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

[LFB 2013-15 Budget Summary: Page 174, #11]

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, 2010.

GOVERNOR

Update statutory references to the Internal Revenue Code under the state individual and corporate income and franchise taxes. For tax years beginning after December 31, 2012, create provisions adopting IRC provisions in effect as of December 31, 2010, with exceptions. [Note that these provisions use the same IRC reference date, December 31, 2010, as current law provisions applying to tax years beginning after December 31, 2010.] Also for tax years beginning after December 31, 2012, adopt 15 IRC provisions which either were added to the IRC prior to December 31, 2010, but not adopted by Wisconsin, or were added to the IRC after December 31, 2010. Each provision is described in greater detail either in the body of this paper or in Appendix 1.

Except for two provisions included in the American Taxpayer Relief Act, specify that the enumerated provisions apply for Wisconsin purposes for tax years beginning after December 31, 2012. Specify that the two American Taxpayer Relief Act provisions apply for Wisconsin purposes at the same time as for federal purposes. Generally, the two American Taxpayer Relief

Act provisions apply to tax years beginning after December 31, 2012. The adoption of the identified provisions would increase individual and corporate income and franchise tax collections by an estimated $15,500,000 in 2013-14 and $18,200,000 in 2014-15.

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. Each of the 15 IRC provisions that would be referenced in state law and included for state tax purposes is described in greater detail in this paper. The administration indicates that eleven of the provisions would have a minimal fiscal effect, and Appendix 1 includes their description. The remaining four provisions would have a more significant fiscal effect, and they are described in points 3 through 6. After their description, this paper presents information on other IRC provisions enacted after December 31, 2010, that are not referenced in Wisconsin's tax statutes.

3. ***Flexible Spending Arrangements.*** The Patient Protection and Affordable Care Act of 2010 (PPACA) limits the amount of medical expense reimbursements through a health flexible spending account under an employer-sponsored cafeteria plan to $2,500 per year. For tax years beginning after 2013, the $2,500 limit is indexed for inflation, in $50 multiples. The limit applies to each employee and includes the employee, the employee's beneficiaries, and the employee's dependents. Cafeteria plans permit employees to reduce their compensation by redirecting the reduction as a contribution to an account to be used by the employee as a reimbursement of medical expenses incurred by the employee. Plans and accounts must comply with certain IRC requirements, and contributions are excludible from the employee's gross income for tax purposes. The administration indicates that the adoption of this provision would increase state tax collections by an estimated $2,800,000 in 2013-14 and $3,000,000 in 2014-15.

4. ***Employer Prescription Drug Plans for Retirees.*** The PPACA removes a provision excluding certain employer prescription drug plan expenses from an adjustment to reflect federal subsidies for retirees. Employers may offer prescription drug plans for their retirees. If the actuarial value of the drug plan equals or exceeds that of a Medicare Part D plan, the employer plan qualifies for certain treatments. These include federal subsidy payments equal to a portion of each retiree's gross covered prescription drug costs. In addition, revenue from the subsidies is not included in the plan sponsor's income for federal tax purposes. Prior to the PPACA, an IRC provision excluded the subsidies from the general rule that a deduction may not be claimed for an expense that is attributable to tax exempt income. As a result, plan sponsors could deduct their expenses for prescription drug costs, without regard to the subsidy. The PPACA eliminates this treatment, and expenses for retiree prescription drug costs must now be reduced by the amount of the federal subsidy that is excluded from income. The administration indicates that the adoption of this provision would increase state tax collections by an estimated $3,100,000 in 2013-14 and

$3,400,000 in 2014-15.

5. ***Threshold for Medical Expense Deduction.*** Individuals incurring unreimbursed medical expenses may claim those expenses as an itemized deduction for federal tax purposes, if those expenses exceed a specified threshold. Prior to the PPACA, only expenses exceeding 7.5% of adjusted gross income (AGI) could be deducted. The PPACA increased the threshold to 10% of AGI. Under the Wisconsin individual income tax, taxpayers are not allowed to claim itemized deductions, but may be eligible for the sliding scale standard deduction instead. However, state taxpayers may claim the itemized deduction tax credit if certain federal itemized deductions exceed their state standard deduction. By referencing this provision in the PPACA, state taxpayers would calculate the state itemized deduction credit based on their medical expenses in excess of 10% of their AGI, rather than 7.5% of their AGI. The administration indicates that the adoption of this provision would increase state tax collections by an estimated $6,500,000 in 2013-14 and $8,400,000 in 2014-15.

