Legislative Fiscal Bureau
One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873

June 8, 2007 | Joint Committee on Finance | Paper #321

Internal Revenue Code Update
(General Fund Taxes -- Individual and Corporate Income Taxes)

Bill Agency

[LFB 2007-09 Budget Summary: Page 158, #11]

CURRENT LAW

State individual income tax and corporate and franchise tax provisions are generally referenced to definitions under federal law. Changes to federal law take effect for state purposes only after action by the Legislature. Generally, the Legislature reviews the previous year's federal law changes each year to update state references to the Internal Revenue Code (IRC). The current statutes refer to the federal IRC in effect on December 31, 2004.

GOVERNOR

Update statutory references to the federal Internal Revenue Code under the state individual income and corporate income and franchise taxes to include certain changes to the IRC enacted in 2005 and through November, 2006. With exceptions, the bill would update state references to federal provisions enacted under the following federal laws:

- Public Law 109-7, related to disaster mitigation payments
- The Energy Tax Incentives Act (ETIA -- Public Law 109-58)
- The Safe, Accountable, Flexible, Efficient Transportation Equity Act (SAFETEA -- Public Law 109-59)
- The Katrina Emergency Tax Relief Act (KETRA -- Public Law 109-73)

- The Gulf Opportunity Zone Act (GOZA -- Public Law 109-135)

- The Employee Retirement Preservation Act (ERPA -- Public Law 109-222)

- The Tax Increase Prevention Act of 2005 (TIPRA -- Public Law 109-151)

- The Heroes Earned Retirement Opportunities Act (HEROA -- Public Law 109-227)

- The Pension Protection Act of 2006 (PPA -- Public Law 109-280)

In addition, modify current law to base filing deadlines for extensions for corporate taxfilers on federal requirements and to conform to federal law regarding electronic reporting of withholding statements.

Provisions not previously adopted related to amortization and accelerated depreciation and expensing would not be adopted, with the exception of certain provisions related to capital investment expense deductions for persons actively engaged in farming. In addition, of the new federal laws passed since the last IRC update and through November, 2006, the bill would not include provisions to conform to Public Law 109-1 (which allowed taxpayers to treat charitable contributions made in January, 2005, for relief related to the Indian Ocean tsunami as a charitable contribution made in 2004), or to other specified provisions enacted under ETIA, SAFETEA, GOZA, TIPRA, and PPA.

Specify that the IRC update provisions would generally apply for Wisconsin purposes at the same time as they apply for federal purposes.

Estimate that these provisions would reduce state income and franchise tax revenues by $0.5 million in 2007-08 and $3.2 million in 2008-09. Most of the fiscal effect is due to provisions included in the federal Pension Protection Act. It should be noted that the IRC update would also affect taxes that would normally be paid during the 2006-07 fiscal year. The Department of Revenue (DOR) estimates that these provisions would reduce state income and franchise tax revenues by $3.0 million. This revenue loss would likely occur during the 2007-09 biennium as amended returns are filed; however, it has not been accounted for in the budget bill.

DISCUSSION POINTS

1. State references to federal law generally provide greater simplicity for taxpayers in preparing returns and reduce the administrative burden and cost for both taxpayers and DOR in assuring compliance with tax laws. The IRC references are used to determine which items of income are subject to taxation prior to specific state modifications. The state uses separate tax rates and brackets and separate provisions regarding standard deductions, itemized deductions, and tax credits.

2. The proposed IRC update in SB 40 addresses federal laws enacted in 2005 and in 2006 through November, 2006. The Department of Revenue has prepared a document reviewing these federal laws and provisions that the state could consider as part of an IRC update. The Department's review, which is included as Attachment 1 to this paper, includes DOR's recommendations about which federal provisions the state should adopt and which ones the state should not conform to. The estimated fiscal effect under the bill is based on the Department's recommendations except that, as noted, the estimates in the bill do not include projected costs associated with prior tax years.

3. While the bill's provisions would generally update state tax references to the IRC to federal law changes through November, 2006, certain federal provisions would not be adopted for state tax purposes. The federal provisions specifically excluded from the IRC update under the bill are described on pages 14 through 18 of Attachment 1.

4. As noted, a number of the federal provisions that would be included in the IRC update under the bill affect taxes that would normally be paid during the 2006-07 fiscal year. DOR has estimated the total fiscal effect associated with such provisions as a reduction in general fund tax revenues of $3.0 million. However, this estimate is the net effect of certain provisions that would reduce state tax revenues and others that DOR had estimated would increase state tax revenues. Upon further review, it appears unlikely that the increases, as well as some of the losses, that are included in this figure would be realized as a result of conforming to the federal provisions for prior years. Therefore, this effect should be reestimated as an additional reduction in tax revenues under the IRC update included in the bill of $5.7 million, which should be reflected in 2007-08.

5. In addition, there are two items related to PPA for which the estimated fiscal effects included in the bill should be eliminated. The first item is a change under PPA that makes it easier for firms to offer automatic enrollment in defined-contribution pension plans, effective for plan years beginning after December 31, 2007, thereby increasing participation in plans and the amount of contributions that would be made on a pre-tax basis. Under the bill, this provision was estimated to reduce individual income tax revenues by $0.8 million in 2007-08 and by $2.1 million in 2008-09. The second item is a change in federal funding rules for single-employer, defined benefit plans, which is expected to result in lower contributions by such employers to benefit plans initially, and higher contributions later, thereby increasing taxable corporate profits and revenues initially and lowering profits and revenues later. Under the bill, this provision was estimated to increase state tax revenues by $4.4 million in 2007-08 and $2.7 million in 2008-09. However, for both items, the estimated fiscal effects are expected to result from the federal law changes themselves, rather than from the proposed update in state tax references to the IRC. Therefore, the changes in revenue associated with these provisions should not be considered to be a result of the proposed IRC update, and should be eliminated from the bill. As a result of these revisions, state tax revenues should be reduced by an additional $3.6 million in 2007-08 and $0.6 million in 2008-09, compared to the estimates in the bill.

6. Based on the two sets of revisions described above, the fiscal effect of the IRC

update included in the bill is reestimated as a reduction in state tax revenues of $9.8 million in 2007-08 and $3.8 million in 2008-09. Compared to the bill, these figures represent additional reductions in state tax revenues of $9.3 million in 2007-09 and $0.6 million in 2008-09. The following table summarizes the revised estimates of the fiscal effects of the IRC update provisions included under the bill.

TABLE 1

Summary of Federal Law Changes Included in SB 40 with Substantive Fiscal Effects (In Millions)

	2007-08	2008-09
Individual Income Tax		
Qualified disaster mitigation payments	Minimal	-$0.05
Inflation indexing of certain income limits for individual retirement accounts (IRAs)	-$0.52	-0.70
Rollover by nonspouse beneficiaries of certain retirement plan distributions	-0.30	-0.26
Tax-free pension distributions for health care and long-term care insurance for public safety officers	-3.18	-1.97
Required condition for charitable contributions of clothing and household goods	0.30	0.36
Tax-free IRA distributions for charitable giving	-2.24	-0.37
Alternative minimum tax	-1.00	0.00
S-corporation basis adjustment for charitable giving	-0.56	Minimal
Individual Income Tax Total	-$7.50	-$2.99
Corporate and Business Taxes		
Treatment of certain income of electric cooperatives	-$0.05	-$0.06
Energy efficiency commercial buildings property deduction	-0.58	0.00
Extend replacement period for nonrecognition of gain	-0.43	Minimal
Enhanced deductions for contributions of food inventories to individuals	-0.94	-0.64
Excess pension assets for future medical benefits	-0.06	-0.05
Allowance for medical benefit reserve	-0.05	-0.07
Enhanced deduction for food	-0.15	-0.00
Corporate and Business Tax Total	-$2.26	-$0.82
IRC Update Total	-$9.8	-$3.8

7. The administration has requested a technical amendment to the bill to correct a federal reference that was mistakenly included in a section of the bill where it is not needed. The amendment should be approved in order to accomplish the bill's intended references to the IRC.

8. Subsequent to introduction of the budget bill, the administration forwarded the Department of Revenue's recommendations regarding updating the budget bill to conform to certain provisions of Public Law 109-432, the federal Tax Relief and Health Care Act of 2006 (TRHCA), which was enacted on December 20, 2006. DOR's review of TRHCA is included as Attachment 2 to this paper. Table 2 provides a list of the items recommended by DOR that are projected to have a significant impact on state tax revenues, along with their estimated fiscal effects.

