrument) provides an inadequate stated rate of interest or when the debt instrument is issued for an amount that is less than the redemption price at maturity (original issue discount--OID). In addition, interest expense on debt incurred to finance the construction or manufacture of certain long-life capital assets or assets that have a long production period is not deductible, but must be capitalized and recovered through an adjustment to basis, depreciation, amortization, or other method. Certain other carrying charges relating to futures contract straddles and other property are also capitalized rather than deducted. Interest expense on debts incurred to purchase or carry tax-exempt securities is not deductible. Finally, certain limitations apply to interest deductions when a corporation is a policyholder or beneficiary of a life insurance, endowment, or annuity contract.

6. Charitable Contributions. Ordinarily, a corporation can claim a limited deduction for charitable contributions made in cash or property to or, for the benefit of, a qualified organization. However, payments made to a charitable organization that are determined to be business expenses are deducible without regard to the percentage limits imposed on charitable contributions. To be a business expense, the payments must bear a direct relationship to the taxpayer's business and are made with a reasonable expectation of a financial return commensurable with the amount of the donation. If the payments made by the business are in fact charitable contributions (made with a charitable intent) they may not be deducted as business expenses. Instead, they are subject to percentage limitations. The total amount of the deduction claimed may not be more than 10% of taxable income. Charitable contributions in excess of the 10% limitation may not be deducted for the tax year but may be carried over and used to offset income for the next five years, subject to the 10% limit. Special rules govern contributions of certain property to charitable organizations.

7. Depreciation. 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. Depreciable property may be either tangible or intangible and either real or personal property. Land is not depreciable. To be depreciable, the property must have a determinable life of more than one year and it must decline in value through use or the passage of time. Only property used in a trade or business or held for the production of income is eligible for a depreciation deduction. Depreciation may not be claimed on assets used in connection with a not-for-profit activity. No deduction is allowed for property used for personal purposes.

For tangible assets, depreciation applies to only that part of the property that is subject to wear and tear, to decay or decline from natural causes, or to exhaustion and obsolescence. The property must also be of a relatively permanent nature with a determinable useful life of over one year.

Intangible assets may be depreciated or amortized if it is known from experience or other factors that the assets will be of use in the business or in the production of income for only a limited period of time and if that time period can be estimated with reasonable accuracy. Certain patents, copyrights, and franchise agreements are examples of depreciable intangibles. Intangible assets cannot be depreciated under an accelerated method but, rather, must be depreciated using a reasonable method, usually the straight-line method. However, under provisions enacted in the federal Revenue Reconciliation Act of 1993, the cost of many intangibles can be amortized over 15 years.

In order to claim depreciation on any property, the taxpayer must have a capital interest in it. Generally, the owner of the depreciable property may claim the deduction. However, the right to deduct depreciation is not predicated solely upon ownership of the legal title, but also upon investment in the property.

The amount to be recovered by depreciation is the cost or other appropriate basis of the property.

The life over which the depreciable basis of property is recovered depends upon the type of asset that is depreciated and the system of depreciation that is used.

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.

Under the general depreciation rules, three particular methods of depreciation are generally authorized:

(a) *The straight-line method.* The straight-line method involves writing off the cost or other applicable basis of the property in equal annual amounts over the established life of the property.

(b) *The declining-balance method.* Under declining-balance methods, depreciation is greatest in the first year and smaller in each succeeding year. Each year, the depreciable basis of the property is reduced by a certain amount and the associated rate of depreciation is applied to the resulting balance in each of the remaining years of the property's life. For example, under the 200% or double declining-balance method, assets are depreciated at twice the straight-line rate. Generally, the taxpayer is allowed to switch to the straight-line method when it becomes advantageous.

(c) *Sum-of-the-years-digits method.* To use this method, the taxpayer must first compute the sum of each of the digits comprising the asset's life. For example, for an asset with a depreciable life of four years, the numbers 4, 3, 2, and 1 are summed to a total of 10. In the first year, 4/10ths of the depreciable basis is written off. In succeeding years, 3/10ths, 2/10ths and 1/10th of the depreciable basis respectively is written off until the entire basis of the asset, minus salvage value, is recovered.

An asset cannot be depreciated below salvage value under a method of depreciation other than ACRS or MACRS. Once this amount has been reached, no more depreciation may be claimed.

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, and before September 11, 2004.

Generally, changes in federal tax law concerning depreciation were effective for Wisconsin corporate income 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 corporate income 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 through tax year 2000. Following enactment of the bonus depreciation provisions in the federal Job Creation and Worker Assistance Act of 2002, the Legislature included provisions in 2001 Wisconsin Act 109 (the 2001-03 budget reform bill), that referenced state amortization and depreciation provisions to the federal IRC in effect on December 31, 2000. Consequently, the federal bonus depreciation provisions were not adopted for state 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 the MACRS. MACRS consists of two systems that determine how a taxpayer depreciates property. The most commonly used system is called the General Depreciation System (GDS). There is also an Alternative Depreciation System (ADS) which must be used for certain types of property such as property used predominately outside the U.S. In addition, taxpayers can elect to use ADS. The main difference between the two systems is that ADS usually provides for a longer period of depreciation and uses only the straight-line method. 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.

Under MACRS, the cost of property is recovered by using accelerated methods of cost recovery and statutory recovery periods and conventions. The deduction is computed by first determining the MACRS basis of the property. Each item of eligible property is then assigned to a specific class and each class establishes a recovery period over which the cost of the property is recouped using the applicable depreciation method and convention. Depreciation tables may be used by multiplying the basis of the assets by the applicable percentage for the applicable year of the recovery period. Alternatively, the deduction can be calculated using the appropriate method, recovery period, and convention. Deductions can be claimed for used property, and the cost recovery methods and periods are the same as those used to depreciate new property.

Specifically, the cost of eligible property is recovered over a 3-, 5-, 7-, 10-, 15-, 20-, 27.5-, 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 ten-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. (Agricultural property used in farming and placed in service after 1988 must be depreciated using the 150% declining balance method.) Property included 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. Fifteen-year property includes municipal waste treatment plants and certain types of telecommunications plant and equipment. Twenty-year property includes municipal sewers. Residential rental property is depreciated over 27.5 years, while nonresidential real property not included in other classes is depreciated over 39 years using the straight-line method. Certain railroad property is depreciated using the straight-line method over 50 years.

8. Amortization. The deduction for amortization is similar to the straight-line method of depreciation in that a taxpayer is allowed to recover certain capital costs through an annual deduction over a fixed period of time. Generally, the capital expenses which are amortized are deducted in equal monthly amounts over the amortization period. Expenses which may be amortized include: the cost of pollution control facilities; certain bond premiums; research and experimental expenditures; the cost of acquiring a lease; qualified forestation and reforestation costs; business start-up expenditures; and certain organizational expenditures.

In addition, the capitalized costs of "amortizable section 197 intangibles" can be amortized over 15 years. The following assets are section 197 intangibles: goodwill; going concern value; workforce in place; business information base; patents, copyrights, formulas, and similar items; customer-based intangibles; supplier-based intangibles; licenses, permits, and other government granted rights; covenants not to compete; and franchises, trademarks, and trade names.

9. Election to Expense Depreciable Assets. Under the IRC, for tax years 2003 and thereafter, 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.

10. Bad Debts. Only bonafide debts qualify for the deduction. A bonafide debt is debt that arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. A debt is considered bad when it is worthless. A debt is worthless when the creditor who has made a reasonable effort to collect the debt no longer has a chance to be repaid. Bad debts are characterized as business or nonbusiness debts, with each type of debt having its own rules for deductibility.

A bad debt is deductible as a business bad debt if the creation of the debt was proximately related to the taxpayer’s trade or business. In addition, the dominant motive for the creation of the debt must be to benefit the taxpayer’s trade or business. Generally, business bad debts are deducted using the specific charge-off method of computing the deduction. Under this method, the debt is deducted as it becomes wholly or partially worthless. The amount deductible for a bad debt loss is the taxpayer’s basis in the bad debt. Certain taxpayers may use the nonaccrual-experience method of accounting where the taxpayer does not accrue income expected to be uncollectible. In addition, small banks and thrift institutions can use the reserve method of deducting bad debts.

Nonbusiness debt is a debt other than: (a) a debt created or acquired in connection with the taxpayer’s trade or business; or (b) a loss from the worthlessness of a debt that is incurred in the taxpayer’s trade or business. Transactions not entered into for profit are treated as nonbusiness debts. If a nonbusiness debt becomes worthless, it is deductible only as a short-term capital loss, and only in the year the debt becomes totally worthless.

11. Rent. Rent expenses are deductible as business expenses if they are incurred as a condition to the continued use or possession of property used in a trade or business and the taxpayer has not taken or is not taking title or has no equity in the property. The amount of rent claimed can be a fixed sum or can be based upon a percentage of profits, a percentage of gross sales or a combination of these. A deduction is allowed where the amount of rent is fixed in an arm's-length transaction without a tax-avoidance motive. In general, rental expenses are deductible in the year they are accrued or paid. However, in certain cases, such as where advance payments are made by a cash-basis taxpayer, special rules for determining the deduction apply. (Royalties are deductible as business expenses under rules that are similar to those governing the deductibility of rent paid for business or income-producing purposes.)

12. Depletion. A deduction for depletion is allowed in determining the income from natural resources; it returns to the owner or operator (extractor) the capital investment on a pro rata basis over the productive life of such resources. Depletion is the exhaustion of natural resources by the process of mining, quarrying, drilling, and felling. The depletion deduction, in effect, represents the reduction in the content of the reserves from which the resource is taken. The taxpayer must have an economic interest (capital investment) in the mineral deposit or timber in order to claim the deduction.

Methods for computing depletion are cost depletion or percentage depletion. Although a taxpayer must use the depletion method that produces the greatest deduction each year, the allowance for percentage depletion has historically been preferred over cost depletion since percentage depletion may be claimed even though the total deductions exceed the cost basis of the resource.

Under the Wisconsin corporate income tax, taxpayers are not allowed to claim the depletion deduction using the percentage depletion method. Therefore, for state tax purposes, depletion is only deductible using the cost method of computing the deduction.

Cost depletion is first determined by estimating the number of units, such as tons or barrels, that make up the deposit. That part of the basis in the property that is allocable to the depletable reserves is then divided by the number of units. The quotient is the cost depletion per unit. This amount multiplied by the number of extracted units sold during the year determines the cost depletion deductible for the year. Each year the basis of the property is reduced by the amount of depletion deducted for that year. The remaining basis is used in computing cost depreciation for the following year.

13. Retirement Plans. Employer contributions to employee retirement plans can be deducted as a current business expense if certain plan-related conditions are met. Retirement plans are savings plans through which employers can set aside money for their employees' retirement.

The most common types of retirement plans include qualified plans, simplified employee pensions (SEP), savings incentive match plans for employees (SIMPLE), individual retirement arrangements (IRAs), and nonqualified plans.

<u>Qualified Plans</u>. The term qualified plan encompasses a wide variety of retirement plans that employers may establish for the benefit of their employees. A plan is qualified if it meets specific requirements concerning its formation, operation, and funding. Although all qualified plans must meet certain minimum standards, each type of plan may be required to satisfy its own unique set of requirements before the IRS recognizes it as qualified. Qualified plans provide the following tax benefits:

(a) a tax-free accumulation of earnings and gains on a plan's invested funds;

(b) a deduction for allowable employer contributions made under the plan;

(c) an exemption from current taxation for employees on the value of employer contributions;

(d) favorable tax treatment of fund distributions; and

(e) taxation of distributions can be further deferred if employees roll the distribution over into another type of qualified plan.

There are two basic types of qualified retirement plans that can be sponsored by an employer:

(a) *Defined Contribution Plans.* Defined contribution plans provide for a separate account for each participant and benefits are based solely on amounts contributed to or allocated to and accumulated in each account.