6. ***Penalty on HSA Distributions for Nonqualified Expenses.*** The PPACA increases the penalty on withdrawals for nonqualified expenses from Health Savings Accounts (HSAs) and Archer Medical Savings Accounts (MSAs). Individuals with high-deductible health insurance plans may establish HSAs and make contributions to their HSA, subject to certain limits, on a pre-tax basis. Amounts in the account earn interest and may be withdrawn to pay for current or future medical expenses not covered by the owner's health insurance plan. Prior to 2007, federal law allowed individuals to establish Archer MSAs, which were precursors to HSAs. While no new MSAs may be created, federal law allows accounts already in existence to be maintained. For state tax purposes, Wisconsin has adopted the federal treatment of HSAs and the federal treatment, as of 2005, of MSAs. Withdrawals from HSAs and MSAs may be made on a tax-free basis, provided the funds are used for qualified medical expenses, as defined by federal law. Withdrawals for nonqualified expenses are considered taxable income, and those withdrawals are also subject to federal penalty. The PPACA increases the federal penalty on such withdrawals to 20%, from 10% for HSAs and 15% for MSAs. Wisconsin also imposes a penalty on nonqualified withdrawals, and the state penalty is set at 33% of the federal penalty. By referencing the PPACA, the Wisconsin penalty would be set equal to one-third of the 20% penalty imposed for federal purposes. The administration indicates that the adoption of this provision would increase state tax collections by an estimated $3,100,000 in 2013-14 and $3,400,000 in 2014-15.

7. Some changes to the IRC that were enacted before December 31, 2010, have not been adopted for state tax purposes and are not proposed for adoption in AB 40. Generally, Wisconsin has not adopted IRC provisions where the state has developed its own treatment or the adoption of the federal treatment would cause a significant reduction in state tax collections.

8. Some changes to the IRC have been enacted after December 3, 2010, and are not recommended for adoption in AB 40. Many of these provisions are similar to the items added to the IRC prior to 2010 and not adopted by previous legislatures. However, some provisions that were enacted by the 112th Congress, in addition to those included in AB 40, could be adopted for state purposes. The FAA Modernization and Reform Act of 2012 contains one such provision. Since 2001, federal law has allowed current or former airline employees who were participants in a

defined benefit retirement plan of the airline and who received a payment from the airline in a bankruptcy proceeding to contribute the payment to a Roth individual retirement account (IRA). Income contributed to Roth IRAs is subject to tax in the year of the contribution, but distributions from Roth IRAs are generally tax-free. The Act allows individuals who have contributed to Roth IRAs under this procedure to roll over the Roth IRA to a traditional IRA. In addition, the Act allows those individuals to file amended tax returns for years in which contributions were made to Roth IRAs. The amended returns would generate tax refunds since contributions to traditional IRAs are made on a pre-tax basis (and distributions from traditional IRAs are subject to tax).

9. Adoption of this provision would decrease state tax collections by an estimated $500,000 in 2013-14 and $200,000 in 2014-15. DOR did not recommend this provision for state adoption. Generally, state law limits amended returns to four years after the unextended due date of the original return. However, amended returns would be allowed back to 2001, if the federal provision is adopted. The Department indicates that the small amount and number of refunds is not sufficient to outweigh the complexity resulting from allowing amended returns so far back.

10. The American Taxpayer Relief Act of 2012 provides a "permanent patch" for the federal alternative minimum tax (AMT). These provisions include: (a) setting the 2012 exemption amounts at $78,750 for joint filers, $50,600 for unmarried filers, and $39,375 for married-separate filers; (b) indexing for inflation the exemption amounts, the exemption phaseout amounts, and the income thresholds for applying the AMT tax rates, beginning in 2013; and (c) allowing the use of nonrefundable tax credits against the individual's regular tax and AMT liability.

