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Domestic Production Activities Deduction
(General Fund Taxes -- Income and Franchise Taxes)

[LFB 2009-11 Budget Summary: Page 259, #11]

CURRENT LAW

Currently, state corporate income and franchise tax provisions are referenced to federal Internal Revenue Code (IRC) provisions that provide a deduction from federal total income for a specified fraction of income attributable to domestic production activities. The deduction is phased in from 2005 through 2010, and is equal to the lesser of a specified percentage of the business' qualified production activities income or its taxable income.

GOVERNOR

Eliminate state individual income and corporate income and franchise tax references to Internal Revenue Code provisions that provide a deduction for domestic production activities income. As a result, the deduction could not be taken under the state individual and corporate income and franchise taxes. The decoupling from the IRC provision would apply to tax years beginning on or after January 1, 2009. At the time the budget bill was introduced, the administration estimated that eliminating the deduction would increase state income and franchise tax revenues by $38,200,000 in 2009-10, and $33,500,000 in 2010-11.

DISCUSSION POINTS

1. State individual income tax and corporate income 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 IRC. The current statutes refer to the

federal IRC in effect on December 31, 2006. The federal deduction for domestic production activities was adopted for state income and franchise tax purposes under provisions of 2005 Wisconsin Act 25 (the 2005-07 biennial budget) that referenced state individual income and corporate income and franchise tax provisions to definitions included in the federal American Job Creation Act (AJCA) of 2004.

2. The state has not always conformed to federal corporate IRC provisions. For example, the state did not adopt federal bonus depreciation provisions enacted in 2002 and 2003. In addition, expansions of the deduction for the cost of certain nonfarm depreciable property (section 179 expensing) since 2003, have not been adopted for state purposes.

3. 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 was required to meet a number of criteria designed to ensure that it had adequate foreign presence. If a corporation qualified as an FSC, a portion of the foreign trade income of the FSC was treated as foreign source income not effectively connected with the conduct of a trade or business within the United States and was exempt from tax.

In 2000, Congress enacted the Federal Sales Corporation Repeal and Extraterritorial Income Exclusion Act (FSCRA). Under FSCRA, the FSC rules were repealed and replaced with an exclusion for extraterritorial income (ETI) that was qualifying foreign trade income. Corporations could claim exclusion for qualified foreign trade income directly, rather than having to create specifically defined FSC subsidiaries. This provision was not adopted for state tax purposes.

4. FSCRA was an effort to comply with a World Trade Organization (WTO) decision that ruled that the FSC provisions were an illegal export subsidy. However, the European Union (EU) challenged FSCRA, and in August, 2001, a WTO panel ruled that the new provisions also violated WTO rules. The United States appealed, and in January, 2002, the WTO Appellate Body affirmed the panel's findings. In August, 2002, the WTO Arbitration Panel ruled that the EU could impose sanctions on approximately $4 billion worth of U.S. exports. In May, 2003, the EU received final authorization from the WTO Dispute Settlement Body to impose sanctions on the U.S. After setting a deadline to repeal the ETI provisions by March 1, 2004, the EU began its retaliatory measures on that date. As a result, the EU imposed an additional duty on 1,608 U.S. products. The duty began at 5% and rose automatically by 1 percentage point each month until it would reach a ceiling of 17% in March, 2005. At that point, the EU indicated it would make a determination on its next course of action if the U.S. had not complied. In October, 2004, Congress passed and the President signed, the American Jobs Creation Act of 2004 (HR 4520). The bill repealed the ETI provisions and provided a deduction for income attributable to production in the Untied States. (The bill contained many other changes to federal tax laws as well.)

5. The domestic production activities deduction was created to replace the ETI provisions. Effective for tax years beginning after December 31, 2004, a deduction against gross income is provided for a portion of the income attributable to domestic production activities. The

deduction is phased-in from 2005 through 2010, and is equal to the lesser of a specified percentage of the business' qualified production activities income or its taxable income. However, the amount of the deduction for any tax year is limited to 50% of the W-2 wages that are properly allocable to domestic production gross receipts. For 2005 and 2006, the deduction equaled 3% of the lesser of: (a) qualified production activities income; or (b) taxable income for the tax year. For 2007 through 2009, the percentage increased to 6%. When the deduction is fully phased-in in 2010, it will equal 9%.

