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

[LFB 2011-13 Budget Summary: Page 187, #10]

CURRENT LAW

State individual income tax and corporate income and franchise tax provisions are generally referenced to definitions under federal law. With limited exceptions, 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). Under current law, state tax references generally refer to the IRC in effect as of December 31, 2008.

GOVERNOR

Update statutory references to the federal Internal Revenue Code under the state individual income and corporate income and franchise taxes to include changes to the IRC relating to: (a) long-term care insurance that is provided as part of an annuity or life insurance contract or as a rider on annuity or life insurance contracts, as authorized under the Pension Protection Act of 2006 (P.L. 109-280); (b) allowing participants in government-sponsored deferred compensation plans, 401(k) defined contribution retirement plans offered by employers, and 403(b) defined contribution retirement plans offered by tax-exempt charitable organizations and educational institutions to make contributions to designated Roth accounts or to roll over amounts in their plans to designated Roth accounts, as authorized under the Small Business Jobs Act of 2010 (P.L. 111-240); (c) permitting partial annuitization of a nonqualified annuity contract, as authorized under the Small Business Jobs Act of 2010 (P.L. 111-240); and (d) qualified tax credit and Build America bonds, as authorized under the Food, Conservation, and Energy Act of 2008 (P.L. 110-246), the Emergency Economic Stabilization Act of 2008 (P.L. 110-343), the American Recovery and Reinvestment Act of 2009 (P.L. 111-5), and the Hiring Incentives to Restore Employment Act of 2009 (P.L. 111-147).

The proposed changes would take effect at the same time for state tax purposes as for federal tax purposes. With respect to P.L. 109-280, the proposed treatment of annuities would first apply to annuities issued after December 31, 1996, but only with respect to long-term care insurance purchased in taxable years beginning after December 31, 2009. With respect to P.L. 110-240, the proposed treatment of contributions to deferred compensation plans would apply to amounts received in tax years beginning after December 31, 2010, and the proposed treatment of rollovers of deferred compensation, 401(k), and 403(b) amounts would apply to distributions after September 27, 2010. With respect to P.L. 110-240, the proposed treatment of the partial annuitization of nonqualified annuity contracts would apply to amounts received in tax years beginning after December 31, 2010. With respect to P.L. 110-246, P.L. 110-343, P.L. 111-5, and P.L. 111-147, the proposed treatment of tax credit and Build America bonds would apply to bonds issued after May 22, 2008, October 2, 2008, February 17, 2009, and March 18, 2010, respectively. The administration estimates that the provision would cause state income and franchise tax revenues to increase by $230,000 in 2011-12 and decrease by $347,000 in 2012-13. These amounts are comprised of: (a) -$710,000 in 2011-12 and -$1,200,000 in 2012-13, relating to long-term care insurance; (b) $822,000 in 2011-12 and $660,000 in 2012-13, relating to contributions and rollovers to Roth accounts; and (c) $118,000 in 2011-12 and $193,000 in 2012-13, relating to partial annuitizations. The administration indicates that codifying IRC references to qualified tax credit and Build America bonds is intended to clarify Wisconsin's tax treatment and would not result in a revenue change.

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 the Department of Revenue (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. Federal law defines qualified long-term care insurance contracts as any insurance contract providing coverage of qualified long-term care services, defined to include "necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance or personal care services that are required by a chronically ill individual and that are provided pursuant to a plan of care prescribed by a licensed health care practitioner." The Pension Protection Act of 2006 (P.L. 109-280) changed the treatment of long-term care insurance provided as part of an annuity or life insurance contract or as a rider to those contracts. Those contracts are comprised of nontaxable and taxable components, which are used to determine the tax treatment of contract payouts. The nontaxable component consists of the initial investment in the contract, which was subject to tax as ordinary income prior to its investment. The taxable component consists of the investment earnings of the contract. Prior to the Act, withdrawals from contracts, as distinguished from payouts, were generally considered as a draw against the taxable component and therefore were subject to tax. Under the Act, charges against the cash value of annuity or life insurance contacts are not considered withdrawals subject to tax if such charges are used as payments for coverage under qualified long-term care insurance contracts. However, the qualified long-term care

insurance contract must be included as part of the annuity or life insurance contract or as a rider to such contracts. Also, the Act allows annuity and life insurance contracts to be exchanged for qualified long-term care insurance contracts on a tax-free basis. Adoption of these provisions is estimated to reduce individual income tax collections by $710,000 in 2011-12 and by $1,200,000 in 2012-13.

3. Employer-sponsored retirement plans include 401(k) plans offered by businesses and 403(b) plans offered by tax-exempt charitable organizations and educational institutions of state and local governments. In addition, state and local governments and tax-exempt organizations may establish deferred compensation plans (457 plans) whereby their employees may elect to defer part of their compensation to the plan on a pre-tax basis. Withdrawals from these plans are subject to tax, provided contributions to the plans have been made on a pre-tax basis. Federal law allows 401(k) and 403(b) plans to be established as pretax accounts or as Roth accounts. Contributions to Roth accounts are subject to tax, but withdrawals are exempt from tax. The Small Business Jobs Act of 2010 (P.L. 111-240) permits 457 plans to be established as Roth accounts. In addition, the Act allows rollovers from 401(k), 403(b), and 457 plans to Roth accounts. However, any rollover amounts are treated as adjusted gross income and subject to tax. If Wisconsin does not adopt these provisions, taxpayers making rollovers would be subject to a 2% penalty for making an excess contribution to a Roth account and, if under age 59.5, would be subject to a 3.33% penalty for making an early withdrawal from a retirement account. Due to the penalties, many Wisconsin taxpayers would be unlikely to initiate conversions. By adopting the federal provisions, Wisconsin taxpayers would be more likely to make conversions, and the converted amounts would be subject to tax. Because taxpayers making rollovers would incur a tax liability, adoption of these provisions is estimated to increase individual income tax collections by $822,000 in 2011-12 and $660,000 in 2012-13.