11. Wisconsin imposes a state AMT based on the federal AMT. It is calculated based on federal AMT income and uses the federal exemption amounts in effect before tax year 2001 ($45,000 if married-joint, $33,750 if single or head-of-household, and $22,500 if married, separate). These are the exemption amounts that would have been used for the federal AMT beginning in 2012, but they were changed by the American Taxpayer Relief Act, as described above. By referencing the AMT provisions in the Act, Wisconsin's exemption amounts would be increased to equal the federal amounts and would increase each year due to the federal indexing provision. If the state's reference to federal law is revised, it should be effective beginning in tax year 2013. Otherwise, taxpayers subject to the tax would have to file amended returns, since 2012 tax forms have already been printed. Adopting this provision would reduce state tax collections by an estimated $2.0 million annually, beginning in 2013-14. It is presented as Alternative #3.

12. In addition, the American Taxpayer Relief Act of 2012 includes a number of provisions that were previously enacted on a temporary basis and then extended by the Act on a temporary basis, generally for tax years 2012 and 2013. In general, Wisconsin has not adopted these temporary provisions previously, and if these provisions were included in AB 40, taxpayers would have to file amended returns to claim the tax treatments for tax year 2012. However, amended returns would not be required if the provisions were adopted effective for tax years beginning after December 31, 2012. Then, the provisions would apply for only one tax year. The provisions include deductions or exclusions from income of: (a) up to $250 in classroom expenses of elementary and secondary school teachers; (b) indebtedness discharged on a principal residence; (c) additional van pool and transit fringe benefits to achieve parity with parking fringe benefits; (d) mortgage

insurance premiums as deductible interest on residences; (e) qualified conservation contributions of property used in agriculture or livestock production; (f) IRA distributions made by trustees directly to charitable institutions on behalf of individuals aged 70 ½ or older; and (g) contributions of food inventory (enhanced deduction). Each provision is described in greater detail in Appendix #2. Adopting these provisions would decrease state tax collections by an estimated $20.1 million in 2013-14 and $3.8 million in 2014-15. Their adoption is presented as Alternative #4, (a) through (g).

13. The American Taxpayer Relief Act of 2012 includes other temporary provisions which Wisconsin has previously adopted. These provisions are business-related and pertain to: (a) permitting the exclusion of certain qualifying payments by a controlled entity to a tax-exempt organization; (b) exempting interest-related dividends and short-term capital gain dividends from a regulated investment company for nonresident alien individuals; (c) extending the term "qualified investment company" to include regulated investment companies that are U.S. real property holding companies; (d) providing that income derived in the active conduct of banking, financing, or similar businesses is not considered foreign personal holding company income; (e) providing "look-through" treatment for payments between related controlled foreign corporations; (f) providing a basis adjustment to stock of S corporations making charitable contributions of property; and (g) establishing the recognition period as the five-year period beginning when a corporation became an S corporation for purposes of computing the built-in gains tax. Each provision is described in greater detail in Appendix #2. Adopting these provisions would decrease state tax collections by an estimated $23.3 million in 2013-14 and $1.0 million in 2014-15. Their adoption is presented as Alternative #4, (h) through (n).

ALTERNATIVES

1. Approve the Governor's recommendation to update statutory references to the federal IRC by referencing the 15 provisions identified in the bill.

2. Modify the Governor's recommendation by deleting the references to the following IRC provisions:

a. Allowing the use of the installment method of accounting by accrual-based taxpayers;

b. Limiting certain tax treatments to Blue Cross Blue Shield organizations and to related health insurance organizations;

c. Limiting the amount of contributions to flexible spending arrangements under cafeteria plans for medical expenses; deleting these references would decrease state tax collections by an estimated $2,800,000 in 2013-14 and $3,000,000 in 2014-15;

ALT 2.c.	**Change to Bill** Revenue
GPR-Tax	- $5,800,000

d. Eliminating a deduction for employers who receive Medicare Part D retiree drug subsidy payments; deleting these references would decrease state tax collections by an estimated $3,100,000 in 2013-14 and $3,400,000 in 2014-15;

ALT 2.d.	**Change to Bill** Revenue
GPR-Tax	- $6,500,000

e. Increasing the threshold for the deduction for unreimbursed medical expenses; deleting these references would decrease state tax collections by an estimated $6,500,000 in 2013-14 and $8,400,000 in 2014-15;

ALT 2.e.	**Change to Bill** Revenue
GPR-Tax	- $14,900,000

f. Increasing the penalty on unqualified distributions from health savings accounts; deleting these references would decrease state tax collections by an estimated $3,100,000 in 2013-14 and $3,400,000 in 2014-15;