(b) *Defined Benefit Plans.* Defined benefit plans include any plans that are not defined contribution plans. The goal of the defined benefit plan is to provide a definitely determinable amount of benefits to an employee and it is the obligation of the employer to make the contributions that are necessary to ensure that the benefits can be paid.

From an employer's point of view, one of the more significant differences between defined contribution plans and defined benefit plans is in the restrictions on the amounts that can be contributed to each type of plan.

As noted, employer's contributions under a qualified retirement plan are deductible if they qualify as ordinary and necessary business expenses, are reasonable in amount, and meet specific limitations. No deduction may be claimed in excess of permitted contributions.

The employer's annual contribution to a defined benefit plan must be great enough to cover the total of normal costs (pension liabilities accruing from an employee's current service) of funding the plan plus amortization of unfunded past service costs (pension liability for an employee's service before the inception of the plan), increases in liabilities and expenses, losses minus amortization of decreases in pension liabilities and experience gains. The actuarial assumptions used to satisfy the minimum funding standards and to determine an employer's annual contributions to a defined benefit plan must be reasonable and represent the actuary's best estimate of anticipated plan experience.

The two principal variations of defined benefit plans are the pension plan and the annuity plan. A pension plan provides for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement.

Under federal law which governs qualified benefit plans, an annuity plan is a pension plan that is not funded through the use of a trust or a custodial account but through the employer's direct purchase of annuity contracts from an insurance company.

The maximum dollar limit on employer-derived annual benefits for an employee under a defined benefit plan is the lesser of: (a) an inflation-adjusted dollar amount ($160,000, subject to cost-of-living increases); or (b) 100% of the employee's average compensation for the highest three consecutive years during which the employee was an active participant in the plan. In some cases, such as certain collectively bargained plans, these limits may be waived. For plan years beginning after 2001, the maximum deduction for contributions can equal the plan's unfounded current liability.

Some of the major variations of defined contribution plans include profit-sharing, money purchase, stock bonus, and target benefit plans:

(a) *Profit-Sharing Plan.* A profit-sharing plan allows employees and their beneficiaries to share in the profits of the business.

(b) *Money Purchase Plan.* A money purchase plan is designed to provide employees or their beneficiaries with benefits that will be paid upon retirement or for a period of years after retirement.

(c) *Stock Bonus Plan.* A stock bonus plan provides benefits similar to those of a profit-sharing plan; however, benefits under the plan are payable in the form of the company's stock.

(d) *Target Benefit Plan.* A target benefit plan is a defined contribution plan under which the amount of employer contributions that are allocated to each participating employee is determined under a formula that does not allow employer discretion but is based on the amount necessary to provide a target benefit that is specified by the plan for each participant.

Generally, the annual amount that can be added to the account of a participant in a defined contribution plan is restricted to the lesser of: (a) $40,000, subject to cost-of-living increases; or (b) 100% of the employee's compensation up to a maximum of $200,000, subject to cost-of-living increases. These limits apply to the aggregate of employer contributions, employee contributions, and forfeitures. The maximum deduction for contributions to a defined contribution plan is 25% of the compensation paid or accrued during the year to employees participating in the plan.

<u>401(k) Plans.</u> A 401(k) plan is a form of qualified retirement plan, also called a cash or deferred arrangement (CODA), that is a special arrangement under which a participant can choose to have the employer contribute part of the employee's before-tax compensation to the plan rather than receive the compensation in cash. The contribution is called an elective deferral because participants choose to set aside the compensation and defer the tax on it until it is distributed to them. A 401(k) plan must satisfy the requirements imposed on other types of qualified plans. In addition, requirements related to employee elections, distributions, and vesting must be met. A 401(k) plan may be maintained as part of a profit-sharing or stock bonus plan and be a money purchase plan established before the date of the federal Employee Retirement Income Security Act (ERISA) (1974).

An annual limit is placed on the aggregate amount of money deferred to a plan by an employee. For 2003, the maximum amount that can be deferred is $12,000 and the amount will increase by $1,000 per year until it reaches $15,000 in 2006. After 2006, the amount will be subject to an inflation adjustment. In addition, for tax years beginning after December 31, 2001, employees age 50 or over may make catch-up contributions to their 401(k) plans. For 2003, the maximum catch-up contribution is $2,000 and it will increase by $1,000 per year until it reaches a maximum of $5,000 in 2006. After 2006, the maximum amount is subject to an inflation adjustment. Employers are not required to include catch-up provisions in their 401(k) plans.

As with other types of qualified retirement plans, employers can claim a current deduction for their allowable contributions to 401(k) retirement plans. The deduction is subject to the limit imposed for contributions to qualified defined contribution plans, which is 25% of the annual compensation paid or accrued to employees participating in the plan.

<u>Savings Incentive Match Plan for Employees (SIMPLE).</u> A savings incentive match plan for employees (SIMPLE) is a written arrangement that provides employers and employees with a simplified way to make contributions to provide

retirement income. SIMPLE plans are designed to encourage small employers to establish retirement plans for their employees. The incentive is exclusion from the requirements applicable to qualified plans and exclusion from the requirements of ERISA. Rather, a SIMPLE plan substitutes a few rules for all the requirements generally applicable to retirement plans under ERISA and the IRC.

An employer can establish a SIMPLE plan only if it has no other retirement plan and had 100 or fewer employees who received $5,000 or more in compensation in the preceding year. A SIMPLE account must include an arrangement under which each eligible employee may elect to have the employer make payments either: (a) directly to the employee in cash; or (b) as a contribution on behalf of the employee to the SIMPLE account (elective contribution). Elective contributions are limited to $8,000 in 2003 and will increase $1,000 each year until reaching $10,000 in 2005. After 2005, the dollar limit is subject to an annual inflation adjustment. For tax years beginning after 2001, a SIMPLE plan can permit participants who are age 50 or older to make catch-up contributions. The maximum catch-up contribution for 2003 is $1,000 and the amount increases $500 per year until it reaches $2,500 for 2006. The $2,500 amount is subject to inflation adjustments in future years.

Generally, the employer is required to match the elective contribution of an employee but the amount of matching contribution cannot exceed 3% of the employee's compensation. However, an employer, upon notification of the employees, can elect to contribute for all employees a smaller percentage, but not less than 1%, of compensation. An employer can meet the matching requirement if it chooses to make nonelective contributions of 2% of compensation for each eligible employee. The compensation taken into account in determining the 2% nonelective contributions cannot exceed $200,000. Again, employees must be notified by the employer of this election. The employer may claim a deduction for its contributions to a SIMPLE, including elective contributions made under a salary reduction arrangement.

<u>Simplified Employee Pensions (SEPs)</u>. Simplified employee pensions (SEPs) are used primarily by self-employed individuals who do not want to become involved with the more complex requirements associated with Keogh plans, but want to contribute and deduct more than the amounts permitted for individual retirement accounts. For the same reasons, corporations may opt to use SEPs as the retirement vehicle for their employees instead of more traditional types of qualified retirement plans.

Under an SEP, an employer can make deductible contributions to a traditional retirement arrangement (called a SEP-IRA) established for each eligible employee. Each year the employer must contribute to the IRA of each employee who: (a) is age 21 or older; (b) has performed services for the employer during at least three of the immediately preceding five calendar years; and (c) has received at least $450 in compensation for the year. Annually, an employer may contribute to and deduct for each participating employee's SEP the lesser of 25% of compensation up to $200,000 or $40,000. Employees may make independent contributions and claim a deduction subject to the limitations imposed by the rules that apply to traditional IRAs.

<u>Nonqualified Retirement Plans.</u> A nonqualified retirement plan is a retirement plan or other type of deferred compensation plan that does not meet the requirements imposed on such plans by the Internal Revenue Code. By establishing a nonqualified plan, an employer loses many tax advantages associated with qualified plans. However, it gains some advantages by offering a plan that need not follow the requirements associated with qualified plans. Chief among these advantages is the fact that participation in the nonqualified plan can be offered to a few, select employees. As a general rule, non-

qualified plans are offered as a means of attracting and retaining the services of key employees. Usually, the nonqualified plan serves as an adjunct to a qualified plan.

Establishment of a nonqualified deferred compensation arrangement consists of two main steps: (a) entering into a contractual arrangement between the employer and employee; and (b) adoption of a nonqualified plan by the employer.

The usual practice is for the employer and employee to formalize the fact that the employee is covered by a nonqualified plan by entering into a written contractual arrangement. The contract provides such plan details as whether the plan will be funded or unfunded, when distributions may be made, what the employee's rights to plan assets are, and the employer's and employee's obligations under the plan. While some nonqualified plans are based upon nothing more than a handshake, a written arrangement is preferred because it protects the interests of both employer and employee.

Many types of nonqualified plans may assist the employer in the development of a comprehensive, or alternate compensation package. Among the nonqualified plans that an employer may offer are:

(a) *Excess Benefit Plan*. These plans provide the employee with benefits that are in excess of those allowed under qualified arrangements.

(b) *Deferred Bonus Plan*. This type of plan usually provides that a bonus for a particular year will be paid out over a number of annual installments. Payments may also be deferred until after retirement, when presumably the individual will be in a lower tax bracket.

(c) *Vested Trusts*. Vested trusts are a type of unfunded deferred compensation trust in which the employee has no right to funds until the occurrence of a specified event (for example, termination, retirement, takeover). It is the occurrence of this event that "vests" the employee.

(d) *Rabbi Trusts*. Under this arrangement, the employer contributes to a irrevocable trust for the benefit of the covered employee. If properly structured, the employee will not be currently taxed on the contributions. For example, fund assets must be subject to the claims of the employer's creditors.

A nonqualified plan may either be funded or unfunded. If the plan is funded, the employer makes current contributions to the plan. If the plan is unfunded, the arrangement between employer and employee involves only the unsecured promise of the employer to pay an amount at some future time.

Contributions made to nonqualified retirement plans are deductible under different rules than qualified retirement plans. In general, to be deductible, contributions to nonqualified plans must be ordinary and necessary expenses of a business or other activity engaged in for the production of income. However, the method of claiming the deduction depends upon whether the nonqualified plan is funded or unfunded.

Generally, a funded nonqualified plan is one under which the deferred compensation is irrevocably contributed by the employer to a separate fund.

When a plan is funded, the employer is allowed to claim a deduction for a contribution to the plan in the year in which an employee's interest in the plan is includible in gross income. The amount of the deduction that may be claimed by the employer is the amount of the original contribution. Any investment gain occurring between the time of contribution to the plan and the vesting in the employee accrues to the employee. The employer is not entitled to a deduction for investment gain vesting in or distributed to the employee.

Ordinarily, an employer's contribution to a nonqualified deferred compensation plan is includible in the employee's gross income and, therefore, is deductible by the employer when the employee's interest in the plan becomes substantially vested. A contribution is substantially vested when it is free from a substantial risk of forfeiture or is transferable to any transferee without substantial risk of forfeiture.

The deduction is allowed when the employee's interest is vested, which may occur before actual distribution. Deduction before distribution is not allowable under a multiple-participant plan, however, unless the plan maintains a separate account for each participant. Similar rules apply when a nonqualified plan is funded by annuity contracts. In cases where the interests of the covered employees in a nonqualified plan change from nonvested to vested during the life of the plan, the deductibility of employer contributions also reflect such changes.

Under an unfunded nonqualified plan, the covered employees often have nothing more than an unsecured promise of the employer to pay them the deferred compensation. Even if the deferred compensation is in fact set aside and invested, the plan is still treated as unfunded if the employees have no legal right to, or interest in, the resulting fund.

If a plan is not funded, the employer is allowed a deduction only when the deferred compensation is actually paid or made available to the employee. This is so whether the employer uses a cash or an accrual method of accounting. The full amount of the deferred compensation is deductible, subject to the requirement of reasonableness.