4. An annuity is a series of equal payments made at equal intervals of time, and a nonqualified annuity is an annuity established outside a qualified retirement plan. As noted above, annuities are comprised of taxable and nontaxable components. An exclusion ratio, based on the taxpayer's contributions and the expected return on that investment over the life of the annuity, is calculated to determine the amount of each component within each annuity payment. The exclusion ratio is not employed for taxpayers who make lump-sum withdrawals or withdrawals other than annuity payments. In those instances, the taxable component of the annuity is withdrawn first. The Small Business Jobs Act clarified that taxpayers making partial withdrawals do not forfeit the ability to receive future payments as annuities based on the exclusion ratio, provided an annuitization period of ten years or more is used. DOR indicates that "failure to adopt this provision would create confusion as to the state tax treatment of these split products." By clarifying this treatment, taxpayers are more likely to make taxable withdrawals. As a result, individual income tax collections are estimated to increase by $118,000 in 2011-12 and $193,000 in 2012-13.

5. Qualified tax credit bonds are issued by state and local governments and include qualified forestry conservation bonds, clean renewable energy bonds, energy conservation bonds, zone academy bonds, and school construction bonds. Generally, the bonds do not bear interest but, instead, generate a tax credit for bondholders based on the interest that would otherwise be expected to accrue. The credit is included in the bondholder's gross income and is subject to tax. Also, the credit may be claimed against the taxpayer's income tax liability, and unused credits may be carried

forward to future years. The American Recovery and Reinvestment Act of 2009 authorized state and local governments to issue Build America bonds, but that authorization expired on January 1, 2011. Interest on Build America bonds is taxable, but the federal government lowers the interest cost by providing a subsidy equal to 35% of the interest cost either as a payment to the issuer or as a tax credit to the bondholder. Most interest on state and local bonds is subject to taxation at the state level, even though it is exempt from federal taxation. Including the indicated provisions would ensure that the tax credits from qualified tax credit bonds and from Build America bonds would be treated like state and municipal bond interest and therefore subject to Wisconsin tax. Since including the IRC references in the state's tax code would serve only to clarify the state tax treatment of tax credit bonds and Build America bonds, no fiscal effect is associated with this provision.

6. Under the bill, the state's income and franchise tax statutes would continue to reference the IRC in effect as of December 31, 2008. With the exceptions noted above, none of the federal tax provisions adopted in 2009 and 2010 would be referenced in state statutes. Examples include provisions in the American Recovery and Reinvestment Act of 2009 (ARRA or P.L. 111-5), the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (P.L. 111-312) and the Affordable Care Act (P.L. 111-149 and 111-152). This office has received multiple inquiries regarding one federal provision that was enacted after December 31, 2008, and it is described below.

7. Employer-provided health insurance benefits for employees and employees' spouses and dependents are excluded from gross income for federal and state income tax purposes. As of March 30, 2010, the Affordable Care Act extends this treatment to employees' non-dependent children who are 26 years of old or younger for the entire calendar year. Because Wisconsin has not adopted this treatment, employees who elect to have their non-dependent children covered under their employer-provided health insurance are subject to tax on the part of the benefit's value that is attributable to the nondependent child. The fair market value of the adult child's health coverage is determined by the employer and its insurance provider. Also, the Affordable Care Act allows employees to use their medical flexible spending accounts to reimburse the eligible medical expenditures of their nondependent children. However, such a reimbursement may not be excluded from income for state tax purposes. In such instances, employers are required to report that income as taxable for state tax purposes on the employee's W-2 statement or the employer must issue a Wisconsin-only W-2 for the employee. DOR estimates that adopting these provisions of the Affordable Care Act would reduce state individual income tax revenues by $23.4 million in 2011-12 and $22.4 million in 2012-13.

ALTERNATIVES

1. Approve the Governor's recommendation to update statutory references to the federal IRC under the state individual and corporate income and franchise taxes to include changes to the IRC related to the treatment of long-term care insurance contracts, the conversion of retirement accounts to Roth accounts, the partial annuitization of annuities, and tax credit and Build America bonds.

2. Modify the Governor's recommendation as follows:

a. Delete references to the IRC provisions relating to long-term care insurance and increase estimated revenue by $710,000 GPR in 2011-12 and $1,200,000 GPR in 2012-13;

ALT 2a	Change to Bill Revenue
GPR	$1,910,000

b. Delete references to the IRC provisions relating to contributions and rollovers to Roth accounts and decrease estimated revenues by $822,000 GPR in 2011-12 and $660,000 GPR in 2012-13;

ALT 2b	Change to Bill Revenue
GPR	- $1,482,000

c. Delete references to the IRC provisions relating to permitting partial annuitization of a nonqualified annuity contract and decrease estimated revenues by $118,000 GPR in 2011-12 and $193,000 GPR in 2012-13;

ALT 2c	Change to Bill Revenue
GPR	- $311,000

and

d. Delete references to the IRC provisions relating to qualified tax credit and Build America bonds.

3. Modify the Governor's recommendation to include IRC references to employer-provided health insurance and medical flexible spending account benefits for non-dependent children beginning in tax year 2011 and decrease estimated revenues by $23,400,000 GPR in 2011-12 and $22,400,000 GPR in 2012-13.

ALT 3	Change to Bill Revenue
GPR	- $45,800,000

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