ALT 2.f.	**Change to Bill** Revenue
GPR-Tax	- $6,500,000

g. Limiting the deduction for remuneration paid by health insurance providers;

h. Repealing a provision in the PPACA that was scheduled to take effect in tax year 2014 and that relates to free choice vouchers for certain employees;

i. Affecting the treatment of corporate repurchases of convertible debt instruments;

j. Affecting the segment rates used to determine the minimum required contribution levels for certain pension funds;

k. Affecting the transfer of excess pension assets to retiree medical accounts;

l. Affecting the transfer of excess pension assets to fund the purchase of retiree group-term life insurance;

m. Exempting the payment of annuities to certain employees participating in a phased retirement program from the early distribution tax;

n. Making permanent various tax treatments; and

o. Allowing current employees to roll over amounts in employer 401(k), 403(b), and 457(b) traditional retirement plans to Roth plans.

3. Modify the Governor's recommendation by including IRC references to the alternative minimum tax, enacted in the American Taxpayer Relief Act, effective for tax years beginning after 2012; decrease state tax collections by an estimated $2,000,000 in 2013-14 and 2014-15.

ALT 3	**Change to Bill** Revenue
GPR-Tax	- $4,000,000

4. Modify the Governor's recommendation by including IRC references to the following provisions, enacted in the American Taxpayer Relief Act, effective for tax years beginning after December 31, 2012:

a. Excluding from income up to $250 in classroom expenses of elementary and secondary school teachers; including this reference would decrease state tax collections by $1,200,000 in 2013-14;

ALT 4.a.	**Change to Bill** Revenue
GPR-Tax	- $1,200,000

b. Excluding from income indebtedness discharged on a principal residence; including this reference would decrease state tax collections by $7,400,000 in 2013-14 and $2,000,000 in 2014-15;

ALT 4.b.	**Change to Bill** Revenue
GPR-Tax	- $9,400,000

c. Excluding from income additional van pool and transit fringe benefits to achieve parity with parking fringe benefits; including this reference would decrease state tax collections by $700,000 in 2013-14 and $100,000 in 2014-15;

ALT 4.c.	**Change to Bill** Funding
GPR-Tax	- $800,000

d. Including mortgage insurance premiums in the itemized deduction for mortgage interest on residences; including this reference would decrease state tax collections by $3,700,000 in 2013-14 and $900,000 in 2014-15;

ALT 4.d.	**Change to Bill**
	Revenue
GPR-Tax	- $4,600,000

e. Including qualified conservation contributions of property used in agriculture or livestock production in the itemized deduction for charitable contributions; including this reference would decrease state tax collections by $900,000 in 2013-14 and $100,000 in 2014-15;

ALT 4.e.	**Change to Bill**
	Revenue
GPR-Tax	- $1,000,000

f. Excluding from income IRA distributions made by trustees directly to charitable institutions on behalf of individuals aged 70 ½ or older; including this reference would decrease state tax collections by $5,700,000 in 2013-14 and $700,000 in 2014-15;

ALT 4.f.	**Change to Bill**
	Revenue
GPR-Tax	- $6,400,000

g. Enhancing the itemized deduction for charitable contributions of food inventory; including this reference would decrease state tax collections by $500,000 in 2013-14 and by a minimal amount in 2014-15;

ALT 4.g.	**Change to Bill**
	Revenue
GPR-Tax	- $500,000

h. Permitting the exclusion of certain qualifying payments by a controlled entity to a tax-exempt organization; including this reference would decrease state tax collections by $100,000 in 2013-14 and by a minimal amount in 2014-15;

ALT 4.h.	**Change to Bill**
	Revenue
GPR-Tax	- $100,000

i. Exempting interest-related dividends and short-term capital gain dividends from a regulated investment company for nonresident alien individuals; including this reference would decrease state tax collections by $300,000 in 2013-14 and by a minimal amount in 2014-15;

ALT 4.i.	**Change to Bill**
	Revenue
GPR-Tax	- $300,000

j. Extending the term "qualified investment company" to include regulated investment companies that are U.S. real property holding companies; including this reference would decrease state tax collections by $100,000 in 2013-14 and by a minimal amount in 2014-15;