TABLE 2

Summary of Federal Law Changes Under TRHCA with Substantive Fiscal Effects (In Millions)

	2007-08	2008-09
Individual Income Tax		
Deduction for educator expenses	-$1.86	-$0.28
Mortgage insurance premiums treated as deductible interest	-0.45	-0.15
Individual Income Tax Total	-$2.31	-$0.43
Corporate and Business Taxes		
Energy efficiency commercial buildings property deduction	-$0.08	Minimal
Extend mental health parity provisions	-0.14	Minimal
Wages to Puerto Rico residents included in QPAI wages	-0.33	-$0.03
Expanded research credits	-2.60	-2.60
Corporate and Business Tax Total	-$3.15	-$2.63
IRC Update Total	-$5.5	-$3.1

9. DOR's review of TRHCA identifies certain provisions that are not recommended for adoption, including certain federal provisions related to health savings accounts (HSAs). These provisions are described on pages five through seven of Attachment 2.

10. Based on the Department's recommendations as to which provisions to conform to, it is estimated that amending the bill to include these provisions would reduce state tax revenues by an additional $5.5 million in 2008-09 and $3.1 million in 2009-10. The additional cost of conforming to the TRHCA could be reduced by delaying the effective date for conformance to the provisions associated with the estimated fiscal effects outlined above. However, for five of the six items shown in the table, the federal benefits under TRHCA are provided for a time-limited basis. If the effective date for such items was to be delayed until after the biennium, there would be no benefit to Wisconsin taxpayers as there would no longer be federal benefits to conform to. The only federal modification under TRHCA shown in the table that is an ongoing federal provision is the modification to provide for expanded research credits, which would affect a Wisconsin research credit that is based on qualified research expenses for purposes of the federal credit. Conformance with this provision could be delayed and still provide a Wisconsin tax benefit in future years.

11. One option that would reduce the estimated fiscal effect of updating state tax references to conform with the TRHCA would be to conform to all of the provisions recommended by DOR, but to delay the effective date of conforming to the expanded research credit to taxable years beginning after June 30, 2009. Under this option, state tax revenues would be reduced by an estimated $2.9 million in 2007-08 and $0.5 million in 2008-09, compared to the reestimated fiscal effects of the IRC update included in the bill, described above. In subsequent years, state tax revenues would be reduced by an additional $2.6 million annually for conformance with the expanded federal research credit.

12. Another option would be to conform only to the recommended provisions of

TRHCA that are not estimated to have a significant fiscal effect. Under this option, there would be no additional modifications to the estimated fiscal effects of the IRC update (compared to the revised estimates, described above, of the fiscal effects of the provisions included in the bill).

13. As noted, one of the federal TRHCA provisions not recommended by DOR relates to HSAs. Wisconsin does not currently conform to either the original federal HSA provisions, which first took effect on January 1, 2004, or to any of the subsequent federal modifications to HSAs. However, two bills have been introduced in 2007, Senate Bill 18 and Assembly Bill 47, each of which would provide a nonrefundable tax credit intended to have an equivalent effect at the state level of the federal HSA treatment (but through a tax credit rather than income tax exclusions and deductions). As the HSA provisions are under consideration as stand-alone legislation, they are not addressed further in this paper.

ALTERNATIVES TO BILL

1. Approve the Governor's proposal with the requested technical amendment. However, reestimate the fiscal effect to reflect an additional reduction of state income and franchise tax revenues of $9.3 million in 2007-08 and $0.6 million in 2008-09.

ALT 1	Change to Bill Revenue	Change to Base Revenue
GPR	- $9,900,000	- $13,600,000

2. Approve the Governor's proposal and requested technical amendment. In addition, update state tax references to conform to the TRCHA provisions recommended in the review by DOR. Compared to the bill, estimate additional reductions in general fund tax revenues of $14.8 million in 2007-08 and $3.7 million in 2008-09. Of these additional amounts, $5.5 million in 2007-08 and $3.1 million in 2008-09 would be based on conformance with the TRCHA provisions and the remainder would be from the reestimated fiscal effects of the IRC update included in the bill.

ALT 2	Change to Bill Revenue	Change to Base Revenue
GPR	- $18,500,000	- $22,200,000

3. Approve the Governor's proposal and requested technical amendment. In addition, update state tax references to conform to the TRCHA provisions recommended in the review by DOR. However, specify that conformance with the federal modifications to the research credit would take effect for taxable years starting after June 30, 2009. Compared to the bill, estimate additional reductions in general fund tax revenues of $12.2 million in 2007-08 and $1.1 million in 2008-09. Of these additional amounts, $2.9 million in 2007-08 and $0.5 million in 2008-09 would be based on conformance with the TRCHA provisions and the remainder would be from the

reestimated fiscal effects of the IRC update included in the bill.

ALT 3	Change to Bill Revenue	Change to Base Revenue
GPR	- $13,300,000	- $17,000,000

4. Approve the Governor's proposal and requested technical amendment. In addition, update state tax references to conform to the TRCHA provisions recommended in the review by DOR except those estimated by the Department to have a significant fiscal effect. Compared to the bill, estimate additional reductions in general fund tax revenues of $9.3 million in 2007-08 and $0.6 million in 2008-09 from the reestimated fiscal effects of the IRC update included in the bill.

ALT 4	Change to Bill Revenue	Change to Base Revenue
GPR	- $9,900,000	- $13,600,000

5. Delete provision.

ALT 5	Change to Bill Revenue	Change to Base Revenue
GPR	$3,700,000	$0

Prepared by: Faith Russell and Ron Shanovich
Attachments

ATTACHMENT 1

Wisconsin Department of Revenue
Division of Research and Policy
November 16, 2006

INTERNAL REVENUE CODE UPDATE
LAWS ENACTED THROUGH AUGUST, 2006

A. INTRODUCTION

Wisconsin's individual income and corporate income and franchise tax bases closely conform to the bases for the federal individual and corporate income taxes. Conformity is achieved through references in Chapter 71 of the Wisconsin Statutes to the federal Internal Revenue Code (IRC). To maintain conformity, these references must be updated to adopt changes made since the most recent update for federal IRC changes through 2004.

During 2005 and 2006, Congress enacted seven bills that affect the IRC:

- Public Law 109-1
- Public Law 109-7
- Public Law 109-58, the Energy Tax Incentives Act (ETIA)
- Public Law 109-59, the Safe, Accountable, Flexible, Efficient Transportation Equity Act (SAFETEA)
- Public Law 109-73, the Katrina Emergency Tax Relief Act (KETRA)
- Public Law 109-135, the Gulf Opportunity Zone Act (GOZA)
- Public Law 109-151, the Employee Retirement Preservation Act (ERPA)
- Public Law 109-222, Tax Increase Prevention Act of 2005 (TIPRA)
- Public Law 109-227, Heroes Earned Retirement Opportunities Act (HEROA)
- Public Law 109-280, Pension Protection Act of 2006 (PPA)

Provisions of these laws that relate to federal credits, federal excise taxes, federal bonds, federal administrative provisions, and federally-mandated studies do not apply for Wisconsin tax purposes. Provisions not previously adopted related to amortization and accelerated depreciation and expensing are not recommended for adoption. One exception to this relates to section 179 expense deductions allowed under TIPRA for persons actively engaged in farming.

The department is also recommending simplifying the process for corporate filers for filing extensions by basing the Wisconsin filing deadlines on federal requirements.

Sections B and C describe the provisions that are recommended for adoption. Provisions that should not be adopted are described in Section D. Certain items that are not recommended for inclusion do not take effect until 2010 and therefore do not need to be adopted at this time. As some of these have significant fiscal effects in later years, the Department recommends analyzing these further prior to adoption.

Adopting these laws at the same time they apply for federal purposes, with the exceptions identified above, and would reduce state revenues by an estimated $3.0 million in FY07, $.54 million in FY08 and $3.2 million in FY09. Table 1 shows the estimated fiscal impacts of provisions with non-minimal impact on Wisconsin tax revenues.

In addition to the above law changes, Wisconsin statutes should be amended to exclude several sections of previously enacted federal laws. In particular, section 301(a) of Public Law 107-147, section 316 of Public Law 108-311, sections 211, 242 and 847 of Public Law

108-357 should be excluded. Excluding these sections will ensure that all provisions related to depreciation and amortization are determined under IRC provisions in effect on December 31, 2000. Excluding these sections will ensure consistent treatment across different types of property and will have minimal to no fiscal effect.