"Qualified production activities income" is determined by reducing domestic production gross receipts by the cost of goods sold and other deductions, expenses, or losses directly allocable to such receipts and a ratable amount of indirect expenses. "Domestic production gross receipts" are the gross receipts of the business that are derived from:

a. The lease, rental, license, sale, exchange, or other disposition of: (1) qualifying production property (generally, tangible personal property, computer software, and sound recordings) manufactured, produced, grown, or extracted by the taxpayer in whole or, in significant part, in the United States; (2) any qualified film produced by the business in the U.S.; and (3) electricity, natural gas, or potable water produced by the taxpayer in the U.S.

b. Construction performed in the U.S.

c. Engineering or architectural services performed in the U.S. for construction projects located in the U.S. The attachment shows the basic calculation of the domestic production activities deduction.

6. The repeal of the ETI at the federal level generated about $6 billion annually in tax revenue, and Congress was faced with the issue of determining what the additional revenue would be used for. Initially, a broad range of tax reductions was proposed for U.S. firms operating in international markets. However, it became clear that, instead of targeted tax reductions for exporters, a broader subsidy for domestic manufacturing or production was preferred by Congress. The initial proposals were viewed as penalizing firms that manufactured or produced in the U.S., while benefiting firms that operated abroad (Brumbaugh, 2004; McClelland, 2006). The domestic production activities deduction was intended to increase domestic investment and employment, improve the competitiveness of manufacturers in global markets, and offset benefits previously provided by ETI. While the provision is formally a deduction, it was designed to act like a tax rate reduction for domestic production activities. By structuring the provision as a deduction, rather than a corporate income tax rate reduction, the benefits of the provision were made available to non-corporate taxpayers, such as partnerships and S corporations. Once the provision is fully phased in, the overall effective corporate income tax rates would decrease by about 3%, while the individual rate would drop somewhat less. By reducing taxes, the provision increases cash flow and could spur increased investment and employment.

7. The AJCA included a provision that reduced taxes on repatriated foreign earnings. Using a model of firm investment criteria, Blouin, Krull, and Schwab (2007) investigated whether

the domestic production activities deduction affected firms' decisions to use repatriated earnings to increase investment, rather than for shareholder payout. The authors found that firms that received an incremental benefit from the deduction decreased shareholder payout, while firms that received no incremental benefit from the deduction increased shareholder payout. The authors conclude that, under certain conditions, firms that benefited from the domestic production activities deduction retained repatriated foreign earnings, which may lead to increased current or future domestic investment.

8. There are a number of tax policy issues related to providing the federal domestic production activities deduction under the state individual and corporate income and franchise taxes. Although the deduction is intended to increase domestic investment and employment, firms can claim the deduction for profits on all national qualifying domestic activities. As a result, companies can claim the deduction in Wisconsin by investing in new production facilities in other states. The deduction provides little incentive for firms to conduct qualifying activities in a particular state. Moreover, the deduction can offset some of the benefit provided by single sales factor apportionment to businesses with a large number of facilities and employees in Wisconsin.

The deduction offers little or no tax benefit to companies that most need assistance. Marginally profitable or break-even firms typically have low marginal tax rates, and insufficient taxable income or tax liability to absorb added deductions. The result is that more profitable companies benefit to a greater extent than less profitable businesses (Billings and Patel, 2007). This characteristic of providing greater benefits to more profitable firms can lessen the effectiveness of the provision in protecting or creating jobs. Marginally profitable or break-even firms considering layoffs receive little benefit, while profitable firms receive benefits regardless of the level of employment. (Mazerov, 2008).