In some unfunded plans, the employer may credit employees with "interest" on deferred compensation. Such interest is not deductible until includible in the employee's income.

14. Employee Benefit Programs. A deduction is allowed for contributions to employee benefit plans not claimed as a deduction elsewhere on the tax return and that are not an incidental part of a pension, profit-sharing, or similar type of retirement plan. For example, a deduction can be claimed for employer contributions to accident and health plans, educational assistance plans, prepaid legal service plans, cafeteria plans, dependent care assistance plans, and premiums on various types of insurance policies covering employees.

(a) *Accident and Health Plans.* Contributions to accident and health plans to provide health or disability benefits (through insurance or otherwise) for employees are deductible as business expenses.

(b) *Educational Assistance Plans.* Contributions to educational assistance plans which provide payments to employees for qualified educational expenses can be deducted. Generally, an educational assistance plan can cover tuition, fees, and the cost of books, supplies and tools, and the courses need not be job-related.

(c) *Prepaid Legal Service Plans.* Employer contributions to a qualified group legal services plan are deductible as business expenses.

(d) *Payments on Insurance Contracts.* Group hospitalization, medical insurance, worker's compensation insurance, unemployment insurance/compensation contribution payments, and life insurance premiums paid by an employer to purchase and maintain policies covering employees and their families are deductible by the employer.

(e) *Dependent Care Assistance.* Employer contributions to plans which provide employees with child and dependent care are deductible business expenses.

(f) *Cafeteria Plans.* Employer contributions under a written cafeteria plan are deductible business expenses. A cafeteria plan is a written benefit plan that allows the employee to choose among two or more benefits consisting of cash and statutory nontaxable benefits. Qualified benefits can include accident and health benefits, adoption assistance, dependent care assistance, and group term life insurance. A plan that provides for deferred compensation generally is not a cafeteria plan.

(g) Employee Stock Options. A stock option is an agreement on the part of the corporation to sell a given number of shares of its stock at a given price (the option price) to an employee within a specified period of time. The decision to exercise the option and buy the shares is left entirely to the employee in most cases. Two primary types of employee stock options plans are incentive stock options and employee stock purchase plans. An incentive stock option is usually designed to give key employees an opportunity to acquire stock at a bargain price without incurring a tax liability until the shares are sold. An employee stock purchase plan is similar to an incentive stock option in that employees are given an option to buy the employer's shares at a price that may be below market when the option is exercised. Employee stock purchase plans are different than incentive stock options in that the plan may not discriminate among employees and are therefore aimed primarily at rank and file employees.

In general, a transfer of stock through an employee stock option plan is not a taxable event. No income is received by the employee when the employee exercises the option and receives the stock. The employee will not be taxed until the stock acquired under the option is sold or exchanged. Also, when stock is transferred pursuant to an option, the employer corporation may not take a business deduction with respect to the transfer, and no amount other than the price paid under the option may be considered as received by the corporation for the stock transferred.

15. Advertising. Advertising expenses that are reasonable in amount and related to the business activities in which the taxpayer is engaged are deductible. Advertising expenses which are used to develop goodwill rather than to obtain immediate sales are deductible. Expenses for indirect advertising such as the promotional costs in sponsoring an amateur basketball team are also deductible. The taxpayer is free to choose the advertising that best serves the taxpayer's purpose; however, the burden of proving the deductibility of advertising expenses is on the taxpayer.

16. Other Deductions. Ordinary and necessary business expenses related to the operation of a trade or business and not deducted elsewhere can be deducted under a general miscellaneous category. Deductible business expenses include: 50% of business meal and entertainment expenses; certain limited lobbying expenditures; the cost of materials and supplies used in business operations; membership payments to business associations; and the cost of professional books, subscriptions, and dues to professional societies.

State Adjustments to Federal Provisions

Although state income and deductions are primarily referenced to federal law, there are a number of modifications that must be made to reflect differences in the state treatment of certain items. The state modifications made to federal definitions include the following:

1. Income received by an original policy holder or original certificate holder from the sale of a life insurance policy or certificate, or the sale of the death benefit under a life insurance policy or certificate under a viatical settlement contract is excluded from gross income. A viatical settlement contract is a written agreement providing for the payment to the policyholder of a life insurance policy, or to the certificate holder of a group life insurance certificate, insuring the life of a person who has a catastrophic or life-threatening illness or con-

dition, in an amount that is less than the expected death benefit under the policy or certificate, for assigning, selling, devising, or otherwise transferring the ownership of or the death benefit under the policy or certificate to the person paying the viatical settlement.

2. The federal gross-up of dividends to reflect taxes claimed in computing the foreign tax credit is excluded in computing income.

3. Corporations subject to the state corporate franchise tax must add to income all interest income not included in federal taxable income under the federal corporate income tax. Also, corporations subject to the state corporate income tax must add to income all interest income not included in federal taxable income except for interest income which by federal or state law is exempt from taxation. For corporations subject to franchise taxes, interest income from all state and local government bonds is included in the computation of Wisconsin net income. For corporations subject to the income tax, all interest income from state and local government bonds, except that which is exempt by federal law from state taxation, and interest from certain state and local obligations is included in the computation of Wisconsin net income. In addition, all interest income received by a bank or other corporation actively engaged in the business of lending money with respect to a securities acquisition loan, is includable in Wisconsin net income.

4. In certain specified circumstances where there is a nonrecognition of income from the discharge of indebtedness, the basis of assets or tax attributes, such as net operating losses, credits, and the depreciable and nondepreciable bases of assets, must be reduced in exchange for the income exclusion. In these cases, state net operating loss and credit provisions apply and the state basis of depreciable property or state tax attributes must be reduced. The reduction rate for credit carryforwards is 7.9%.

5. The federal deduction for wages, salaries, commissions, and bonuses can be claimed only if the name, address, and amount paid to each resident of Wisconsin to whom compensation of $600 or more has been paid during the taxable year is reported to the Department of Revenue or if the Department is satisfied that failure to report has resulted in no revenue loss to the state. Rent payments may be deducted only if the amount paid along with the names and addresses of the parties to whom the rent is paid is reported. Also, payments for salaries, wages, bonuses, interest, and other expenses paid to an entertainer or entertainment corporation may be deducted only if certain withholding and cash deposit or bond requirements are met.

6. The federal deduction for taxes paid is modified so that: (a) foreign taxes are not deductible unless the income on which the taxes are based is taxable; (b) state utility gross receipts and ad valorem taxes are deductible; and (c) the state net proceeds tax on mining of metallic minerals is deductible. Also, state taxes and the taxes of the District of Columbia that are value-added taxes, single business taxes, or taxes on, or measured by, all or a portion of net income, gross income, gross receipts, or capital stock are not deductible. The federal windfall profits and environmental taxes are not deductible.

7. The rules for federally taxable bonds also apply to bonds that are taxable under the state corporate income and franchise tax and the rules for federally tax-exempt bonds apply to bonds that are exempt from Wisconsin taxation. Therefore, if a bond is taxable for Wisconsin purposes, a taxpayer may deduct the amortizable bond premium for Wisconsin. If the bonds are not taxable for Wisconsin purposes, the amortizable bond premium is not deductible. Also, Wisconsin law conforms with federal provisions that require the basis of certain tax-exempt state and local bonds to be reduced by the amount of amortizable bond premium disallowed as a deduction so that it only

applies to bonds that are tax-exempt for Wisconsin.

8. State net operating loss provisions are substituted for federal law. Specifically, corporations may carry forward and offset against Wisconsin net business income, any Wisconsin net business loss sustained for up to 15 years after the year in which the loss is incurred. However, unlike federal law, losses cannot be carried back to offset income in prior tax years.

9. Instead of federal dividends received provisions, corporations may deduct all dividends received from a corporation with respect to its common stock if the corporation receiving the dividends owns, directly or indirectly, for its entire taxable year, at least 70% of the total combined voting stock of the payor corporation. The federal dividends paid deduction for certain preferred stock of public utilities is excluded from state law.

10. Federal provisions governing the treatment of expenses and interest relating to tax-exempt income are replaced by the state rule that amounts otherwise deductible that are directly or indirectly related to income that is wholly exempt from state tax is not deductible. Furthermore, amounts that are directly or indirectly related to losses from the sale of assets, gains from which would have been exempt under state law, are also not deductible. "Wholly exempt income" includes amounts received from affiliated or subsidiary corporations as interest, dividends, or capital gains that, because of the degree of common ownership, control, or management between the payor and payee, are not subject to the state corporate income tax. "Wholly exempt income" also includes interest on obligations of the U.S. government for corporations subject to the state corporate income tax rather than the state franchise tax. "Wholly exempt income" does not include income that is excludable, not recognized, exempt, or deductible under specific corporate income tax provisions.

11. Federal provisions governing treatment of losses, expenses, and interest in transactions between related taxpayers are modified so that, in circumstances where it is applicable, gains on the sale of transferred property may be reduced only if the corresponding loss was incurred while the corporation was subject to the Wisconsin corporate income tax.

12. Federal provisions which require the reduction in the amount deductible for certain tax preference items do not apply to deductions that are allocable to income that is taxable under the state corporate income or franchise tax.

13. Federal laws relating to the treatment of net operating loss carryforwards and excess credits in certain corporate acquisitions and limitations on the use of net operating loss carryforwards, certain credits, and capital losses in corporate acquisitions are modified so that Wisconsin net operating loss and credit provisions are substituted for federal items.

14. The federal deduction for qualified payments to nuclear power plant decommissioning reserve funds is allowed only if the fund is subject to the Wisconsin corporate income tax.

15. State provisions concerning the treatment of nonprofit institutions, political organizations, cooperatives, associations, and other tax-exempt organizations replace federal provisions except that state law includes federal definitions of the taxable unrelated business income of such organizations.

16. State law does not follow federal law regarding percentage depletion for certain natural resources. Corporations must use cost depletion in determining the depletion deduction under the state corporate income and franchise tax.

17. For tax years beginning before January 1, 1995, Wisconsin did not follow the federal treatment of foreign sales corporations (FSCs). However, 1995 Wisconsin Act 27, included

provisions that federalized the state treatment of FSCs, for tax years beginning on or after January 1, 1995. To qualify as an FSC, a corporation must meet a number of requirements designed to ensure that it has adequate foreign presence. If a corporation qualifies as an FSC, a portion of the foreign trade income of the FSC is treated as foreign source income not effectively connected with the conduct of a trade or business within the United States and is exempt from tax. This income is also excluded.

In 2000, Congress enacted the Federal Sales Corporation Repeal and Extraterritorial Income Exclusion Act (FSCRA). Under FSCRA, the present FSC rules are repealed and replaced with an exclusion for extraterritorial income that is qualifying foreign trade income. Corporations can claim exclusion for qualified foreign trade income directly rather than having to create specifically defined FSC subsidiaries. FSCRA was an effort to comply with a World Trade Organization (WTO) decision that ruled that FSC provisions were an illegal export subsidy. However, the WTO found the new act illegally subsidizes U.S. companies by allowing the exclusion of foreign-source income from tax.

18. State law does not follow federal treatment of domestic international sales corporations (DISCs). In general, DISCs have no special status for state tax purposes. If the DISC has nexus in Wisconsin for tax purposes and if it is not a "paper corporation" without substance, it is taxed like any other corporation. However, if the DISC is a "paper corporation" having no employees and no actual involvement or activity in connection with the sales that give rise to its income, the income is allocated to the corporation that actually earned the income, which is usually the parent corporation. The DISC's income is included in that corporation's income for state corporate franchise tax purposes. Generally, a DISC that meets only minimum qualifying requirements and does not carry on any substantial business activity is treated as a paper corporation.