TABLE 1
FISCAL EFFECT OF ADOPTING FEDERAL TAX PROVISIONS ENACTED IN 2005

Federal Tax Change	Effective Date	Fiscal Effect ($ millions) FY07	FY08	FY09
Public Law 109-7				
Mitigation Payments	1/7/05	minimal-	minimal-	-0.05
Energy Tax Incentives Act				
Treatment of Certain Income of Electric Cooperatives	01/01/06	miminal-	-0.05	-0.06
Energy Efficicney Commercial Buildings Property Deduction	12/31/05	-0.42	-0.16	minimal-
Modification of recapture rules for Sec. 197 Intangibles	8/8/05	0.06	minimal+	minimal+
Katrina Emergency Tax Relief Act				
Enhanced deduction for food inventory		-0.15	-	-
Extend replacement period for nonrecognition of gain	9/23/05	-0.35	-0.08	minimal-
Tax Increase Prevention and Reconciliation Act				
Increase in AMT exemption levels	1/01/06	-1.00	-	-
Pension Protection Act				
Increase funding rules for single-employer plans	12/31/06	2.5	4.4	2.7
Indexing IRA income limits	12/31/06	-0.12	-0.40	-0.70
Rollover by nonspouse beneficiaries of certain retirment plan distributions	12/31/06	-0.10	-0.20	-0.26
Excess pension assets for future medical benefits	08/17/06	miminal-	-0.06	-0.05
Allowance for medical benefit reserve	12/31/06	miminal-	-0.05	-0.07
Tax free pension distributions used for health & long term care insurance - public safety officers	12/31/06	-1.38	-1.80	-1.97
Automatic enrollment in defined contribution plans	12/31/07	0.00	-0.76	-2.10
Tighten condition of charitable goods	08/17/06	0.07	0.30	0.36
Tax-free IRA distributions for charitable giving	12/31/05-1/1/08	-1.30	-0.94	-0.37
S-corporation basis adjustment for charitable giving	12/31/05-1/1/08	-0.50	-0.06	minimal-
Extend enhanced deduction for food inventory	12/31/05-1/1/08	-0.37	-0.67	-0.64
TOTAL		-3.02	-0.54	-3.20

B. INDIVIDUAL INCOME TAX

1. Qualified disaster mitigation payments excluded from gross income

Federal Law Change: Under Public Law 109-7, qualified disaster mitigation payments are excluded from gross income. The IRS had ruled that payments received under the Robert T. Stafford Disaster Relief and Emergency Assistance Act and the Natural Flood Insurance Act were exempt from taxation until June 2004, when they became taxable. This act specifically excludes the above payments from gross income. There is no increase in the basis. Property sold under certain hazard mitigation programs is treated as an involuntary conversion.

Effective Date: Amounts received before, on, or after April 15, 2005.

Fiscal effect: -Minimal in FY07 and FY08, -$55,000 in FY09.

Public Law 109-73 Katrina Emergency Tax Relief Act of 2005 and Gulf Opportunity Zone Act of 2005 (provisions originally found in the Katrina Act and expanded by the Gulf Opportunity Act include the fiscal effect total for both acts).

2. Penalty-free withdrawals from retirement plans

Federal law Change: Wisconsin currently applies 33% of the 10% federal penalty for early withdrawal from retirement accounts. For distributions from August 25, 2005, through December 31, 2006, victims of Hurricanes Katrina, Rita, and Wilma may withdraw up to $100,000 from an IRA or eligible retirement plan without penalty.

Taxpayers who are able to repay the distributions have three years to repay the funds to qualify for rollover treatment and exclude the repayments from income. Otherwise, they will be taxed on their distribution.

Effective Date: Distributions on or after 8/25/05 and before 1/1/07.

Fiscal effect (includes Katrina and Gulf Acts): -Minimal.

3. Recontributions of withdrawals from retirement plans for home purchases cancelled due to Hurricanes Katrina, Rita, or Wilma.

Federal Law Change: First-time home buyers who withdrew funds from an IRA or other eligible retirement plan after February 28, 2005, (and before August 29 for homes located in the Katrina disaster area, before September 24, 2005, for those in the Rita disaster area, and before October 24, 2005, for those in the Wilma disaster area) for the purchase or construction of a first-time home in a hurricane disaster area but could not complete that purchase or construction because of Hurricanes Katrina, Rita, or Wilma may put the funds back into their IRA or other eligible retirement plan without penalty if they do so before March 1, 2006.

Effective Date: Distributions received after 2/28/05 and before 8/29/05.

Fiscal effect (includes Katrina and Gulf Acts): -Minimal.

4. Loans from qualified retirement plans for relief relating to Hurricanes Katrina, Rita, or Wilma.

Federal Law Change: Under current federal law, loans from qualified retirement plans are treated as taxable distributions. An exception is allowed for loans up to $50,000 for the purchase of a principal residence if the loan is repaid within five years. The act increases the limit from $50,000 to $100,000 for hurricane victims whose principal place of residence was in one of the three hurricane disaster areas on August 28 (Katrina), September 23 (Rita), and October 23 (Wilma). Loans must be made on or after September 24, 2005, for Hurricane Katrina victims, and on or after December 21, 2005, for Hurricanes Rita and Wilma and before January 1, 2007.

Furthermore, if a taxpayer had a qualifying outstanding loan on August 25 (Katrina victims), September 23 (Rita victims) or October 23 (Wilma victims) any payments due between those dates and December 31, 2006, are extended for one year.

Effective Date: December 21, 2005 (date of enactment).

Fiscal effect (includes Katrina and Gulf Acts): -Minimal.

5. Increase in standard mileage rate for charitable use of a vehicle related to Hurricane Katrina.

Federal Law Change: The standard mileage rate for the personal use of automobiles for charitable purposes is $0.14 per hour. Effective August 25, 2005, the standard mileage rate for the personal use of automobiles to provide charitable services related to Hurricane Katrina is 70% of the standard business mileage rate. As a result, the new standard mileage rate for Katrina-related charitable use of a vehicle is $0.29 per mile during the period of August 25, 2005, through August 31, 2005, and $0.34 per mile from

September 1, 2005, to December 31, 2005. Wisconsin's standard mileage rate for charitable use of a vehicle is 14 cents per mile.

Effective Date: 8/25/05 through 12/31/06.

Fiscal effect: -Minimal.

6. **Mileage reimbursements to charitable volunteers excluded from gross income for providing relief related to Hurricane Katrina.**

Federal Law Change: Reimbursement received by a volunteer for the cost of using a passenger automobile in connection with providing relief to Hurricane Katrina victims is excluded from income up to the amount that equals the full standard business mileage rate: $0.405 per mile for the period August 25 though August 31, 2005, and $0.485 per mile for the period September 1 through December 31, 2005.

Effective Date: 8/25/05 through 12/31/06.

Fiscal effect: -Minimal.

7. **Exclusions of certain cancellations of indebtedness for certain taxpayers affected by Hurricane Katrina.**

Federal Law Change: Ordinarily, income from the discharge of indebtedness is generally taxable. Under KETRA, discharges of non-business debts (such as mortgages) made from August 25, 2005, to December 31, 2006, are excluded from income for individuals whose principal residence was in the Hurricane Katrina disaster area on August 25, 2005. Unlike with other provisions, similar relief was not extended to victims of Hurricanes Rita and Wilma.

Effective Date: Discharges made on or after 8/25/05 and before 1/1/07.

Fiscal effect: -Minimal.

8. **Allow residents of Hurricane disaster areas who experienced a loss of income due to Hurricanes Katrina, Rita or Wilma to elect to use prior year's income in the calculation of the earned income credit and the refundable child tax credit.**

Federal Law Change: Taxpayers can use their 2004 earned income to calculate their earned income credit and additional child tax credit for 2005 if their 2005 earned income is less than their 2004 earned income; and if their main home was in the Gulf Opportunity (GO) Zone, the Hurricane Katrina disaster area, the Rita GO Zone, the Hurricane Rita disaster area, the Wilma GO Zone or the Hurricane Wilma disaster area. In any of the Hurricane disaster areas, residents must have been displaced from their homes to be allowed to use the prior year's income to figure these credits.

Effective Date: Taxable year that includes the date of the hurricane (tax year 2005).

Fiscal effect (includes both Katrina and Gulf Acts): -Minimal.

9. **IRS authorized to adjust application of tax laws for hurricane victims.**

Federal Law Change: The IRS may adjust the application of tax laws for taxable years beginning in 2005 or 2006 to ensure that taxpayers do not lose any deduction or credit or experience a change of filing status because of temporary relocations as a result of Hurricanes Katrina, Rita or Wilma.

Effective Date: Taxable years beginning in 2005 or 2006.

Fiscal effect: -Minimal.

10. Gross income exclusion for lodging furnished by an employer.

Federal Law Change: GOZA provides that a qualified employee's gross income does not include the value of any in-kind lodging provided to the employee, the employee's spouse or dependents by or on behalf of a qualified employer for any month during the tax year. The amount of the exclusion for any month cannot exceed $600. The exclusion is only available for lodging provided during the six-month period beginning on January 1, 2006. The exclusion does not apply for purposes of Social Security and Medicare taxes or unemployment tax.