ALT 4.j.	**Change to Bill**
	Funding
GPR-Tax	- $100,000

k. Providing that income derived in the active conduct of banking, financing, or similar businesses is not considered foreign personal holding company income; including this reference would decrease state tax collections by $19,400,000 in 2013-14 and $900,000 in 2014-15;

ALT 4.k.	**Change to Bill**
	Revenue
GPR-Tax	- $20,300,000

l. Providing "look-through" treatment for payments between related controlled foreign corporations; including this reference would decrease state tax collections by $2,700,000 in 2013-14 and $100,000 in 2014-15;

ALT 4.l.	**Change to Bill**
	Revenue
GPR-Tax	- $2,800,000

m. Providing a basis adjustment to stock of S corporation making charitable contributions of property; including this reference would decrease state tax collections by $200,000 in 2013-14 and by a minimal amount in 2014-15; and

ALT 4.m.	**Change to Bill**
	Revenue
GPR-Tax	- $200,000

n. Establishing the recognition period as the five-year period beginning when a corporation became an S corporation for purposes of computing the built-in gains tax; including this reference would decrease state tax collections by $500,000 in 2013-14 and by a minimal amount in 2014-15.

ALT 4.n.	**Change to Bill**
	Revenue
GPR-Tax	- $500,000

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Attachment

APPENDIX 1

Federal Law Changes Included in AB 40 That Would Have a Minimal Fiscal Effect

The bill would update statutory references to the IRC under state individual and corporate income and franchise taxes to include the following provisions, each of which would have a minimal fiscal effect according to the administration.

Installment Method for Accrual Basis Taxpayers. Under current law, taxpayers that use the accrual method of accounting cannot report income from an installment sale using the installment method of accounting. Gain from the sale of property must be recognized in the year of the sale. Effective for dispositions of property on or after December 17, 1999, federal law prohibited the use of the installment method of accounting for taxpayers that used the accrual method. However, the Installment Tax Correction Act of 2000 repealed the federal prohibition on the use of the installment method for taxpayers using accrual accounting. An installment sale is defined as a disposition of property where at least one payment is to be received after the close of the tax year in which the disposition occurs. The installment method of accounting means a method under which the income recognized from a disposition of property, for any tax year, is that proportion of the payments received in that year which the gross profit (realized, or to be realized when the payment is completed) bears to the total contract price.

Treatment of Certain Health Organizations. The PPACA modified the treatment of certain health organizations, such as Blue Cross Blue Shield. Blue Cross Blue Shield organizations were exempt from taxation as "social welfare organizations" prior to the Tax Reform Act of 1986. That Act revoked their exemption and subjected them to taxation under Section 833 of the IRC, which provides that they are subject to the income tax rules that apply to property and casualty insurers. However, the Act extended two special tax treatments to Blue Cross Blue Shield organizations, as well as to other organizations offering health insurance, provided the other organizations meet certain conditions. The special tax treatments relate to a deduction tied to cost-plus contracts and an exclusion from a provision that reduces a deduction that applies to property and casualty insurers. The PPACA limits these special tax treatments to organizations with a medical loss ratio standard of 85%. The Joint Committee on Taxation analysis of the Act indicates that "an organization's medical loss ratio is determined as the percentage of total premium revenue expended on reimbursement for clinical services that are provided to the enrollees under the organization's policies during the taxable year."

Deduction for Remuneration Paid by Health Insurance Providers. For publicly held corporations, the amount of compensation that may be deducted as a business expense is generally limited to no more than $1 million per year for each executive. For insurance providers where health insurance plans contribute at least 25% of the provider's gross premium income, the PPACA limits the deduction for compensation to no more than $500,000 annually for each executive. By referencing the PPACA provision, the compensation deduction would be limited for state tax purposes, as well.