19. State law does not follow federal law governing controlled foreign corporations. As a result, Subpart F income is not includable in the computation of Wisconsin net income. Subpart F income is undistributed income from controlled foreign corporations which is required to be included in the federal net income of the U.S. shareholders of such corporations. Any actual income received from a controlled foreign corporation, such as dividends or interest, is included in the computation of Wisconsin net income, provided the income is not wholly exempt income.

20. Federal treatment of involuntary conversions as nontaxable exchanges is modified so that the federal provisions do not apply to involuntary conversions of property in this state that produce nonbusiness income when the property is replaced with similar property outside the state. In addition, federal provisions do not apply to involuntary conversions of property in the state that produce business income when the property is replaced with property outside the state if, at the time of replacement, the taxpayer is not subject to the Wisconsin corporate income tax.

21. Federal rules governing the filing of consolidated income tax returns and related provisions are not included in state law.

22. Federal provisions concerning amortization and depreciation authorized under the IRC in effect December 31, 2000, are included in state law. A corporation is required to compute amortization and depreciation under the federal IRC provisions which were in effect on December 31, 2000. In addition, specific state provisions which governed depreciation of property placed in service before January 1, 1987, under state law continue to apply for certain property.

Although state corporate tax provisions are referenced to federal law, with limited exceptions, changes to federal law take effect for state corporate income tax purposes only after action by the Legislature. Each year the Legislature must review the previous year's federal law changes to determine which items to federalize and which items to exclude from Wisconsin tax law. As is noted above, 2001 Wisconsin Act 109 included a provision that eliminated the automatic referencing of state depreciation and amortization provisions to the IRC. Instead, state depreciation and amortization provisions are referred to the Code in effect on December 31, 2000. The Legislature must take action to update these references in future years.

In addition, the Legislature has not adopted certain corporate income tax provisions included in federal laws that were enacted in 2000, 2001, and 2002--the Federal Sales Corporation Repeal and Extraterritorial Income Exclusion Act, the Community Renewal Tax Relief Act, the Installment Tax Correction Act, and the Job Creation and Worker Assistance Act. As a result, the state corporate income and franchise tax is not referenced to IRC provisions in the federal bills. Items not referenced for state corporate income and franchise tax purposes include: (a) bonus depreciation; (b) extension of election to currently deduct environmental remediation costs; (c) extension and expansion of the deduction for corporate donations of computer technology; (d) duplication or acceleration of loss through assumption of certain liabilities; and (e) repeal and replacement of foreign sales corporation rules.

Allocation and Assignment of Income

For state tax purposes, specified rules and laws are used to allocate or assign income of a particular corporate taxpayer.

100% Wisconsin Corporations

A corporation which conducts all of its business and owns property only in Wisconsin has all of its income subject to taxation in Wisconsin. Usually, such firms are incorporated in Wisconsin. These types of firms are often referred to as 100% Wisconsin firms and they compute their taxes very much like a Wisconsin resident does under the individual income tax.

Multijurisdictional Corporations

A corporation which conducts its business operations and owns property both within and outside of the state is subject to a different corporate income tax treatment than is a 100% Wisconsin firm. When the states tax the income of corporations generated by activities carried on across state lines, they are required under the strictures of the due process and commerce clauses of the U.S. Constitution to tax only income that is fairly attributable to activities carried on within the state. In order to meet this constitutional obligation, Wisconsin generally employs one of three methods of assigning income to the state--separate accounting, formula apportionment or specific allocation.

1. *Separate Accounting.* Under separate accounting, a geographic or functional area of a single, multistate corporation is treated separately from the rest of the business activities of the corporation. Net income is computed as if the activities of the corporation were confined to that geographic or functional area. Separate accounting implies that both the income and expenses of each specific function or activity of a multijurisdictional corporation can be accounted for individually and independently. For example, if a corporation manufactures automobile parts in Wisconsin and owns a motel in Illinois, using separate accounting, its Wisconsin tax liability would be based solely on its income and expenses generated by manufacturing automobile parts in Wisconsin. Any business transactions which occur between the in-state business and out-of-state businesses are required to be valued at "arm's length."

Under Wisconsin law, a multijurisdictional corporation may use separate accounting when the corporation's business activities in the state are not an integral part of a unitary business. Generally, a unitary business is one that operates as a unit; its business cannot be segregated into independently operating branches. Its operations are integrated, and each branch is dependent upon or contributory to the operating of the business as a whole. The Department of Revenue may permit separate accounting in any case in which it is satisfied that the use of the method will properly reflect the income that is taxable by the state. Currently, few multijurisdictional corporations in the state use separate accounting to determine their net tax liability.

2. *Formula Apportionment.* Under the formula apportionment method of assigning corporate income, a formula is employed for dividing the income of a multistate corporation among the states in which its business is conducted. States have developed apportionment formulas as a rough means of attributing a reasonable share of the income tax base of a multistate unitary business to the taxing state.

A principal reason for using formula apportionment is that many corporations cannot explicitly attribute the income generated by multistate activities or businesses to a particular state. It is frequently difficult to separately identify the income that is earned in and the expenses that are associated with a particular activity or a particular state. An example would be a corporation which produces and sells tractors with manufacturing divisions in Ohio, Indiana, and Wisconsin, assembly divisions in Wisconsin and Illinois, retail outlets in all fifty states, and headquarters, administration, and research operations located in New York. In this case, it would be quite difficult to determine through separate accounting the portion of total corporate income and expenses that is generated by each operation in each state. For example, what amounts of total administrative and other corporate business expenses and income are generated solely by the manufacturing operations in Ohio? Formula apportionment provides a standard method for allocating the corporation's net income among the state taxing jurisdictions.

Another reason for using formula apportionment is that it eliminates the need to establish "transfer prices" for transactions within the corporation. Under separate accounting, transactions between the in-state and out-of-state operations of a corporation must be valued at market price or "arms length" for tax purposes. However, when the transaction occurs entirely within a corporation and a market value is never actually established, it can make the determination of income more complicated. In the example above, separate accounting would require the Wisconsin manufacturing operation to determine the market sales price of an unassembled tractor sold to the Illinois assembly plant.

Transfer pricing also raises the issue of income shifting. Concerns have been expressed that, to some extent, it is possible for a corporation to determine the amount of income reported to each state through transfer pricing arrangements. For example, it would be possible for the corporation described above to shift income from Wisconsin to Indiana (perhaps to take advantage of a lower tax rate) by increasing the price the Indiana manufacturing division charges its Wisconsin assembly division. Because the firm would subtract the cost of purchased production goods in computing Wisconsin taxable income, the increased cost of unassembled tractors would reduce Wisconsin net income. Conversely, Indiana net income would increase. Since there is no freely-established market price for an unassembled tractor, it would be very possible to shift income through transfer pricing arrangements in such a case. Formula apportionment reduces the possibility of such income shifting through transfer pricing arrangements because it is not necessary to separately account for the amount of income earned and the amount of expenses applicable to operations in each state. Instead, the corporate income that is subject to taxation in a particular state is determined through the apportionment formula rather than by attempting to separately account for income and expenses.

Under Wisconsin law, formula apportionment is used if a corporation's Wisconsin activities are an integral part of a unitary business which operates both within and outside of the state. In these cases, the corporation adds its total gross income from its in-state and out-of-state unitary activities, subtracts its deductions, and multiplies the amount of net income by its apportionment ratio as determined by the Wisconsin apportionment formula. The apportionment ratio is used to approximate how much of a corporation's total net income is generated by activities in Wisconsin.

The apportionment ratio is the end result of the application of the Wisconsin apportionment formula to a particular corporation. For most corporations, the apportionment ratio or fraction is based on three factors: property, payroll, and sales. Specifically, the apportionment ratio is determined by adding three fractions--the corporation's property value in Wisconsin divided by its total property value, the corporation's payroll in Wisconsin divided by its total payroll, and the corporation's sales in Wisconsin divided by its total sales--double weighting the sales factor, and dividing the aggregate sum by four. Figure II provides an illustration of the Wisconsin apportionment formula.

The property factor of the apportionment formula is the ratio of the average value of real and tangible personal property owned or rented and used by the taxpayer in Wisconsin to that for the company as a whole. Tangible property includes land, buildings, machinery and equipment, inventories, furniture and fixtures, and other tangible personal property actually owned and used in producing apportionable income. Property owned by the taxpayer is valued at its original cost adjusted for any improvements. Rented property is valued at eight times the net annual rent. Property used in the production of nonapportionable income must be excluded from the numerator and denominator of the property factor.

The payroll factor is the ratio of the total amount of compensation paid by the company in the state to the total compensation paid by the company. Compensation includes wages, salaries, commissions, and any other form of remuneration paid to employees for personal services. Compensation is considered to be paid in Wisconsin if: (a) the individual's service is performed entirely in Wisconsin; (b) the individual's service is performed within and outside of the state, but the service performed outside of the state is incidental to the service performed in Wisconsin; (c) a portion of the service is performed within the state and the individual's base of operations is in Wisconsin; (d) a portion of the service is performed within the state, and if there is no base of operations, the place from which the individual's service is directed or controlled is in Wisconsin; (e) the individual's residence is in Wisconsin and a portion of the service is performed within the state and neither the base of operations of the individual nor the place from which the service is directed or controlled is in any state in which some part of the service is performed; or (f) the individual is neither a resident of nor performs services in the state, but is directed or controlled from an office in Wisconsin and returns to Wisconsin periodically for business purposes, and the state in which the individual resides does not have jurisdiction to impose income or franchise taxes on the employer.

The sales factor is the ratio of the total sales of the taxpayer in the state to total sales everywhere. Sales are generally all gross receipts from the course of the taxpayer's regular trade or business operations which produce apportionable business income. For the sales factor, sales of tangible personal property are generally considered to be in Wisconsin if the property is delivered or shipped to a purchaser within Wisconsin or if the property is shipped from Wisconsin and the taxpayer is not subject to the taxing jurisdiction of the state of destination. The latter type of sales are "throwbacks" and are single-weighted in the apportionment formula. In addition, sales of tangible personal property from an office in the state, but shipped from an out-of-state supplier to an out-of-state customer are considered throwback sales if neither the supplier nor the customer are subject to the taxing jurisdiction of the states in which they are located. Sales to the federal government are only considered to be in Wisconsin if they are shipped from a location within the state and are delivered to the federal government at a location within the state or if they are "throwback" sales. Federal throwback sales are single-weighted in the apportionment formula. Sales other than the sales of tangible personal property are usually considered to be in Wisconsin if the income-producing activity is performed wholly in Wisconsin. Generally, sales of intangible assets are excluded from the sales factor. Sales which produce nonapportionable income are also excluded from the sales factor.

Interstate air carriers, motor carriers, railroads, pipeline companies, and financial organizations are required to use different apportionment formulas to determine Wisconsin net taxable income. These corporations must use special apportionment factors in order to attribute income to their Wisconsin business activities. The specific apportionment factors used by these types of firms are shown in Table 1. Public utilities not specified in Table 1 are required to use the arithmetic average of the ratios of the regular three-factor (payroll, property, and sales) formula to apportion income to the state. Thus, generally, public utility companies apportion income using the average of the ratios of payroll, property, and sales in-state to total payroll, property, and sales. The sales factor is not double-weighted.

3. *Specific Allocation*. Specific allocation traces income to the state of its supposed source and includes the income in that state's tax base. Generally, this method of assigning income is applied to income from property with the source of the income generally following the location of the property. Many states, for example, specifically allocate the income from real and tangible personal property, such as rents from real estate, and oil and mineral royalties, to the state where the underlying property is located. Income from intangible property, such as dividends and interest, is often allocated to the taxpayer's commercial or legal domicile or to the state in which the intangible property is utilized.