A qualified employee is a person whose principal residence was in the Gulf Opportunity Zone on August 28, 2005, and who performs substantially all of his or her employment services in the Gulf Opportunity Zone for the qualified employer who has furnished the lodging. A qualified employer is any employer with a trade or business in the Gulf Opportunity Zone.

Effective Date: December 21, 2005 (date of enactment).

Fiscal Effect: -Minimal, probably zero.

11. Including combat pay as earned income for purposes of earned income credit.

Federal Law Change: A taxpayer may choose to treat combat zone compensation that is otherwise excluded from gross income under IRC Sec. 112 as earned income for purposes of the earned income credit. This was scheduled to end on December 31, 2005 but was extended through December 31, 2006, by GOZA.

Effective Date: December 31, 2005 (date of enactment).

Fiscal Effect: -Minimal.

12. Increase alternative minimum tax exemption amount for 2006.

Federal Law Change: Under TIPRA, married joint filers may exempt $62,550 from the alternative minimum tax (AMT) and single filers may exempt $42,500. Prior to TIPRA, the 2006 AMT exemption amounts were to revert to the 2001 levels of $45,000 for married joint filers and $33,750 for single filers.

Effective Date: Taxable year beginning after December 31, 2005

Fiscal Effect: Using the federal AMT exemption levels for the WI AMT calculation will reduce collections by an estimated $1 million in FY06.

13. Modification of Exclusion for Citizens Living Abroad.

Federal Law Change: TIPRA raises the foreign-earned income exclusion allowed for certain taxpayers living abroad from $80,000 to $82,400. Limits exclusion allowed for foreign housing costs.

Effective Date: Taxable years after December 31, 2005.

Fiscal Effect: +Minimal.

14. Allow sec. 179 expensing for persons actively engaged in farming.

Federal Law Change: TIPRA extends the higher expensing deduction allowed under sec. 179 from 2008 to 2010. Wisconsin has not adopted federal treatment with regard to sec. 179 expensing. However, 2005 Wisconsin Act 362 created s. 71.765, Wis. Stats., to provide that for property acquired and placed in service in taxable years beginning on or after January 1, 2008, a person who is actively engaged in farming may compute an expense deduction on property used in farming under any subsequent change to sec. 202 of P.L. 108-27 and sec. 201 of P.L. 108-357.

Under s. 71.765, Wis. Stats, this would not apply unless a federal law change enacted after December 31, 2005, revises sec. 202 of P.L. 108-27 or section 201 of P.L. 108-357. (Sec. 202 of P.L. 108-27 increased the amount that may be expensed under sec. 179 IRC from $25,000 to $100,000 and the phase out amount from $200,000 to $400,000, for taxable years beginning after 2002 and before 2006. Section 201 of P.L. 108-357 extended the 2006 date to 2008.)

The sec. 179 expense deduction has been extended for federal purposes. However, it was not extended by revising either sec. 202 of P.L. 108-27 or sec. 201 of P.L. 108-357, but rather by TIPRA.

In order to have the sec. 179 expense deduction apply for Wisconsin for persons actively engaged in farming, s. 71.765, Wis. Stats., must be amended to refer to the extension of sec. 179 expenses allowed by TIPRA (sec. 101 of P.L. 109-222).

Effective Date: Taxable years beginning on or after January 1, 2008.

Fiscal Effect: Minimal revenue decrease in the year of the deduction and increase in revenue in subsequent years.

15. Allow contributions to IRAs from excluded combat zone pay.

Federal Law Change: Under current law, contributions to an IRA are deductible to the extent that the contributions do not exceed taxable earned income. Under the HEROA, members of the armed forces serving in combat zones may make contributions to an IRA even if the compensation on which such contributions are based is excluded from gross income.

Effective Date: Taxable years beginning after December 31, 2003.

Fiscal Effect: Minimal.

16. Inflation indexing of certain income limits for IRAs.

Federal Law Change: PPA indexes the income limits for IRA contributions beginning in 2007. The indexing applies to the income limits for deductible contributions for active participants in an employer-sponsored retirement plan, the income limits for deductible contributions if the individual is not an active participant in a plan but his or her spouse is, and the income limits for Roth IRAs. The phase out ranges are not indexed.

Effective Date: Taxable years beginning after 2006.

Fiscal Effect: -$120,000 in FY07, -$410,000 in FY08, -$700,000 in FY09.

17. Extends retirement plans and IRA treatment to nonspouse beneficiaries.

Federal Law Change: Current law allows a taxpayer to roll over his or her deceased spouse's interest in a qualified retirement plan, government plan or IRA into an IRA. Thus, the inherited IRA is treated as the IRA of the surviving spouse, in which case the surviving spouse may make contributions to the IRA and the same rules apply for distributions of the inherited IRA as for other IRAs of the surviving spouse. PPA extends this treatment to nonspouse beneficiaries.

Effective Date: Distributions after December 31, 2006.

Fiscal Effect: -$110,000 in FY07, -$210,000 in FY08, -$260,000 in FY09.

18. Automatic enrollment in defined contribution retirement plans.

Federal Law Change: PPA makes it easier for firms to offer automatic enrollment in defined-contribution pension plans, thereby increasing participation in plans and the amount of contributions that would be made on a pre-tax basis.

Effective Date: Plan years beginning after December 31, 2007.

Fiscal Effect: -$800,000 in FY08, -$2.1 million in FY09.

19. Permit tax-free distributions from governmental retirement plans.

Federal Law Change: Under PPA, pension distributions from governmental retirement plans used to pay for health insurance are excludible from income, up to a maximum of $3,000 annually. The provision applies only to retired public safety officers.

Effective Date: For distributions in taxable years beginning after December 31, 2006.

Fiscal Effect: -$1.4 million in FY07, -$1.8 in FY08, -$2.0 in FY09.

20. Clarify condition of charitable contributions.

Federal Law Change: PPA tightens the rules for donation of clothing and household goods; such donations must be in good condition and cannot have a minimal value.

Effective Date: Contributions made after August 17, 2006.

Fiscal Effect: +$66,000 in FY07, +$290,000 in FY08, +$360,000 in FY09.

21. Allow tax free IRA distributions for charity.

Federal Law Change: PPA allows tax-free distributions from IRAs for charitable purposes through December 21, 2007. The maximum annual cap is $100,000.

Effective Date: Distributions made in taxable years beginning after December 31, 2005 but before January 1, 2008.

Fiscal Effect: -$1.3 million in FY07, -$1 million in FY08, - $400,000 in FY09.

22. Basis adjustment to S-corp stock for charitable contributions.

Federal Law Change: Under current law, if an S corporation contributes money or property to charity, each shareholder reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder. Under PPA, the reduction of a shareholder's basis equals the shareholder's pro rata share of the adjusted basis of the contributed property.

Effective Date: Contributions made in taxable years beginning after December 31, 2005 and before January 1, 2008.

Fiscal Effect: -$470,000 in FY07, -$64,000 in FY08 and minimal in FY09.

CORPORATE INCOME AND FRANCHISE TAX

1. Elimination of Sunset on Treatment of Certain Income of Electric Cooperatives.

Federal Law Change: Certain local benevolent life insurance associations, mutual ditch or irrigation companies, mutual or cooperative telephone companies and other similar organizations are exempt from tax if at least 85% of the income of the organization consists of amounts collected from members for the sole purpose of meeting losses and expenses. The 85% test is applied annually so that an electric cooperative could be taxable one year and exempt the next. A revenue ruling, set to expire in 2007, interprets "income" for the 85% test as "gross income."

ETIA eliminates the sunset date for the rules. As a result, certain income received or accrued by tax exempt rural electric cooperatives will continue to be exempt if it is from certain open access electric energy transmission or distribution services, nuclear decommissioning transactions, asset exchange or conversion transactions for purposes of the 85% test. In addition, the sunset date for rules pertaining to treatment of load loss transactions in the 85% test is also eliminated.

Effective Date: For tax years beginning on August 8, 2005.

Fiscal Effect: -Minimal in FY 07; -$50,000 in FY 08, -$60,000 in FY09.

2. Energy Efficiency Commercial Buildings Property Deduction.

Federal Law Change: The ETIA creates a deduction for costs from depreciable energy-efficient commercial building property certified pursuant to a plan to reduce overall energy and power costs and placed in service after December 31, 2005, and before January 1, 2008. The maximum is $1.80 per square foot and the basis of the property must be reduced.

Effective Date: For property placed in service after December 31, 2005, and before January 1, 2008.

Fiscal Effect: -$416,000 in FY 07 and -$159,000 in FY 08.