Taxation of Free Choice Vouchers for Health Plans. The Department of Defense and Full-Year Continuing Appropriations Act of 2011 repeals a provision in the Patient Protection and Affordable Care Act that was scheduled to take effect in 2014 and that relates to free choice vouchers for certain employees. Beginning in that year, the PPACA provided that certain employees covered by an employer-sponsored health plan, who are responsible for part of the plan's cost, could opt out of the plan and receive "free choice vouchers" from the employer to be used to purchase health plans offered through affordable insurance exchanges. The value of the voucher was to equal the amount of the employer contribution to the employer-sponsored health plan and was not to be included in the employee's gross income, to the extent the voucher was used to purchase a health plan. This provision was limited to employees whose contributions fell between 8% and 9.5% of their household income and whose household income did not exceed 400% of the federal poverty level. Due to its repeal, this provision will not take effect, and federalizing the provision in the Department of Defense and Full-Year Continuing Appropriations Act would clarify that vouchers would be treated as employee compensation for state tax purposes.

Corporate Repurchase of Debt Instrument. In general, the deduction for a premium paid or incurred by an issuing corporation for repurchase of a debt instrument that is convertible into the stock of the issuing corporation, or a corporation in control of, or controlled by, the issuing corporation, may be disallowed or limited in certain cases. The federal FAA Modernization and Reform Act of 2012, modified the definition of "control" to include indirect control relationships included in the IRC definition of controlled group.

Pension Funding Rules for Determining Segment Interest Rates. The IRC specifies minimum funding requirements that generally apply to single-employer defined benefit pension plans. If these funding requirements are not met, a plan could be disqualified, and amounts in the plan could become taxable to the employee. Under the funding rules for single-employer defined benefit plans, the minimum required contribution generally depends on a comparison of the value of the plan's assets with the plan's funding target and target normal cost. The funding target is the present value of all the benefits earned as of the beginning of the plan year. The target normal cost is the present value of benefits expected to be earned during the plan year. Present value is determined using three interest rates, referred to as the first, second, and third, segment rates, each of which applies to benefit payments expected to be made during a certain period. A segment rate is determined using the portion of a corporate bond yield curve (based on average corporate bond yields for the preceding 24-month period) attributable to bonds maturing during the particular segment rate period. The Moving Ahead for Progress in the 21st Century Act (MAP-21) provides that each of the three segment rates used in determining present value must be increased or decreased as necessary to fall within a specified range of the average segment rate for the preceding 25-year period. This change would have the effect of reducing the aggregate required taxpayer contributions to pension funds and the related deductions.

Transfer of Excess Pension Assets to Retiree Medical Accounts. A second provision in the MAP-21 Act extends a provision in the Pension Funding Equity Act of 2004 that was scheduled to expire on January 1, 2014, that relates to the transfer of excess pension assets of a defined benefit plan to retiree medical accounts. Federal law defines excess pension assets as the value of the assets in a pension plan exceeding 125% of the sum of the plan's funding target and the plan's target cost for the plan year. Excess assets may be transferred to a retiree medical account within the plan to fund current health benefits for retirees. By previously adopting provisions in the Pension Funding Equity Act, Wisconsin federalized its treatment of transfers through December 31, 2013. For federal tax purposes, the Moving Ahead for Progress in the 21st Century Act permits transfers through December 31, 2021, so adopting provisions in that Act would maintain Wisconsin's conformity regarding the transfer of excess pension assets to retiree medical accounts through 2021.

Transfer of Excess Pension Assets to Fund the Purchase of Retiree Group-Term Life Insurance. A third provision in the MAP-21 Act also relates to the transfer of excess pension assets. As noted above, federal law allows the transfer of excess pension assets of a defined benefit plan to retiree medical accounts. Prior to the Act, federal law limited the use of excess pension assets to funding current health benefits for retirees. However, the Act also permits qualified transfers to a separate account within a defined benefit plan to be used for the purchase of retiree group-term life insurance not in excess of $50,000. Also, federal law specifies that the cost of employer-provided group-term life insurance coverage is not included in an employee's gross income, if the coverage does not exceed $50,000. The Act extends this treatment to group-term life insurance coverage provided through a pension plan.

Exception from the Early Distribution Tax for Certain Annuities. A fourth provision in the MAP-21 Act relates to an exception from the early distribution tax of annuities under a phased retirement program. Prior to the Act, federal law allowed certain exceptions to the 10% tax on early distributions, but none of the exceptions applied to payments that commenced before separating from service with the employer. A phased retirement program is available to certain full-time federal employees, which allows those employees to reduce their work schedules and receive reduced retirement annuities that reflect their work schedule reduction. The Act exempts those retirement annuity payments from the early distribution tax.