FIGURE II

Computation of Apportionment Percentage Under the Wisconsin Apportionment Formula

$$\text{Apportionment Percentage} = \left[\left[\frac{\text{Property in WI}}{\text{Total Property}} \right] + \left[\frac{\text{Payroll in WI}}{\text{Total Payroll}} \right] + 2 \left[\frac{\text{Sales by WI Destination}}{\text{Total Sales}} \right] \right] \div 4$$

Table 1: Apportionment Factors Used by Certain Types of Multijurisdictional Corporations

Type of Corporation	Apportionment Factors
Interstate Air Carrier	1. Ratio of aircraft arrivals and departures in state to total aircraft arrivals and departures.
	2. Ratio of revenue tons handled at airports in state to total revenue tons handled.
	3. Ratio of originating revenue in state to total originating revenue.
Interstate Motor Carrier	1. Ratio of gross receipts from carriage of persons or property, or both first acquired for carriage in Wisconsin to total gross receipts from carriage of persons or property, or both.
	2. Ratio of ton miles of carriage in Wisconsin to total ton miles of carriage.
Interstate Railroads and Sleeping Car and Carline Companies	1. Ratio of gross receipts from carriage of property, or persons, or both, first acquired for carriage in Wisconsin to total gross receipts from carriage of property, or persons, or both, everywhere.
	2. Ratio of revenue ton miles of carriage in Wisconsin to revenue ton miles of carriage everywhere.
Interstate Pipeline Company	1. Ratio of net cost of real and tangible property owned and used in Wisconsin to produce apportionable income to total net cost of such property used everywhere.
	2. Ratio of traffic units (e.g. barrel miles, cubic foot miles or other appropriate measure of product movement) in Wisconsin to the total of such units everywhere.
	3. Ratio of compensation paid to employees located in the state to total compensation paid to all employees.
Interstate Finance Company	1. Ratio of gross receipts in Wisconsin to total gross receipts. ("Gross receipts" include all business income, such as interest, finance charges, and service charges associated with the lending of money in the normal course of business. Gains from sales of assets, charges to a related corporation for personal services of employees, and miscellaneous income are excluded.) Gross receipts are assigned to Wisconsin if the transaction producing the income was principally negotiated in Wisconsin.
	2. Ratio of compensation paid to employees located in Wisconsin to total compensation paid to employees everywhere. Compensation paid includes deductible management or service fees paid to a related corporation for the performance of personal services.

Wisconsin law distinguishes nonapportionable income from apportionable income. In determining a corporation's tax liability, total corporate nonapportionable income or loss is removed from the total income of a unitary multistate corporation and the remaining income or loss is apportioned to the state. Nonapportionable income allocated to Wisconsin is then added to apportioned business income to determine Wisconsin net income.

Nonapportionable income is allocable directly to the state in which the nonbusiness property that produced the income, gain, or loss is located. For state income and franchise tax purposes, nonapportionable income includes income, gain, or loss from: (a) the sale of nonbusiness real property or nonbusiness tangible personal property; (b) rental of nonbusiness real property or nonbusiness tangible personal property; and (c) royalties from nonbusiness real property or nonbusiness tangible personal property. In addition, income or gain or loss from intangible property that is earned by a personal holding company is nonapportionable income and is allocated to the state in which the business is incorporated.

The state statutes provide that income or loss from intangibles (interest, dividends, royalties from patents, and similar types of income) is generally apportionable business income which follows the situs of the business. However, interest, dividends, and capital gains may be exempt from state tax when the recipient and payor are not a unitary business and the recipient and payor are not related as a parent company and subsidiary or affiliates, and the investment activity from which the income is received is not an integral part of a unitary business, or the transaction does not serve an operational function. Conversely, if the corporation has commercial or legal domicile in Wisconsin, this intangible income is treated as business income for tax purposes.

Insurance Companies

Although most insurance companies that conduct business in the state are generally exempt from the state corporate income and franchise tax and, instead, pay the state insurance premiums tax, certain types of insurance companies are subject to the corporate franchise tax. Specifically, the state corporate franchise tax is imposed on most domestic nonlife insurance companies and on the nonlife insurance business of domestic life insurance companies. Insurers generally exempt from the state franchise tax include:

(a) Foreign insurance companies (companies not organized under Wisconsin laws);

(b) Domestic life insurance companies engaged exclusively in life insurance business. If a life insurance company engages in a business other than life insurance, the net income from the nonlife insurance business is subject to the state franchise tax. These companies pay the state premiums tax on their life insurance business;

(c) Domestic insurers transacting mortgage guaranty insurance business as defined under the state administrative code;

(d) Town mutual insurers organized under or subject to state law;

(e) Insurers exempt from federal income taxation under the IRC; and

(f) Certain corporations that are bona fide cooperatives operating without pecuniary profit to any shareholder or member, or operated on a cooperative plan pursuant to which they determine and distribute their proceeds in compliance with state law. However, cooperative sickness care associations, service insurance corporations, and nonprofit organizations that derive income from an HMO or LSHO are subject to tax on that income.

It should be noted that exempt insurers that realize income from the sale or purchase and subsequent sale or redemption of lottery prizes, if the winning ticket was purchased in Wisconsin, must pay state franchise tax on this income.

Similar to the tax treatment of other corporations, the income and deductions of insurance companies are generally determined by reference to federal law. The basis for determining net Wisconsin taxable income is federal taxable income. However, insurance companies are required to make the following adjustments to federal taxable income:

1. Business or capital loss carryforwards or carrybacks deducted in determining federal taxable income are added to income.

2. Federal depreciation or amortization that exceeds the amount of depreciation or amortization allowed under Wisconsin law is added to income.

3. For assets that are disposed of, the excess of federal basis over the basis allowed under Wisconsin law is added to income.

4. Interest income received or accrued and not included in federal taxable income is added to income.

5. Dividend income received and used as a deduction in determining federal taxable income is added to income.

6. State taxes that are value-added taxes, single business taxes, or taxes on, or measured by, gross income, gross receipts, or capital stock deducted in determining federal taxable income are added to income. Gross receipts taxes assessed in lieu of property taxes are deductible.

7. Other items not included in federal taxable income, but taxable under state law, such as the federal deduction for unpaid losses or state credits, are added to income.

8. Dividends received that are deductible under state law are subtracted from income.

9. Depreciation or amortization allowed under state law and in excess of such amounts permitted under federal law is subtracted from income.

10. The basis of assets allowed under state law that is in excess of the basis allowed under federal law for assets disposed of is subtracted from income.

11. Other items included in federal income that are not included in state taxable income are subtracted from income.

Depending upon the type of insurance company involved, the adjusted federal taxable income amount might require further modifications before arriving at Wisconsin net taxable income. Domestic insurance companies not engaged in the sale of life insurance that have collected premiums written on property and risks located only in Wisconsin are not required to further modify this measure of income. For these insurance corporations, adjusted federal taxable income is Wisconsin net income (before any offset for business loss carryforwards).

However, domestic insurance corporations that are not engaged in the sale of life insurance but that have collected premiums written on property and risks located both in and outside of Wisconsin must allocate a portion of total adjusted federal income to the state. The allocation is accomplished by computing the average of: (a) the ratio of the company's payroll paid outside the state to total payroll paid everywhere; and (b) the ratio of the company's premiums written on property and risks located outside the state to total premiums written on property and risks located everywhere. The average ratio is then applied to adjusted federal income. This amount is subtracted from total adjusted federal income to arrive at Wisconsin net income before any offset for business loss carryforwards.

Domestic insurance companies that are engaged in the sale of both life insurance and other types of insurance must first determine the nonlife insurance portion of total adjusted federal income. As a first step in calculating Wisconsin net income, these companies are required to multiply total adjusted federal income by the ratio of the company's net gain from its nonlife insurance operations to total net gain from operations (with specific exceptions). If this amount is from premiums written on property and risks located only in Wisconsin, then the amount represents Wisconsin net income (before business loss carryforward offsets). However, if the calculated nonlife insurance income is from premiums written on property and risks located both in and outside of the state, then Wisconsin net income is determined using the allocation method described above.

Under state law, the amount of tax that an insurance company pays under the state franchise tax cannot exceed 2% of gross Wisconsin premiums. (The 2% gross premiums limitation does not apply to income from lottery prizes.)

Net Operating Losses

Although similar to federal provisions, Wisconsin has specific state provisions governing the determination and use of net operating losses for state corporate income tax purposes. Under state law, a net operating loss is generally defined as the excess of business expenses allowed as deductions in computing net income over the amount of income attributable to the operation of a trade or business in the state. Nonapportionable losses having situs in Wisconsin are included in Wisconsin net business loss; nonapportionable income having situs in the state is included in net business income.

Net operating losses are determined in a manner similar to the way taxable income is determined. The taxpayer starts with gross income and subtracts business expenses allowable as deductions. If expenses are greater than income, a net operating loss is generated. Wisconsin law allows net operating losses to be carried forward for 15 years to offset income. Federal law permits net operating losses to be carried back for three years but state law does not provide for carrybacks of net operating losses. Under state tax provisions, net operating losses, if any, are used to offset state taxable income before the state tax rate is applied to net income.

State Corporate Income Tax Rate

The state corporate income tax rate is 7.9% and is applied to all income subject to the state corporate income tax. The resulting amount is the corporation's gross tax liability. Currently, the federal corporate income tax uses a graduated rate and bracket structure that ranges from 15% to 35% with higher 38% and 39% marginal tax rates that apply over certain ranges of taxable income.

Recycling Surcharge

The state recycling surcharge was first imposed on businesses for tax years ending after April 1, 1991, and it remained in effect until April 1999. From tax year 1991 until tax year 1997, the surcharge was equal to 5.5% of the gross tax liability of corporations. Beginning in tax year 1998, the surcharge rate was reduced to 2.75% of the gross tax liability of corporations. There was a minimum payment of $25 and a maximum payment of $9,800. Corporations (including S corporations) with less than $4,000 in total receipts were excluded from the recycling surcharge.

Nonfarm sole proprietorships, partnerships and limited liability companies (LLCs), and S corporations were also subject to a recycling surcharge of 0.4345% of net business income from tax year 1991 to tax year 1997. The rate was reduced to 0.2173%, beginning in tax year 1998. The minimum payment was $25 and the maximum was $9,800. Members of the clergy and noncorporate farms with less than $1,000 of net farm profits were also exempt from the surcharge. Farms that were not regular or S corporations that were subject to the surcharge paid a flat amount of $25. The rates of 0.4345% and then 0.2173% applied to the net business income of sole proprietorships, partnerships, S corporations, and LLCs taxed as partnerships were equivalent to the 5.5% and 2.75% rates, respectively, that applied to the gross tax liability of corporations. For corporations, gross tax liability is determined by applying the corporate tax rate of 7.9% to net income. When the corporate tax rate of 7.9% is multiplied by the surcharge rates of 5.5% and 2.75%, the resulting tax rates are 0.4345% and 0.2173%, respectively.

As noted, the recycling surcharge was eliminated for all businesses beginning with tax years ending after April, 1999. Therefore, businesses were generally not subject to the recycling surcharge for tax year 1999. However, 1999 Wisconsin Act 9 (the 1999-01 biennial budget) included provisions that reimposed the recycling surcharge on businesses, beginning in tax year 2000. Under the provisions of Act 9, the recycling surcharge is 3% of gross tax liability for corporations or 0.2% of net business income for nonfarm sole proprietorships, partnerships, limited liability companies taxable as partnerships, and S corporations. There is a minimum payment of $25 and a maximum payment of $9,800. Farms and other businesses with less than $4,000,000 in gross receipts are excluded from paying the surcharge.

The Department of Revenue is authorized to administer the temporary surcharge under provisions governing administration of the individual and corporate income and franchise taxes, including provisions relating to audits and assessments, claims for refund, statutes of limitations, IRS adjustments, confidentiality, appeals, collections, and set-offs for debts owed other state agencies.