3. Modification of Recapture Rules for Sec. 197 Intangibles Amortization.

Federal Law Change: IRC section 197 amortizable property is generally an intangible held by a taxpayer in the conduct of a trade or business. The cost of a section 197 intangible is recoverable using a 15-year straight line method of amortization. Gain on the sale of property must be recaptured as ordinary income to the extent of deductions previously claimed. The recapture amounts are computed separately for each item of property. Calculating the amortization recapture separately allows for manipulation that could lead to gain being taxed at the lower capital gain rates.

Under the ETIA, if multiple section 197 properties are sold or disposed of in a single transaction or in a series of transactions, the seller must calculate recapture as if all of the intangibles were a single asset. Allocation of sales proceeds to specific assets is unnecessary for determining amortization recapture. The new recapture rules do not apply to intangibles that have an adjusted basis that exceeds fair market value (sold at a loss).

Effective Date: For dispositions of property after August 8, 2005.

Fiscal Effect: $60,000 in FY 07 and + Minimal in FY 08.

4. Enhanced Deductions for Contributions of Food Inventories to Individuals.

Federal Law Change: Under the Katrina Act (KETRA), noncorporate taxpayers may claim an enhanced deduction for qualified donations of food inventory that was formerly limited to C corporations. Contributions of "apparently wholesome food" must occur on or after August 28, 2005, and before January 1, 2006, and be to a qualified charity or private operating foundation for use in the care of the ill, the needy or infants.

The amount of the enhanced deduction equals the lesser of (1) the donated item's basis plus one-half of the item's appreciation, or (2) two times the donated item's basis. The amount of appreciation is the amount of gain that would be realized if the donated item was sold at fair market value on the date of the gift. The total deduction for donations must not exceed 10% of the taxpayer's net income from the trades or businesses making the donations. Prior to this provision, the deduction was limited to the donor's basis of the donated items.

PPA extends the provision through December 31, 2007.

Effective Date: For contributions made on or after August 28, 2005, in tax years ending after that date, and before January 1, 2008.

Fiscal Effect: -$520,000 in FY 07, -$670,000 in FY08, -$640,000 in FY09.

5. Enhanced Deductions for Contributions of Book Inventories to Public Schools.

Federal Law Change: The KETRA allows C corporations to claim an enhanced deduction for qualified donations of book inventories to public schools that occur on or after August 28, 2005, and before January 1, 2006. A qualified contribution must be to an elementary or secondary school that maintains a regular faculty and curriculum with a regularly enrolled student body. The school must certify in writing that the books are suitable for use in the school's educational programs and that it will actually use the books.

Effective Date: For contributions on or after August 28, 2005, in tax years ending after that date, and before January 1, 2006. PPA extends the provision through December 31, 2007.

Fiscal Effect: -Minimal.

6. Nonrecognition of Gain for Property Located in Katrina Disaster Area.

Federal Law Change: Generally, an involuntary conversion of property occurs when property is damaged, destroyed, stolen or condemned, and the owner receives other property or money in payment, such as insurance. Generally, the owner does not have to report a gain (if any) if the property is replaced within four years for a principal residence in a presidentially declared disaster area and two years for business property.

Under the KETRA, the replacement period for business and residential property in the Katrina disaster area that is converted on or after August 25, 2005, due to the hurricane is extended from two to five years. The extension applies only if substantially all of the use of the replacement property is in the Katrina disaster area.

Effective Date: September 23, 2005.

Fiscal Effect: -$350,000 in FY 07; -$75,000 in FY 08.

7. Extension of Parity Limits for Mental Health Benefits.

Federal Law Change: The Mental Health Parity Act of 1996 contains rules regarding parity of mental health benefits with medical and surgical benefits. Plans that offer mental health benefits are not allowed to impose annual or lifetime dollar limits on mental health benefits that are not also imposed on medical and surgical benefits. Plans are not required to offer mental health benefits. The provision was set to expire on December 31, 2005.

ERPA extends the parity provision for an additional year, through December 31, 2006.

Effective Date: January 1, 2006.

Fiscal Effect: -Minimal in FY 07 and F08.

8. Wage Limitation for Qualified Production Activity Income.

Federal Law Change: Under TIPRA, the Form W-2 wage limit for the deduction will be based on wages allocable to domestic production activities, rather than all of a company's Form W-2 wages. TIPRA also simplifies the rules for determining W-2 wages of partners and S-corporation shareholders.

Effective Date: Taxable years after May 17, 2006.

Fiscal Effect: +Minimal.

9. Superfund settlement funds exempt.

Federal Law Change: Under TIPRA, escrow funds established for hazardous waste sites under agreement with the Environmental Protection Agency under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA) are exempt so long as the funds are controlled by a government agency.

Effective Date: Accounts and funds established after May 17, 2006 and before January 1, 2011.

Fiscal Effect: Minimal.

10. Active Business Test for Tax Free Corporate Spin Offs & Clarification of Disqualified Investment Corporations.

Federal Law Change: (a) TIPRA simplifies active business test for tax-free corporate spin-offs. In a spin-off, a corporation distributes stock in a subsidiary that it controls to its shareholders. The shareholders receiving the stock do not have to surrender any of their stock in the parent corporation. The receipt of the stock is tax-free if immediately after the stock distribution, the parent and subsidiary corporations are engaged in the active conduct of a trade or business. Under the law change, all members of the parent corporation's affiliated group and all members of the subsidiary's affiliated group are considered when determining if the active business test is met. By applying the active business test at the group level, corporate groups do not have to restructure in order for a spin-off to be tax-free.

(b) Also under TIPRA, tax-free treatment will no longer apply to a corporate spin-off if either the parent corporation or the subsidiary corporation is a disqualified investment corporation immediately after the transaction and any person who did not hold at least 50% of the value of the corporation's stock before the transaction holds 50% or more of the disqualified investment corporation after the transaction. A corporation is a disqualified investment corporation if at least two thirds of the fair market value of all of its assets consists of investment assets.

Effective Date: (a) Distributions made after May 17, 2006 and on or before December 31, 2010.

(b) Distributions made after May 17, 2006.

Fiscal Effect: Minimal.

11. Interest Expense Deduction.

Federal Law Change: A corporation's interest expense deduction is limited when the corporation pays interest to a related person that is exempt from U.S. tax. Corporations try to get around the limitation by using partnerships. The law change codifies the IRS's proposed regulations that apply the limitations to corporate partners. The corporation's share of the partnership's interest income or interest expense is treated as interest income or expense of the corporation.

Effective Date: Taxable years beginning on or after May 17, 2006.

Fiscal Effect: Minimal.

12. Treatment of Sale or Exchange of Self-Created Musical Works

Federal Law Change: Under TIPRA taxpayers may elect to treat the sale or exchange of self created musical work as a capital asset (taxed at 15%) rather than ordinary income (that can be taxed as high as 35%).

Effective Date: Sales and exchanges in taxable years beginning after May 17, 2006 and before January 1, 2011.

Fiscal Effect: Minimal.

13. Distributions by Regulated Investment Company (RIC)

Federal Law Change: Nonresident aliens and foreign (non-U.S.) corporations generally are taxed on net gains from the disposition of U.S. real property. Net gains from the disposition of U.S. real property passed through from a regulated investment company (RIC) or a real estate investment trust (REIT) are taxable only if certain conditions are met.

a. Under TIPRA, distributions by a RIC to foreign shareholders of amounts attributable to the sale of U.S. real property interests are not treated as income under the Foreign Investment in Real Property Tax Act (FIRPTA) unless the RIC is a real property holding company.

b. Also under TIPRA, distributions by a RIC of amounts attributable to sale of U.S. real property interests are not treated as FIRPTA gains if certain conditions are met; they are treated as dividend distributions.

Effective Date: (1) Dividends with respect to taxable years of RICs beginning after December 31, 2004.

a. Taxable years beginning after December 31, 2005, except that no amount shall be withheld with respect to any distribution before May 17, 2006 if not required under any provision then in effect.

Fiscal Effect: +Minimal.

14. Prevention of tax avoidance on investments through wash sales transactions

Federal Law Change: TIPRA modifies the law related to the tax avoidance on investments of foreign persons in U.S. real property through wash sales transactions.

Effective Date: Taxable years beginning after December 31, 2005, except that no the amendment will not apply to any distribution occurring before 39 days after May 17, 2006.

Fiscal Effect: Minimal

15. Repeal of foreign sales corporation extraterritorial income exclusion

Federal Law Change: When foreign sales corporation (FSC) treatment was repealed, an exception was created for transactions involving FSCs under binding contracts. Similarly, when the federal extraterritorial income exclusion was repealed, a binding contract provision was retained (none of the extraterritorial income exclusion provisions were adopted by Wisconsin). The World Trade Organization Appellate Body found that the binding contract relief provisions are prohibited export subsidies.

TIPRA repeals the foreign sales corporation extraterritorial income exclusion binding contract relief.

Effective Date: Taxable years beginning after May 17, 2006.