The beneficial treatment given to income from qualified production activities will encourage more investment in these activities (manufacturing) and less in nonqualified activities (services), as well as encourage more equity investment in the affected sectors. As a result, the provision increases distortions between different investments, even for those whose marginal return it improves. There may be other, more neutral, ways to provide such benefits (Gravelle, 2005). In addition, the deduction simply reduces net income subject to tax, and does not reflect a business expense.

Federal tax return data for tax year 2005 indicate that 94% of the domestic production activities deduction was claimed by the 0.4% of firms with assets over $100 million. According to the data, 26.5% of the total amount of the deduction claimed by businesses was claimed by the petroleum industry. Conversely, the automobile manufacturing and textile industries accounted for less than 4% of the deduction (Mazerov, 2008).

In a 2004 letter to Congress regarding the domestic production activities deduction, IRS Commissioner Mark Everson wrote that many businesses, particularly small businesses, would find it difficult to understand and comply with complex tax rules related to the deduction, and that taxpayers would be required to devote substantial additional resources to comply with the tax provisions. Some small businesses could find that the additional costs outweighed the benefits of the deduction (Congressional Record, October 11, 2004). The deduction creates compliance and enforcement difficulties, because firms have incentives to characterize as much income as possible as qualified production income (Clausing, 2004). Administrative issues also include: (a) disputes concerning the definition of qualified production activities; and (b) the allocation of income and deductions across different types of businesses, such as manufacturing and retail sales, in vertically integrated firms (Gravelle, 2005).

According to the Department of Revenue, at least 20 states have not adopted the domestic production activities deduction for state tax purposes.

9. On May 11, 2009, this office provided revised estimates of general fund tax revenues that projected a reduction in tax revenues for fiscal years 2008-09 through 2010-11 of $1,382 million in individual income taxes and $282 million in corporate income and franchise taxes. As a result, the estimates of the additional revenues that would result from decoupling state individual income and corporate income and franchise tax provisions from the federal domestic production activities deduction provisions have also been revised. Specifically, the additional revenues generated by decoupling state income and franchise tax provisions from federal IRC domestic production activities deduction provisions are reestimated to be $27,300,000 in 2009-10 and $27,600,000 in 2010-11. These estimates are lower by $10,900,000 in 2009-10 and $5,900,000 in 2010-11 than the amounts included in the bill.

ALTERNATIVES

1. Adopt the Governor's recommendation to eliminate state individual income and corporate income and franchise tax references to Internal Revenue Code provisions that provide a deduction for domestic production activities income. Reestimate the additional revenues generated by eliminating the deduction to be $27,300,000 in 2009-10 and $27,600,000 in 2010-11.

ALT 1	Change to Bill Revenue
GPR	- $16,800,000

2. Delete the Governor's recommendation.

ALT 2	Change to Bill Revenue
GPR	- $71,700,000

Prepared by: Ron Shanovich
Attachment

ATTACHMENT

Determination of Domestic Production Activities Income

1. **BASE: Domestic Production Gross Receipts (DPGR).** Includes, but not limited to, gross receipts from: (a) lease, license, sale, or other disposition of qualified production property (QPP) that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part, in the U.S. (b) qualified films largely created in the U.S.; (c) production of electricity, natural gas, or potable water in the U.S.; (d) construction of real property in the U.S. in a construction trade or business; and (e) engineering and architectural services for domestic construction.

2. **LESS: Allocable Expenses**

a. ***Cost of Goods Sold.*** Generally includes direct materials, direct labor, factory overhead, and a portion of mixed service costs (combination of fixed and variable costs).

b. ***Deductions, Expenses, and Losses, Directly Allocable.*** Includes selling and marketing expenses.

c. ***Indirectly Allocable Deductions, Expenses, and Losses.*** Includes general and administrative expenses.

3. EQUALS: Qualified Production Activities Income (QPAI)

4. MULTIPLE: Lesser of OPAI or Taxable Income

2005-2006	3%
2007-2009	6%
2010 and thereafter	9%

5. **EQUALS**: **Potential Domestic Production Activities Deduction**

6 **DEDUCT: Lesser of: Potential Domestic Production Activities Deduction or 50% of Form W-2 Wages.**