Total recycling surcharge collections were $9.6 million in 1990-00, $26.3 million in 2000-01, and $12.5 million in 2001-02.

Corporate Income Tax Credits

A tax credit is an amount that is subtracted from the gross income tax liability of the taxpayer in a given year. A tax credit differs from a deduction in that the credit is subtracted from the tax itself, resulting in a dollar-for-dollar reduction in the gross tax liability; a deduction is subtracted from income, resulting in a reduction in the amount of income subject to tax. Rather than adopting federal tax credits for state purposes, Wisconsin provides its own corporate income tax credits for certain business expenditures. State corporate income tax credits include the manufacturing sales tax credit for fuel and electricity, research and research facilities credits, farmland preservation credit, farmland tax relief credit, community development finance credit, development zones credits, and technology zones credits. State development zones tax credits can be claimed by eligible taxpayers that conduct business operations in development, enterprise development, development opportunity, and the agricultural development zones. Similarly, technology zones credits can be claimed by businesses located in the zones.

The following sections describe the credits provided under the state corporate income tax. Where available, information is presented on the number of claimants and the amount of credit claimed in the 2000-01 processing year, which primarily reflects tax year 2000.

1. *Manufacturing Sales Tax Credit for Fuel and Electricity.* A credit against corporate income taxes due may be claimed for the amount of sales and

use tax paid for fuel and electricity consumed in manufacturing in Wisconsin. The credit may not be claimed for heating, light, or other uses of energy. The manufacturer must allocate manufacturing use as a portion of total energy use for purposes of computing the credit. For noncorporate claimants, the credit can only be claimed against the tax imposed on the business operations of the claimant in which the fuel and electricity are consumed. If the credit exceeds tax liability for the year, it is not refundable but any unused portion may be carried forward for fifteen years to offset any future tax liability.

Manufacturing is the production by machinery of a new article with a different form, use, and name from existing materials by a process popularly regarded as manufacturing. Manufacturing includes the assembly of finished units of tangible personal property and packaging when: (a) it is part of an operation performed by the producer of the product or by another on the producer's behalf; and (b) the package or container becomes part of the tangible personal property as such unit is customarily offered for sale by the manufacturer. Manufacturing also includes: (a) conveyance of raw materials and supplies from plant inventory to the work point of the same plant; (b) conveyance of work in progress directly from one manufacturing operation to another in the same plant; and (c) conveyance of finished products to the point of first storage on the plant premises. It includes testing or inspection throughout the production cycle. Manufacturing does not include storage, delivery to or from the plant, repairing or maintaining facilities, or research and development.

According to the Department of Revenue's corporate aggregate statistics report for the 2000-01 tax processing year, the total amount of manufacturing sales tax credits and credit carryforwards claimed were about $237.5 million in that year. The total amount of credits that were used to offset tax liabilities in that year was about $24.7 million; the remaining amount was available as a carry-over to offset future tax liabilities. About 2,900 corporations claimed the manufacturing sales tax.

This credit was extended to noncorporate taxpayers, effective for tax year 1998.

2. *Research Credit.* The state research credit is equal to 5% of the increase in a corporation's qualified research expenditures in Wisconsin over the base amount. The "base amount" is calculated by multiplying the taxpayer's average annual gross receipts for the preceding four years by a fixed-base percentage. However, the base amount does not include sales treated as throwback sales in the corporate apportionment formula. The "fixed-base" percentage is the percentage that the taxpayer's total aggregate qualified research expenditures for a specified five-year period is of the taxpayer's total aggregate gross receipts for those years. The fixed-base percentage cannot exceed 16%. In addition, the base amount cannot be less than 50% of research expenses in the year for which the credit is claimed. Consequently, the state research credit is 5% of the lesser of: (a) the excess of current year research expenses over the base amount; or (b) 50% of current year research expenses.

Start-up companies must use a minimum fixed-base percentage of 3%. As a result, start-up companies must spend 3% of their gross receipts on research in order to qualify for the credit. For years six to ten, the percentages are an increasing portion of the percentage which qualified research expenses bear to gross receipts for certain prior years. A "start-up company" is defined as a firm that, during the five-year period used to compute the fixed-base percentage, has fewer than three taxable years in which the taxpayer had both gross receipts and qualified research expenses.

The credit applies only to research expenditures paid or incurred in connection with the trade or business of the taxpayer that are research and development costs in an experimental or laboratory sense. In general, qualifying expenses are noncapital, and thus, do not include spending for buildings and equipment. Qualified research expenses are the sum of: (a) in-house expenditures for research wages and supplies used in research plus certain amounts paid for research use of laboratories, equipment, computers, or other personal property; and (b) 65% of the amount paid by the taxpayer for qualified research conducted on behalf of the taxpayer. Examples of eligible costs include: (a) the costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property; and (b) the cost of improving this type of property. Qualified research is research which is undertaken for the purpose of discovering information which is technological in nature and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer. In addition, substantially all of the activities of the research must be elements of a process of experimentation relating to a new or improved function, performance, reliability, or quality.

In all cases, only the expenses for eligible research activities conducted in Wisconsin qualify for the credit. If the credit amount exceeds the corporation's tax liability, it is not refundable, but unused amounts can be carried forward fifteen years to offset future tax liabilities.

For the 2000-01 tax processing year, a total of $65.4 million in research credits was claimed while approximately $9.1 million was used to offset tax liabilities for that year. The unused credit amounts could be carried forward to offset future tax liabilities. In that year, about 300 corporations claimed the research expenses credit.

3. *Research Facilities Credit.* The research facilities credit is equal to 5% of the annual expenditures for constructing or equipping new facilities or expanding existing facilities in Wisconsin to conduct qualified research activities. Qualified research activities are defined as those eligible for the research expense credit. Eligible capital expenditures include only amounts paid or incurred for tangible depreciable property but do not include expenditures for replacement property. This credit also is not refundable but unused amounts can be carried forward to offset corporate income tax liability for up to fifteen years.

Aggregate data for processing year 2000-01 indicate that the total amount of research facilities credits claimed for that processing year was about $8.9 million. Of that total, approximately $800,000 was used to offset tax liabilities and the remaining unused credit amounts million were available to be carried forward to future tax years. A total of 70 corporations claimed the research facilities credit.

4. *Farmland Preservation Tax Credit.* Corporate owners of eligible farmland can receive a refundable tax credit under the farmland preservation program. To be eligible, the claimant must own at least 35 acres of state farmland and that land must have produced: (a) at least $6,000 in gross farm profits during the year for which the credit is claimed; or (b) at least $18,000 during the year for which the credit is claimed and the preceding two years. The credit amount is determined by formula and based on the property taxes levied on the eligible farmland and the household income of the farm owner. Income is broadly defined and includes such items as nonfarm business losses and farm depreciation expenses in excess of $25,000. For corporate claimants, income includes the household income of each shareholder of record. In addition, the amount of credit depends on the land use provisions, such as agricultural zoning ordinances and preservation agreements, that cover the land. The maximum potential credit which can be received for a given tax year is $4,200.

For tax processing year 2000-01, approximately $284,200 in farmland preservation tax credits was claimed by corporations, of which $223,500 was in the form of refunded credits. Approximately 380 corporations claimed the credit.

5. *Farmland Tax Relief Credit.* Eligible corporations can claim a refundable farmland tax relief credit equal to a percentage of the amount of property taxes levied on agricultural land (excluding improvements), up to a maximum credit claim of $1,500. The Department of Revenue annually determines the reimbursement rate that will distribute the estimated total expenditures under the farmland tax relief credit for that year. Annual expenditures for the credit under the individual and corporate income and franchise taxes equal $15 million plus an amount equal to the amount estimated to be expended as farmland tax relief credits in the previous year minus the actual expenditure of farmland tax relief credits in the previous year. To be eligible, the claimant must meet the same acreage and production requirements as those used for the farmland preservation tax credit. The sum of the farmland preservation and farmland tax relief credits cannot exceed 95% of the total property taxes accrued on the farm.

For tax year 2001, DOR established the reimbursement rate at 13% of the first $10,000 in property taxes. For tax year 2002, with $18,487,400 available for distribution, DOR established the credit reimbursement rate at 30% of the first $10,000 in property taxes. However, the maximum credit is limited to $1,500.

In the 2000-01 tax processing year, approximately $417,600 in farmland tax relief credits was claimed by corporations; approximately $264,600 was in the form of refundable credits. A total of 901 corporations claimed the credit.

6. *Community Development Finance Credit.* A corporation that contributes an amount to the Community Development Finance Authority or to the Housing and Economic Development Authority and, in the same year, purchases common stock or partnership interests of the community development finance company in an amount no greater than the contribution may credit against taxes otherwise due an amount equal to 75% of the purchase price of the stock or partnership interests. However, the credit cannot exceed 75% of the contribution to the Community Development Finance Authority. The credit is not refundable but can be carried forward fifteen years to offset corporate income tax liability.

7. *Development Zones Credit.* Prior to 1997 Act 27, businesses in development zones, development opportunity zones, and enterprise development zones were eligible for any of seven development zone tax credits including: the jobs credit; investment credit; location credit; sales tax credit; research credit; day care credit; and environmental remediation credit. The jobs and sales tax credits were refundable.

Currently, a consolidated development zone credit can be claimed by businesses in development, enterprise development, development opportunity, and technology zones, and the agricultural development zone. Businesses in technology zones may claim the development zones tax credit only if certified by the Department of Commerce. Businesses in the agricultural development zone first qualify for the credit for taxable years beginning on or after January 1, 2003. The credit is based on amounts spent on environmental remediation and the number of full-time jobs created or retained. In general, the credit can only be used to offset income from the claimant’s business activities in the zones.

a. *Environmental Remediation Component.* A credit against income taxes due can be claimed for 50% of the amount expended for environmental remediation in a development, development opportunity, enterprise development, technology, or agricultural development zone,. "Environmental remediation" is defined as removal or containment of environmental pollution, and restoration of soil or groundwater that is affected by environmental pollution in a brownfield if removal, containment, or restoration began after the area that contains the site where the work was done was designated a zone. Investigation costs are eligible unless the investigation determines that remediation is required and remediation is not undertaken. "Environmental pollution" means the contaminating or rendering unclean or impure the air, land, or waters of the state, or making the same injurious to public health, harmful for commercial or recreational use, or deleterious to fish, bird, animal, or plant life. "Brownfield" is defined as an industrial or commercial facility the expansion or redevelopment of which is complicated by environmental contamination.

b. *Full-Time Jobs Component.* A credit of up to $8,000 against corporate income taxes can be claimed for: (1) each full-time job created in a development, enterprise development, development opportunity, technology, or agricultural development zone; and (2) retaining a full-time job in an enterprise development zone if the Department of Commerce determines that a significant capital investment was made to retain the full-time job. In addition, a credit of up to $6,000 can be claimed for each full-time job created or retained in a development enterprise development, development opportunity, technology, or agricultural development zone that is filled by an individual who is not a member of a targeted group. At least one-third of job credits claimed must be based on jobs created and filled by targeted group members. In addition, except for businesses that only claim credits for environmental remediation, 25% of all tax credits must be based on creating or retaining full-time jobs.

"Full-time job" is defined as a regular, nonseasonal full-time position in which an individual, as a condition of employment, is required to work at least 2,080 hours per year, including leave and paid holidays, and for which the individual receives pay equal to at least 150% of the federal minimum wage and also receives benefits that are not required by federal or state law. A full-time job does not include initial training before an employment position began.