Fiscal Effect: Minimal.

16. Funding rules for employer pension plans

Federal Law Change: PPA alters the funding rules for single-employer, defined benefit plans. The changes would result in lower contributions to plans initially and higher contributions later, thereby increasing taxable corporate profits and revenues initially and lowering profits and revenues later.

Effective Date: Plan years after 2007.

Fiscal Effect: +$2.5 million in FY07, +$4.4 million in FY08, +$2.7 million in FY09.

17. Use of excess pension assets for future retirees

Federal Law Change: PPA allows transfers of excess pension assets to retiree medical accounts to fund the expected cost of retiree medical benefits for the current and future years.

Effective Date: Transfers after August 17, 2006.

Fiscal Effect: -Minimal in FY07, - $60,000 in FY08, -$50,000 in FY09.

18. Allowance of reserve for medical benefits

Federal Law Change: Current law provides a deduction for contributions to accounts to fund current year medical benefits. PPA allows deductions for contributions to fund a reserve for future medical benefits provided through qualified associations. These are associations formed for purposes other than obtaining insurance but that offer health insurance coverage to members of the association, such as the American Association of Retired Persons (AARP).

Effective Date: Taxable years after December 31, 2006.

Fiscal Effect: -Minimal in FY07, -$50,000 in FY08, -$70,000 in FY09.

19. Federalizing filing extensions to 30 days after the federal due date or extended due date

Under current law, Wisconsin corporation tax returns are due by the 15th day of the 3rd month following the close of a corporation's taxable year (March 15 for a calendar-year filer). A corporation may receive one of the several extensions for filing its Wisconsin franchise or income tax return. With the move to electronic filing, the Internal Revenue Service is considering eliminating paper extension forms and granting automatic 6-month extensions to all taxpayers.

The complexity of Wisconsin's extension provisions in sec. 71.24(7), Wis. Stats., makes it difficult for taxpayers to comply. To simplify the process for receiving extensions of time to file corporation returns, the department recommends amending sec. 71.24(7) to eliminate Wisconsin-only extensions and to allow an automatic extension of 7 months or 30 days after the federal due date, whichever is later. Rather than requiring the taxpayer to attach a copy of the extension form to the Wisconsin return filed, require the taxpayer to report the extended due date in the manner specified by the department.

Effective Date: Taxable years that begin on January 1, 2006.

Fiscal Effect: Minimal

20. Amend W-2 filing requirement to match IRS requirement for electronic reporting.

Federal Law Change: The provision requires electronic reporting of withholding statements for employers with 250 or more employees. The change replaces language referring to magnetic media filing with language referring to electronic filing. Wisconsin currently adheres to the 250 employee threshold.

Effective Date: Withholding statements filed after December 31, 2006.

Fiscal Effect: Minimal

D. PROVISIONS NOT RECOMMENDED FOR ADOPTION

1. **Public Law 109-1.** Allows taxpayers to treat charitable contributions made in January 2005 for tsunami relief as a charitable contribution made in 2004.

   Effective Date: Amounts received before, on, or after April 15, 2005.

   Fiscal effect: minimal.

2. **Modification to Special Rules for Nuclear Decommissioning Costs.** Utilities that own or operate a nuclear power plant are required to decommission the plant at the end of its useful life. The utility may elect to currently deduct certain contributions it makes to a Nuclear Decommissioning Reserve Fund established to help pay the decommissioning costs, rather than wait and take the deduction when the costs are actually paid or incurred. The special rules for decommissioning cost deductions were modified in the ETIA to remove certain restrictions on the amount of contributions that are deductible. A taxpayer may now make deductible contributions sufficient to cover the present value of 100 percent of a nuclear power plant's estimated decommissioning costs.

   Effective Date: For tax years beginning after December 31, 2005.

   Fiscal Effect: -$740,000 in FY 07 and -$525,000 in FY 08.

3. **Deduction for Capital Costs Incurred in Complying with EPA Sulfur Regulations.** The Environmental Protection Agency (EPA) has issued rules that limit the amount of sulfur in gasoline and highway diesel fuel. Small business refiners may elect to expense up to 75% of costs paid or incurred in complying with EPA requirements, rather than depreciate them. The ETIA allows a small business refiner cooperative to elect to allocate all or a portion of the permitted deduction among any other cooperatives that directly hold an ownership interest in the refiner.

   Effective Date: For expenses paid or incurred after December 31, 2002, in tax years ending after that date.

   Fiscal Effect: -$114,000 in FY 07 and +Minimal in FY 08.

4. **Determination of Small Refiner Exception to Oil Depletion Deduction.** Oil and gas producers are generally allowed to claim depletion deductions determined under the cost depletion method. Independent producers and royalty owners are exempt from this rule and may use a percentage depletion method that is limited to a certain percentage of the average daily production of domestic oil and natural gas. The percentage depletion method does not apply to retailers or refiners whose refining operations exceed 50,000 barrels per day. The ETIA increases the 50,000 barrel limitation to 75,000 barrels. The 75,000 barrel limit is determined based on average refinery runs for the tax year rather than actual runs.

   Effective Date: Taxable years ending after August 8, 2005.*Fiscal Effect:* -$70,000 in FY 07; -Minimal in FY 08.

5. **Tax Treatment of State Ownership of Railroad Real Estate Investment Trust.** The Transportation Act treats a state-owned railroad real estate investment trust (REIT) as a tax-exempt governmental entity if certain conditions are met. Income of the qualified corporation is treated as accruing to the state. A state must own all of the outstanding stock of a corporation that is a REIT on August 10, 2005, and is a non-operating class III railroad.

   Effective Date: On or after the date that a state becomes owner of all of the outstanding stock of a qualified corporation through the action of the corporation's board of directors, so long as the state becomes owner of all of the voting stock on or before December 31, 2003, and becomes owner of all of the outstanding stock of the corporation on or before December 31, 2006.

Fiscal Effect: -Minimal in FY 06 and FY 07.

6. **Temporary suspension of limitations for qualified charitable contributions** GOZA temporarily eliminates the 50% of adjusted gross income limitation on the deductibility of charitable contributions for cash contributions made by individuals from August 28, 2005, through December 31, 2005; these contributions need not be related to hurricane relief. The corporate limit on contributions is also lifted for donations made from August 28, 2005, through December 31, 2005, to a qualified charitable organization for Hurricane Katrina, Rita or Wilma relief efforts.

   Effective Date: Paid beginning 8/28/05 and ending 12/31/05.

   Fiscal effect: $6.1 million in FY07, $203,000 in FY08, and minimal thereafter (includes corporate and individual).

7. **Sunset of Deduction for Clean-Fuel Vehicles** Taxpayers are allowed a deduction of up to $2,000 for the cost of most qualified clean-fuel vehicles placed in service during the tax year. The deduction increases to $5,000 for certain clean-fuel trucks, vans, and buses with gross vehicle weight of 10,000 pounds, and to $50,000 for trucks or vans with gross vehicle weight of more than 26,000 pounds. The deduction is scheduled to be phased out.

   Prior to the Working Families Tax Relief Act of 2004 (WFTRA), the deduction would have been reduced by 25% for property placed in service in 2004, 50% for property placed in service in 2005, and 75% for property placed in service in 2006. No deduction would have been available for property placed in service in 2007. WFTRA eliminated the phase out for 2004 and 2005.

   The ETIA accelerates the phase-out of the deduction so that no deduction is available for property placed in service in 2006. The deduction is replaced with an alternative motor vehicles credit.

   Effective Date: August 8, 2005.

   Fiscal Effect: +Minimal in both years.

8. **Allow sec. 179 expensing through 2010.**

   Federal Law Change: TIPRA extends the higher expensing deduction allowed under sec. 179 from 2008 to 2010. Wisconsin has not adopted federal treatment with regard to sec. 179 expensing.

   Effective Date: For tax years after 2007 and before 2010.

   Fiscal effect: -$5.4 million in FY08, -$11.1 million in FY09.

9. **Amortization of musical works and copyrights over five year period.**

   Federal Law Change: Under TIPRA, taxpayers may elect to amortize expenses incurred in creating or acquiring any musical composition or any copyright of a musical composition over a five-year period rather than the depreciation based on the income forecast method (adjusted basis times the ratio of the income generated by the property in the taxable year to total estimated income generated over 10 years).

Effective Date: Property placed in service in taxable years beginning after December 31, 2006 and before January 1, 2011.

Fiscal Effect: Minimal.

10. Amortization of geological expenditures for certain integrated oil companies.

Federal Law Change: TIPRA replaces the two-year amortization for geological expenditures with five years for integrated oil companies that have an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year, gross receipts in excess of $1 billion in 2005 and an ownership interest in a crude oil refiner of 5% or more.

Effective Date: Amounts paid or incurred after May 17, 2006.

Fiscal Effect: +$72,000 in FY06, +$121,000 in FY07, +$133,000 in FY08.

11. Modifies treatment of below-market loans for continuing care facilities.

Federal Law Change: Under current law, lenders who provide below-market interest loans must report as taxable income an imputed interest payment. An exception is provided for loans made to a continuing care facility by lenders who are 65 years or older up to a maximum aggregate loan of $163,300. TIPRA removes the maximum aggregate loan amount. Thus, no below-market loans made to continuing care facilities by lenders who are 65 or older would impose reporting requirements for imputed payments.

Effective Date: Calendar years beginning after December 31, 2005 for loans made before, on, or after that date and before calendar years after 2010.

Fiscal Effect: Minimal.

12. Eliminates the $100,000 AGI ceiling for IRA conversions

Federal Law Change: Current law prohibits taxpayers from converting traditional IRAs to Roth IRAs if their income exceeds $100,000 and prohibits taxpayers whose income exceeds $160,000 from contributing to a Roth IRA.

TIPRA eliminates the $100,000 AGI ceiling for converting a traditional IRA to a Roth IRA. A conversion is treated as a taxable distribution but is not subject to an early withdrawal penalty. Taxable distributions from conversions made in 2010 can be reported over two years. The bill in effect eliminates the income ceiling for Roth IRA contributions insofar as a taxpayer who is prohibited from contributing to a Roth IRA can first contribute to a traditional IRA and then convert the traditional IRA to a Roth IRA.

Effective Date: Taxable year beginning after December 31, 2009.

Fiscal Effect: -$842,000 in FY09.

Joint Committee of Taxation estimates a revenue increase beginning in 2011 (total federal revenue gain of $6.4 billion for the 2009-2015 period); however, Urban Institute-Brookings Institution Tax Policy Center estimates a federal revenue loss of $100 billion through 2049.

13. Extend higher IRA contributions and other retirement arrangements.

Federal Law Change: PPA makes permanent the changes to IRAs and other retirement provisions introduced in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Changes made in EGTRRA were sunsetted at the end of 2010.

The major changes made under EGTRRA affecting individual income tax collections include the following:

- Increased traditional IRA contributions to $4,000 (but no more than the individual's compensation) in 2006 and $5,000 in 2008-2010.
- Allowed catch-up contributions for older workers ($1,000 after 2005 for IRAs, $2,5000 for SIMPLE plans, $5,000 for 401(k) plans)

Changes affecting corporate tax collections include:

- Increased dollar limits on defined contribution plans ($44,000 in 2006), elective deferrals (including $15,000 in 2006 for 401(k) plans), 457 plan deferrals ($15,000 in 2006) and SIMPLE plan contributions ($10,000 in 2006).
- Increased annual benefit limit under a defined benefit plan ($175,000 for 2006)
- Created Roth 401(k) and 403(b) plans.
- Enhanced rollover rules and provided greater portability for 403(b) and 457 plans.

Effective Date: August 17, 2006.

Fiscal Effect: No effect until FY11; -$16 million by FY13 for individual income tax and -$9 million by FY13 for corporate tax collections.

14. Treatment of annuities and life insurance with long term care insurance feature.

Federal Law Change: PPA changes the rules that apply to life and long-term care insurance to allow certain withdrawals from annuities for payment for long-term care insurance to be tax free.

Effective Date: For annuities issued after December 31, 1996 but only with respect to long-term care insurance purchased in taxable years beginning after December 31, 2009.

Fiscal Effect: No effect until FY10; -$11 million by FY15.

*RB:*skr

ATTACHMENT 2

Wisconsin Department of Revenue
Division of Research and Policy
February 13, 2007

INTERNAL REVENUE CODE UPDATE
TAX RELIEF AND HEALTH CARE ACT OF 2006

A. INTRODUCTION

Wisconsin's individual income and corporate income and franchise tax bases closely conform to the bases for the federal individual and corporate income taxes. Conformity is achieved through references in Chapter 71 of the Wisconsin Statutes to the federal Internal Revenue Code (IRC). To maintain conformity, these references must be updated to adopt changes made by Public Law 109-432, Tax Relief and Health Care Act of 2006 (TRHCA).

Provisions of this law that relate to federal credits, federal excise taxes, federal bonds, federal administrative provisions, and federally-mandated studies do not apply for Wisconsin tax purposes. Provisions not previously adopted related to amortization and accelerated depreciation and expensing are not recommended for adoption.

Sections B and C describe the provisions that are recommended for adoption. Provisions that should not be adopted are described in Section D. Adopting this law at the same time they apply for federal purposes, with the exceptions identified above would reduce state revenues by an estimated $2.86 million in FY08 and $461,000 in FY09. The table below shows the estimated fiscal impacts of provisions with non-minimal impact on Wisconsin tax revenues.

Federal Tax Change	Effective Date	Fiscal Effect ($ millions)	
		FY08	FY09
Tax Relief and Health Care Act			
Deduction for educator expenses	1/1/07-12/31/07	-1.86	-0.28
Energy efficiency commercial buildings property deduction	1/1/08-12/31/08	-0.08	minimal-
Extends mental health parity provisions	1/1/06-12/31/07	-0.14	minimal-
Wages paid to Puerto Rico residents included in QPAI wages	1/1/06-12/31/07	-0.331	-0.03
Mortgage insurance premiums treated as deductible interest	12/31/06-12/217	-0.45	-0.15
Expand research credits		-2.60	-2.60
TOTAL		-5.46	-3.06

B. INDIVIDUAL INCOME TAX

1. Including combat pay as earned income for purposes of earned income credit.

Federal Law Change: A taxpayer may choose to treat combat zone compensation that is otherwise excluded from gross income under IRC Sec. 112 as earned income for purposes of the earned income credit. This was scheduled to expire on December 31, 2006 (Under the 2006 Gulf Opportunity Zone Act). TRHCA extends the treatment through December 31, 2007.

Effective Date: December 31, 2006 (date of enactment).

Fiscal Effect: -Minimal.

2. Deduction for educator expenses.

Federal Law Change: For tax years through 2005, current law allows a maximum $250 above line deduction for expenses paid by educators for books, supplies, computer equipment and other materials used for educational purposes. TRHCA extends the deduction through December 31, 2007.

Effective Date: January 1, 2007

Fiscal Effect: -$1.86 million in FY08, -$28,000 in FY09.

3. Archer Medical Savings Accounts

Federal Law Change: Current law allows tax deductible contributions to Archer Medical Savings Accounts through 2005. These accounts are available to employees covered under an employer-sponsored high deductible plan of a small employer and self employed individuals covered under a high deductible plan. After 2005, contributions to existing accounts can be made, but no new accounts can be created.

TRHCA allows new contributions to Archer Medical Savings Accounts through December 31, 2007.

Effective Date: January 1, 2007.

Fiscal Effect: Minimal.

4. Deductions allowed for whistleblowers.

Federal Law Change: TRHCA provides an above-the line deduction for attorney's fees and costs paid an individual in connection with any award for providing information regarding the violation of tax laws; the deduction may not exceed the amount includible in the taxpayer's gross income on account of such award.

Effective Date: Enactment.

Fiscal Effect: Minimal

5. Exclusion of gain on sale of a principal residence by a member of the intelligence community.

Federal Law Change: Under current law, a taxpayer may exclude up to $250,000 ($500,000 for joint filers) of gain realized on the sale of a principal residence if the taxpayer owned and used the residence as a principal residence for at least two of the five years ending on the sale. Under TRHCA, certain employees of the intelligence community may elect to suspend the running of the five-year test period during any period in which they are serving on extended duty.

Effective Date: Sales after enactment and before January 1, 2011.

Fiscal Effect: Minimal.

6. Nonrecognition of Gain Provisions Relating to Sales of Property due to Conflicts of Interest Extended to Judicial Officers

Federal Law Change: Current law allows executive branch federal employees to defer recognition of gain of property sold due to conflict of interest requirements; employees who are required to sell property may postpone the recognition of gain by investing in an approved replacement property within 60 days. The basis of the replacement property is reduced by the unrecognized gain.

TRHCA extends these provisions to judicial officers, including justices serving on the U.S. Supreme Court, U.S. courts of appeals, and district courts.

Effective Date: Upon enactment.

Fiscal Effect: Minimal.

7. Mortgage Insurance Premiums Treated as Deductible Interest

Federal Law Change: Current law allows an itemized deduction for interest paid on a principal residence and second homes. Under TRHCA, premiums paid on mortgage insurance in connection with debt for a qualified residence are treated as interest on the home and are thus deductible. The deduction is phased out for taxpayers with AGI over $110,000.