Member of a targeted group is defined as a Wisconsin resident who receives food stamps or is a member of one of the following groups:

a. *Dislocated Workers.* A dislocated worker includes an individual who: (1) has been terminated or laid-off, or has received a termination or layoff notice, is eligible for or has exhausted his or her entitlement to unemployment compensation, and is unlikely to return to his or her previous industry occupation; (2) has been terminated or has received notice of termination as a result of any permanent closure or substantial layoff at a plant, facility, or enterprise; (3) was self-employed (including farmers) and is unemployed as a result of general economic conditions in the community in which he or she resides or because of natural disasters; or (4) is a displaced homemaker.

b. *Economically Disadvantaged Youths.* An individual who is between 18 and 23 years of age on the hiring date and is a member of an economically disadvantaged family (family income level no greater than 70% of the U.S. Bureau of Labor Statistics lower living standard).

c. *Economically Disadvantaged Ex-Convicts.* An individual who: (1) was convicted of a felony under any federal or state law; and (2) is a member of an economically disadvantaged family; and (3) is hired within five years of being convicted or released from prison.

d. Vocational Rehabilitation Referrals. An individual who: (1) has a physical or mental disability that results in a substantial barrier to employment; and (2) is referred to the employer upon completing or while receiving rehabilitative services under an individualized written rehabilitation plan under a state plan for vocational rehabilitation or a program of vocational rehabilitation for veterans.

e. *Economically Disadvantaged Veterans.* An individual who: (1) served on active duty in the U.S. Armed Forces for more than 180 days or who was discharged or released from active duty because of a service-connected disability; (2) was not on active duty for more than a 90-day period or any day in the 60-day period that ends on the date the employee is hired; and (3) is a member of an economically disadvantaged family.

f. *General Assistance Recipients.* An individual who received assistance under a general assistance program for any month ending within the 60-day period that ends on the date the individual is hired.

g. *Supplemental Security Income (SSI) Recipients.* An individual who received SSI benefits for any month ending within the 60-day period that ends on the date the individual is hired.

h. *Qualified Summer Youth Employees.* An individual who: (1) works for the employer between May 1 and September 15; (2) is between 16 and 19 years of age when hired, or on May 1 if the individual is hired before that date, or under 18 when hired or on May 1, if hired after May 1; (3) has not previously worked for the employer; and (4) is a member of an economically disadvantaged family.

i. *Wisconsin Works (W-2) Participants.* An individual who: (1) is employed in an unsubsidized job but meets eligibility requirements; (2) is employed in a state-subsidized trial job; or (3) is eligible for W-2 child care assistance.

j. *Resident of a Federally Designated Enterprise Community.* An individual who is a resident of a federally designated enterprise community. In Wisconsin, the designated area is the Northwoods Niijii Enterprise Community in Northern Wisconsin.

In general, the development zone tax credit can only be used to offset the amount of tax that is attributable to the income from business operations in the development zone. Credits that are not entirely used to offset income or franchise taxes in the current year can be carried forward up to fifteen years to offset future tax liabilities. Internal Revenue Code provisions govern the carry-forward of unused credits in cases where there is a change of ownership. If a certification of eligibility for tax benefits is revoked, credits cannot be claimed for the tax year in which the certification was revoked or for successive tax years and unused credits cannot be carried forward to offset tax liabilities for the year in which certification was revoked and succeeding years. In addition, credits cannot be claimed for the year in which a person that was certified for tax benefits ceases business operations in a zone, and unused credit amounts cannot be carried forward from that year or from previous years.

The Department of Revenue administers credit claims and can take any action, conduct any proceeding, and proceed as authorized under income and franchise tax provisions relating to timely claims, assessments, refunds, appeals, collection, interest, and penalties. Provisions related to the pass-through of the current development zones jobs tax credit for partnerships, limited liability companies, and tax-option corporations apply.

8. Technology Zones Credit. The 2001-03 biennial budget (2001 Wisconsin Act 16) created the technology zones program under which the Department of Commerce is authorized to create eight technology zones. A business that is located in a technology zone and that is certified by the Department of Commerce may be eligible to claim certain development zones tax credits and the technology zone tax credit. To be certified as eligible for the technology zone credit, the business must be new or expanding and be a high-technology business. High-technology business means either of the following:

a. A business engaged in the activities of the research, development, or manufacture of advanced products or materials for use in factory automation, biotechnology, chemicals, computer hardware, computer software, defense, energy, environmental, manufacturing equipment, medi-cal, pharmaceuticals, photonics, subassemblies and components, test and measurement, telecommunications, and transportation;

b. A business identified as part of a target cluster that is a knowledge-based business or a business that utilizes advanced technology production processes, systems, or equipment. Knowledge-based businesses possess some, if not all, of the following attributes: highly skilled and educated workforce; high level of research and development activities; strong export orientation; high percentage of intangible assets; and products and materials with short life expectations and high gross margins. In addition, knowledge-based businesses are considered more likely to use and/or develop advanced technologies and to be innovative in their products, services, or processes.

The technology zone tax credit equals the sum of the following: (a) the amount of real and personal property taxes paid during the tax year; (b) the amount of state income and franchise taxes paid during the tax year; and (c) the amount of state, county, and special district sales and use taxes paid during the tax year.

The maximum amount of credits that can be claimed in a technology zone is $5.0 million. Credits that are not entirely used to offset income or franchise taxes in the current year can be carried forward up to 15 years to offset future tax liabilities. The Department of Revenue is authorized to deny any portion of a technology zone credit that was claimed if allowing the full amount of the credit to be claimed would cause the total amount of credits to be claimed to exceed the maximum credit limit for the zone. DOR is required to notify the Department of Commerce of all technology zone tax credit claims, administer credit claims, take any action, conduct any proceeding, and proceed as authorized under income and franchise tax provisions relating to timely claims, assessments, refunds, appeals, collection, interest, and penalties. Income and franchise tax provisions related to change of ownership also apply.

9. *Development Zone Capital Investment Credit.* Act 16 also created a development zone capital investment tax credit that is available to businesses in the Milwaukee and Beloit development opportunity zones, technology zones, and the agricultural development zone. Businesses in technology zones can only claim the credit if certified by the Department of Commerce. Businesses in the agricultural development zone may first qualify for the credit for taxable years beginning on or after January 1, 2003.

The development zone capital investment tax credit equals 3% of the following:

a. The purchase price of depreciable, tangible personal property. The property must have been purchased after the claimant was certified as eligible for tax benefits and the personal property has to have at least 50% of its use in the claimant's business location in the development opportunity zone. If the property is mobile, the base of operations for at least 50% of its use must be in the zone.

b. The amount expended to acquire, construct, rehabilitate, remodel, or repair real property in the zone. Such expenses are eligible for the credit if the claimant began the physical work of construction, rehabilitation, remodeling or repair, or any demolition or destruction in preparation for the physical work, after the place where the property is located was designated a zone, or if the completed project is placed in service after the claimant is certified for tax benefits. A credit cannot be claimed for expenses for preliminary activities such as planning, designing, securing financing, research, developing specifications, or stabilizing the property to prevent deterioration.

A claimant can also claim a tax credit for amounts expended to acquire real property, if the property was not previously owned and the claimant acquired the property after the place where the property was located was designated a development opportunity, technology, or agricultural development zone or if the completed project was placed in service after the clamant was certified as eligible for tax benefits. In addition, the property is subject to the federal prohibition on the deductibility of losses on the sale or exchange of such property to related parties. However, the federal 50% ownership interest threshold for determining a related party is eliminated so that any interest in another entity would make it a related party.

In calculating the capital investment credit for purchases of real property, a claimant is required to reduce the amount expended to acquire the property by a percentage equal to the percentage of the area of the real property that is not used for the purposes for which the claimant is certified as eligible for tax benefits. Similarly, the amount expended for other purposes must be reduced by the amount expended on the part of the property not used for purposes for which the claimant is certified.

Credits that are not entirely used to offset income or franchise taxes in the current year can be carried forward up to 15 years to offset future tax liabilities. Internal Revenue Code provisions apply in cases where there is a change of ownership of the business. Claimants are required to include with their tax return: (a) Commerce verification that the claimant is eligible for tax credit; and (b) a statement from Commerce verifying the purchase price and eligibility of the investment. If a certification of eligibility for tax benefits is revoked, credits cannot be claimed for the tax year in which the certification is revoked or for successive tax years, and unused credits cannot be carried forward to offset tax liabilities in succeeding years. In addition, credits cannot be claimed for the year in which a business that is certified for tax benefits ceases businesses operations in a zone and unused credit amounts cannot be carried forward from that year or from previous years.

The Department of Revenue administers credit claims and is authorized to take 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. DOR is authorized to deny any portion of a credit that was claimed if allowing the full credit would cause the total amount of credits to exceed the maximum credit limit.

10. *Authority to Claim Tax Credits Based on the Economic Activity of Another*. Development zone tax credits can be claimed based on the economic activity of another in the Milwaukee and Beloit development opportunity zones. The Department of Commerce is authorized to certify as eligible for tax credits a business that is conducting economic activity in either of the zones that would not otherwise be entitled to claim the credits if certain criteria are met. (This provision is intended to address cases where a person develops a business location for lease to another business and the lessee business created jobs but could not claim the jobs component of the development zones credit.) In order for Commerce to certify a business as eligible for credits based on the economic activity of another business, the following must apply:

a. The economic activity must be instrumental in enabling another business to conduct economic activity in the development opportunity zone.

b. Commerce determines that the economic activity of the other person would not occur without involvement of the person to be certified.

c. The business to be certified for tax benefits will pass the tax benefits through to the other person conducting economic activity in the development opportunity zone.

d. The other business conducting economic activity in the zone does not itself claim tax benefits.

The business that intends to claim tax benefits based on the economic activity of another business is required to submit an application to Commerce with information required by Commerce and DOR. Commerce is required to verify information submitted for tax credits and to notify DOR of all business that are certified to claim the credits. Commerce is required to revoke entitlement to claim tax credits if the business does any of the following: (a) supplies false or misleading information to obtain tax benefits; (b) ceases operations in the development opportunity zone; or (c) does not pass the benefits through to the other business conducting economic activity in the zone.

11. *Development Zones Investment Credit.* As noted, prior to the 1998 tax year, seven development zones tax credits, including the development zones investment tax credit, could be claimed by businesses in development and enterprise development zones. However, the current consolidated development zones environmental remediation and jobs tax credit was created in the 1997-99 biennial budget. The former development zones investment tax credit can still be claimed by businesses in technology zones and certain development opportunity zones, under current law. Businesses in technology zones may only claim the credit if certified by the Department of Commerce. The development zones investment tax credit provides a credit against income and franchise taxes due equal to 2.5% of the purchase price of depreciable tangible personal property or 1.75% of the purchase price of depreciable tangible personal property that is expensed under section 179 of the IRC. The property must be purchased after the business is certified for tax benefits by the Department of Commerce. The credit is available only for qualified new and used property that has at least 50% of its use devoted to the conduct of business operations at a location in the zone or, if the property is mobile, the base of operations of the property for at least 50% of its use must be at a location in a zone. If the credit is claimed for used property, the claimant may not have used the property for business purposes at a location outside the zone.

Only taxes due on income generated by or directly related to business activities in the development zone can be offset by the credit. The credit is not refundable but unused credit amounts can be carried forward fifteen years to offset future tax liabilities on income generated by activities in the development zone. However, if the corporation ceases business operations in the development zone, unused credit amounts cannot be carried forward. If certification is revoked, no credit can be claimed beginning with the year in which the revocation occurs and unused credits may not be carried forward to offset tax liabilities in succeeding years. The claimant is subject to recapture provisions when the investment credit property is disposed of or moved outside the development zone.

12. Supplement to Federal Historic Rehabilitation Credit. A corporation may claim a credit against taxes due of up to 5% of qualified rehabilitation expenditures for certified historic structures. A certified historic structure is defined as a building that is listed in the National Register of Historic Places or that is determined to be historic and will be listed in the National Register. The building must be used for the production of income, such as commercial, industrial, or residential rental purposes. "Qualified rehabilitation expenditures" are expenses properly chargeable to a capital account and incurred with respect to depreciable real property and made in connection with the rehabilitation of a qualified rehabilitated building. Expenses properly chargeable to a capital account are those that are properly includable in calculating the basis of real property, such as architectural, engineering, and site survey fees and construction period interest and taxes that are treated by the taxpayer as chargeable to a capital account. Also included are legal and development fees, insurance premiums, and construction costs.