Effective Date: For amounts paid or accrued after December 31, 2006 and before December 21, 2007.

Fiscal Effect: -$453,000 in FY08 and -$151,000 in FY09.

8. Exclusion of Gain from Conservation Sale

Federal Law Change: TRHCA allows a 25% exclusion from income of long-term capital gain from the conservation sale of a qualifying mineral or geothermal interest. The sale must be made to an eligible entity that acquired the property for conservation purposes.

Effective Date: Upon enactment.

Fiscal Effect: Minimal.

C. CORPORATE INCOME AND FRANCHISE TAX

1. Energy Efficiency Commercial Buildings Property Deduction.

Federal Law Change: TRHCA extends a deduction for costs from depreciable energy-efficient commercial building property certified pursuant to a plan to reduce overall energy and power costs and placed in service after December 31, 2008 and prior to January 1, 2009. The maximum is $1.80 per square foot and the basis of the property must be reduced.

Effective Date: For property placed in service after December 31, 2007, and before January 1, 2009.

Fiscal Effect: -$80,000 in FY 08 and –Minimal in FY 09.

2. Extension of Parity Limits for Mental Health Benefits.

Federal Law Change: The Mental Health Parity Act of 1996 contains rules regarding parity of mental health benefits with medical and surgical benefits. Plans that offer mental health benefits are not allowed to impose annual or lifetime dollar limits on mental health benefits that are not also imposed on medical and surgical benefits. Plans are not required to offer mental health benefits. The provision was set to expire on December 31, 2006 (under the 2006 Employee Retirement Preservation Act).

TRHCA extends the parity provision through December 31, 2007.

Effective Date: January 1, 2006.

Fiscal Effect: -Minimal in FY 08 and FY 09.

3. Wage Limitation for Qualified Production Activity Income.

Federal Law Change: Current law allows a deduction equal to a portion of a taxpayer's qualified production activities income. The amount of the deduction is limited to 50% of the wages paid by the taxpayer.

Under TRHCA, taxpayers are allowed to treat Puerto Rico as part of the United States in calculating its domestic production gross receipts and activities income if all of the taxpayer's gross receipts from sources within Puerto Rico are taxable for federal income tax purposes. The provision also allows taxpayers to take wages paid to residents of Puerto Rico into account for purposes of calculating the 50% wage limitation.

Effective Date: Tax years beginning after December 31, 2005 and before January 1, 2008.

Fiscal Effect: -$331,000 FY 08, -$31,000 FY09.

4. Superfund settlement funds exempt.

Federal Law Change: escrow funds established after May 17, 2006 and before January 1, 2011 for hazardous waste sites under agreement with the Environmental Protection Agency under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA) are exempt so long as the funds are controlled by a government agency. TRHCA makes this provision permanent.

Effective Date: Enactment (effective January 1, 2012)

Fiscal Effect: Minimal.

5. Extension of Research Credits; Increase Credit Rates

Federal Law Change: Prior to TRHCA, the federal research credit terminated after December 31, 2005; TRHCA extends the federal research credit through December 31, 2007. The extension of the federal research credit does not affect Wisconsin. However, Wisconsin provides a research credit based on "qualified research expenses" as defined for federal purposes. The credit is based on the increase in research expenditures relative to a base period. The Wisconsin credit rate is 25% (50% for certain types of research) of the federal rate.

The federal research credit allows an alternative incremental credit. Wisconsin has adopted a similar alternative incremental credit based on federal rates. TRHCA increases the rates used to calculate the alternative incremental credit. To provide consistency with federal law, Wisconsin should adopt these increased rates.

TRHCA also creates a third simplified alternative to the credit computation. Wisconsin could also provide this alternative, prorated to the same extent, i.e., 25% (50% for certain types of research), as the regular credit. It is estimated that most credit claimants would maximize their credit under either the regular credit or the alternative incremental credit under the increased rates and would not benefit from a prorated simplified alternative. However, some may choose the new simplified alternative for ease of computation.

Effective Date: Tax years ending after December 31, 2006. Special transitional rules apply to fiscal year 2007 taxpayers in the computation under the alternative.

For Wisconsin, it is proposed that the changes first apply to taxable years beginning on January 1, 2007.

Fiscal Effect: -$2.6 million in FY08 and thereafter.

6. Treatment of Sale or Exchange of Self-Created Musical Works

Federal Law Change: Taxpayers may elect to treat the sale or exchange of self created musical work as a capital asset (taxed at 15%) rather than ordinary income (that can be taxed as high as 35%). Prior to TRHCA, this treatment applied only to sales and exchanges in taxable years beginning after May 17, 2006 and before January 1, 2011.

TRHCA makes permanent these provisions.

Effective Date: Enactment (effective January 1, 2011).

Fiscal Effect: Minimal.

D. PROVISIONS NOT RECOMMENDED FOR ADOPTION

1. **Determination of Small Refiner Exception to Oil Depletion Deduction.** Oil and gas producers are generally allowed to claim depletion deductions determined under the cost depletion method. Independent producers and royalty owners are exempt from this rule and may use a percentage depletion method that is limited to a certain percentage of the average daily production of domestic oil and natural gas. The percentage depletion

method does not apply to retailers or refiners whose refining operations exceed 75,000 barrels per day. The 75,000 barrel limit is determined based on average refinery runs for the tax year rather than actual runs.

Current law also limits the percentage depletion allowance to 15% of the taxpayer's gross income from oil- or gas-producing property; the amount deducted may not exceed 100% of the taxable income from that property. However, for marginal production, the 100% limit was suspended for taxable years through December 31, 2005. Under TRHCA, the 100% limit is suspended through December 31, 2007.

Effective Date: January 1, 2006 through December 31, 2007.

Fiscal Effect: -$393,000 in FY08

2. **Modifies treatment of below-market loans for continuing care facilities.**

Federal Law Change: Under current law, lenders who provide below-market interest loans must report as taxable income an imputed interest payment. An exception is provided for loans made after December 31, 2005 and before January 1, 2010 made to a continuing care facility by lenders who are 65 years.

TRHCA makes this provision permanent.

Effective Date: Upon enactment (effective January 1, 2010).

Fiscal Effect: Minimal.

3. **Deduction for higher education expenses.**

Federal Law Change: TRHCA extends the above line deduction for higher education expenses. The maximum deduction is $4,000 for fees and tuition for higher education for filers whose adjusted gross income does not exceed $65,000 ($130,000 for joint filers) or $2,000 for filers whose AGI does not exceed $80,000 ($160,000 for joint filers).

Wisconsin does not conform to the current deduction because it provides its own deduction for tuition paid to a Wisconsin or Minnesota university, college or technical college.

Effective Date: The federal deduction is extended through December 31, 2007.

Fiscal Effect: Adopting the federal treatment would result in a revenue loss of $12.3 million in FY08; however, if the Wisconsin deduction was eliminated the fiscal effect would be a revenue increase of $9.9 million in FY08.

4. **Enhanced deduction for charitable contributions of scientific property used for research.**

Federal Law Change: Under current law, corporate charitable contributions of scientific property used for research and contributions of computer technology and equipment made through December 31, 2005 are allowed an enhanced deduction equal to the lesser of 1) the basis plus one half of the fair market value in excess of the basis or 2) two times the basis. Wisconsin has not adopted this provision.

TRHCA extends the enhanced deduction for contributions made through December 31, 2007.

Effective Date: Tax years after December 31, 2005.

Fiscal Effect: Minimal.

5. Health Savings Account

Federal Law Change: TRHCA makes the following changes to Health Savings Accounts (HSAs). Wisconsin has not adopted federal treatment of HSAs.

a. Allow rollovers from health flexible spending arrangements (FSAs) and health reimbursement accounts (HRAs) into HSAs. This is designed to assist individuals in transferring from another type of health plan to a high deductible plan.

   Effective Date: Enactment through December 31, 2011

b. Modifies the limit on the annual deductible contribution made to an HSA so that the maximum deductible contribution is not limited to the annual deductible under the insurance plan. Under the provision, the maximum annual contribution would $2,850 for single and $5,650 for family coverage in 2007.

   Effective Date: January 1, 2007

c. Index the maximum contribution amounts to consumer price index.

   Effective Date: January 1, 2008

d. Allow full contribution to an HSA for part-year enrollees, such that a person who first becomes eligible in the last month of the tax year is treated as eligible for all months.

   Effective Date: January 1, 2007

e. Allow a one-time rollover from an IRA to an HSA. The amount that can be distributed from the IRA and contributed to the HSA is limited to the otherwise maximum deductible HSA contribution.

   Effective Date: January 1, 2007

   Fiscal Effect: -$400,000 in FY08, -$483,000 in FY09. By FY2015, these provisions will result in an annual revenue loss of $1.35 million.

RB:skr