Qualified rehabilitation expenditures are eligible for the credit only if incurred in connection with substantial rehabilitation of property located in the state if the physical work of construction or destruction in preparation for construction begins after December 31, 1988, and the rehabilitated property is placed in service after June 30, 1989. The test of substantial rehabilitation generally is met if the qualified expenditures during a two-year period (60 months for phased rehabilitation) exceed the greater of $5,000 or the adjusted basis of the building. However, qualified rehabilitation expenditures that are eligible for the credit are not limited to those used for the purposes of meeting the substantial rehabilitation test. Unused credit amounts can be carried forward up to fifteen years to offset future tax liabilities.

In the 2000-01 processing year, approximately $5.9 million in federal historic rehabilitation supplement credits was claimed by 22 corporations. About $337,300 was used to offset tax liabilities.

Summary Data

The following tables provide summary data concerning the Wisconsin corporate income tax.

Corporate income and franchise tax collections, state general fund tax collections, and corporate tax collections as a percent of total general fund collections for fiscal year 1991-92 through fiscal year 2001-02 are shown in Table 2. The table indicates that corporate tax collections as a percentage of total general fund collections rose from 1992-93 through 1994-95, but have decreased in more recent years.

The distribution of corporate income tax liability by Wisconsin net income class for the 2000-01 tax processing year (primarily composed of tax 2000 returns) is illustrated in Table 3. The table shows that most corporations that filed returns paid no tax for the tax year. However, it should be noted that, generally, under current law, a substantial majority of corporate taxfilers have no tax liability. A significant number of these firms are S corporations whose net incomes are passed-through to shareholders and taxed under the individual income tax. Other corporations have no tax liability because deductible expenses or loss carryforwards entirely offset income. In other cases, tax credits entirely offset tax liability. Table 3 also shows that a large proportion of the corporate income tax was paid by a relatively small number of corporations. About 81% of total corporate tax liability was generated by less than 1% of the corporations.

Aggregate data also indicates that multijurisdictional firms represented 19.6% of the total number of corporate taxfilers but paid about 72.1% of total corporate tax liabilities. Table 3 does not directly translate into taxes paid by size of corporation since, for example, a very large corporation which suffered a loss could have no taxable income in the year of the loss or in succeeding years if the loss was carried forward. Also, because the table primarily shows the distribution of total tax liability for the 2000 tax year, it differs from the total corporate collections shown for fiscal year 2000-01 in Table 2. Processing year amounts do not include additional collections due to audit adjustments and delinquent collections. Also, fiscal year collections include declaration payments for a more recent year than the tax year collections included in the processing year amounts.

In 2000-01, forty-five states imposed a corporate income tax. Michigan imposes a single business tax which is a form of a value-added tax. Nevada, Texas, Washington, and Wyoming have no corporate income tax. Tables 4 and 5 provide measures of how the level of the Wisconsin corporate income tax compares to that of other states. The tables show the contribution of corporate income taxes to total state revenues and the level of corporate income taxes per capita and per $1,000 of income for all states which have corporate income taxes. Table 4 shows that, for 2000-01, the state corporate income and franchise tax's proportionate share of total state tax revenue

Table 2: Wisconsin Corporate Tax Collections 1989-90 to 1999-00 ($ in Millions)

Fiscal Year	Corporate Tax Collections*	Percent Change	Total General Fund Collections	Percent Change	Corporate Tax As Percent of General Fund Collections
1991-92	$437.7	-0.7%	$6,339.6	4.4%	6.9%
1992-93	492.0	12.4	6,871.0	8.4	7.2
1993-94	541.3	10.0	7,287.6	6.1	7.4
1994-95	631.8	16.7	7,806.9	7.1	8.1
1995-96	636.0	0.7	8,235.6	5.5	7.7
1996-97	643.8	1.2	8,817.5	7.1	7.3
1997-98	627.0	-2.6	9,528.4	8.1	6.6
1998-99	635.2	1.3	9,948.4	4.4	6.4
1999-00	644.6	1.5	10,945.9	10.0	5.9
2000-01	537.2	-16.7	10,063.4	-8.1	5.3
2001-02	503.0	-6.4	10,020.2	-4.3	5.0

*Excludes temporary recycling surcharge that is deposited in the segregated recycling fund.

Table 3: Corporate Tax Liability by Net Income Class (2000-01 Processing Year)

Wisconsin Net Income	Number of Returns	Percent of Total Returns	Liability (In Millions)	Percent of Total Tax Liability
Zero or less	82,786	78.37%	$0	0.00%
$0 to $10,000	9,375	8.88	2,203,881	0.42
10,000 to 25,000	3,801	3.60	4,817,069	0.91
25,000 to 50,000	3,058	2.89	8,570,189	1.62
50,000 to 100,000	2,586	2.45	13,695,076	2.59
100,000 to 250,000	1,730	1.64	20,130,879	3.80
250,000 to 500,000	783	0.74	21,057,380	3.98
500,000 to 1,000,000	592	0.56	31,288,299	5.91
1,000,000 to 5,000,000	703	0.67	107,482,704	20.29
5,000,000 to 10,000,000	111	0.11	56,164,769	10.60
10,000,000 and over	106	0.10	264,297,585	49.89
Total	105,631	100.00%	$529,707,831*	100.00%

* The $529.7 million amount shown in this table reflects the 2000-01 processing year, which is primarily comprised of tax year 2000 returns. The $537.2 million amount shown in Table 2 for 2000-01 reflects the 2000-01 state fiscal year. The processing year amount is lower because it does not include collections due to audit adjustments and delinquent taxes. Also, fiscal year collections include declaration payments for a more recent year.

Source: Department of Revenue, Corporation Aggregate Statistics

Table 4: Contribution of Corporate Income and Franchise Taxes to Total State Tax Revenue by State (2000-01)

State	Percent of Total	Rank	State	Percent of Total	Rank
Alaska	28.03%	1	North Carolina	4.63%	25
New Hampshire	19.73	2	Kentucky	4.60	26
Illinois	9.58	3	Nebraska	4.56	27
Delaware	9.53	4	Colorado	4.49	28
Michigan	9.44	5	South Dakota	4.44	29
Tennessee	8.61	6	Mississippi	4.44	29
Indiana	8.09	7	**Wisconsin**	**4.21**	**31**
California	7.63	8	Louisiana	4.07	32
New York	7.13	9	Utah	4.00	33
Massachusetts	7.03	10	Connecticut	3.90	34
Montana	6.93	11	Arkansas	3.79	35
New Jersey	6.76	12	Maine	3.61	36
Arizona	6.40	13	Rhode Island	3.48	37
Florida	6.38	14	Ohio	3.38	38
West Virginia	6.26	15	Iowa	3.23	39
Pennsylvania	6.21	16	South Carolina	3.12	40
Idaho	5.55	17	Virginia	2.90	41
Oregon	5.48	18	Vermont	2.87	42
Minnesota	5.41	19	Alabama	2.73	43
North Dakota	5.15	20	Missouri	2.67	44
Georgia	4.81	21	Oklahoma	2.64	45
New Mexico	4.77	22	Hawaii	1.72	46
Kansas	4.74	23			
Maryland	4.65	24	Average**	5.95%	

*Total state tax revenue amounts include segregated fund revenues such as motor fuel taxes.
**Average of percent of total for each state.

NOTE: Nevada, Texas, Washington and Wyoming do not have a corporate income tax. Texas has a corporate tax that is partially based on net income.

Source: "State Government Tax Collections, 2001," U.S. Department of Commerce, Bureau of Census.

was 4.2%. This ranks 31st numerically and is below the national average of 5.95%. (The total tax amounts include segregated revenues such as the state motor fuel tax.)

Table 5 shows that Wisconsin ranks 24th in terms of corporate taxes per capita and 25th in corporate taxes per $1,000 of personal income. The state's per capita collections of $91.72 are below the national average of $124.77; collections per thousand dollars of personal income of $3.28 are also below the national average of $4.26. However, due to the erratic nature of corporate profits, rankings such as those shown in the tables can fluctuate from year to year. In addition, differences among states in economic characteristics can influence these measures as much as the specific type of corporate income tax structure which exists.

Table 5: Rank of States' Corporate Tax Collections for 2000-01 Fiscal Year*

State	Corporate Tax Collections Per Capita	Rank	State	Collections Per $1,000 Personal Income	Rank
Alaska	$630.62	1	Alaska	$21.52	1
New Hampshire	278.29	2	New Hampshire	8.56	2
Delaware	260.45	3	Delaware	8.48	3
Michigan	210.40	4	Michigan	7.26	4
California	199.97	5	California	6.30	5
Massachusetts	189.93	6	Illinois	5.59	6
Illinois	177.60	7	West Virginia	5.44	7
New York	168.30	8	Montana	5.08	8
New Jersey	153.32	9	Massachusetts	5.05	9
Minnesota	147.23	10	Indiana	5.04	10
Indiana	134.92	11	New York	4.88	11
Connecticut	120.62	12	New Mexico	4.77	12
West Virginia	118.92	13	Minnesota	4.65	13
Tennessee	117.33	14	Idaho	4.62	14
Montana	114.68	15	Tennessee	4.56	15
Pennsylvania	114.05	16	Arizona	4.19	16
Idaho	107.48	17	New Jersey	4.16	17
New Mexico	104.25	18	North Dakota	3.98	18
Arizona	101.97	19	Pennsylvania	3.86	19
North Dakota	99.98	20	Kentucky	3.71	20
Florida	97.06	21	Florida	3.56	21
Maryland	93.28	22	Mississippi	3.54	22
Oregon	92.90	23	Oregon	3.40	23
WISCONSIN	**91.72**	**24**	North Carolina	3.33	24
Kentucky	88.88	25	**WISCONSIN**	**3.28**	**25**
North Carolina	88.40	26	Kansas	3.21	26
Kansas	87.84	27	Arkansas	3.17	27
Georgia	82.48	28	Utah	3.10	28
Nebraska	80.58	29	Georgia	3.02	29
Colorado	76.97	30	Maine	2.97	30
Maine	74.81	31	Connecticut	2.97	30
Mississippi	73.75	32	Nebraska	2.91	32
Rhode Island	73.65	33	Louisiana	2.84	33
Vermont	72.77	34	Maryland	2.81	34
Utah	71.70	35	Vermont	2.72	35
Arkansas	69.20	36	Rhode Island	2.55	36
Louisiana	65.63	37	Colorado	2.42	37
Ohio	58.32	38	South Dakota	2.21	38
South Dakota	57.31	39	Iowa	2.16	39
Iowa	57.05	40	Ohio	2.09	40
Virginia	50.61	41	Oklahoma	2.05	41
Hawaii	49.43	42	South Carolina	1.99	42
Oklahoma	48.33	43	Hawaii	1.79	43
South Carolina	47.27	44	Alabama	1.66	44
Missouri	41.96	45	Virginia	1.65	45
Alabama	38.99	46	Missouri	1.55	46
AVERAGE FOR STATES WITH CORPORATE INCOME TAX**	$124.77		AVERAGE FOR STATES WITH CORPORATE INCOME TAX**	$4.26	

SOURCE: State Government Tax Collections 2001, and State Government Finances, 2001, U.S. Department of Commerce.

*Four states do not impose a broad-based corporate income tax: Nevada, Texas, Washington, and Wyoming. Texas has a corporate tax that is partially based on net income.

**Aggregate total ratio of tax per capita and per thousand dollars of personal income.