Temporary IRC Provisions Made Permanent. The American Taxpayer Relief Act extends a number of temporary IRC provisions on a permanent basis. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) contained a number of IRC provisions that became effective in tax years 2001 and 2002, but were enacted on a temporary basis. Many of the EGTRRA provisions were scheduled to be sunset after December 31, 2010, but the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 suspended the sunset date until December 31, 2012. A provision in the American Taxpayer Relief Act extends the following EGTRRA provisions permanently: (1) increases the maximum annual contribution limit for Coverdell education savings accounts from $500 to $2,000; (2) increases the income phase-out range for contribution limits to Coverdell accounts for married taxpayers to twice the amount as for single taxpayers; (3) allows Coverdell accounts to be used for elementary and secondary education expenses, as well for higher education expenses; (4) provides an exclusion of up to $5,250 annually of employer-provided educational assistance and permits the assistance to be used for graduate level courses; (5) increases the income phase-out range for student loan interest deductions and eliminates the 60-month limitation on the deduction and the restriction on voluntary payments of interest; and (6) excludes certain scholarships with obligatory service requirements from gross income.

Traditional Retirement Plan Roll Over to Roth Plans. The American Taxpayer Relief Act allows individuals to roll over amounts in certain traditional retirement accounts to certain Roth accounts. Employers may establish 401(k) plans for their employees where employees elect to defer part of their compensation and make contributions to the plan on a pre-tax basis. Distributions from 401(k) plans are subject to taxation and generally may be made after the participant reaches the age of 59 ½. A 403(b) retirement plan is similar to a 401(k) plan, except 403(b) plans are offered by tax-exempt charitable organizations and educational institutions of state and local governments. Section 457 of the IRC authorizes state and local governments and tax-exempt organizations to establish deferred compensation plans whereby their employees may elect to defer part of their compensation to the plan on a pre-tax basis. Distributions from plans are subject to tax. Federal law also allows employers to establish Roth 401(k), 403(b), and 457 programs, where participants have all, or part, of their deferrals deposited in Roth accounts. Unlike "traditional" accounts, amounts deposited in Roth accounts are subject to tax when earned, but are not subject to tax when withdrawn, provided the withdrawal is a qualified distribution. The Act allows amounts in traditional retirement accounts to be rolled over into Roth accounts. The amounts are subject to tax in the year of the rollover, but rollover amounts are not subject to the federal penalty, at 10%, on non-qualified distributions. If Wisconsin does not adopt this provision, rollovers would be considered a non-qualified distribution and subject to state penalty.

APPENDIX 2

Provisions of the Federal American Taxpayer Relief Act Not Included in AB 40

The American Taxpayer Relief Act of 2012 contains a number of provisions that could be adopted for state tax purposes but that are not included in AB 40. The following material describes provisions from the Act that are included in Alternative #4.

Classroom Expenses. Secondary and elementary school teachers may take an above-the-line deduction of up to $250 for out-of-pocket classroom expenses for items such as books, supplies, equipment, and other materials used in the classroom. Originally, the deduction was extended for two years beginning in 2002, and it has been extended on a two-year basis five times and is now available for federal tax purposes through 2013.

Indebtedness Discharged on a Principal Residence. In response to the subprime mortgage crisis, mortgage holders were encouraged to avoid foreclosures by restructuring mortgages. However, taxpayers are generally required to recognize cancelled debt as income. The Mortgage Forgiveness Debt Relief Act of 2007 created a temporary exception to this rule by allowing homeowners to exclude amounts cancelled as debt from income if the debt is for the taxpayer's principal residence and does not exceed $2 million. The exclusion applied to tax years 2007 through 2009 and was extended for an additional three years (2010 through 2012) by the Emergency Economic Stabilization Act of 2008. The American Taxpayer Relief Act extends the exclusion for one year through December 31, 2013.

Van Pool and Transit Fringe Benefits. Fringe benefits that employers provide to their employees are considered taxable income of the employees unless otherwise specifically exempt. One such exclusion permits employers to provide transportation fringe benefits to their employees on a pre-tax basis. These benefits include van pooling, transit passes, qualified parking, and bicycle commuting. Monthly benefits are subject to an inflation-adjusted monthly limitation. Initially, the IRC set a higher monthly limitation for parking benefits than for van pooling or transit benefits, but the American Recovery and Reinvestment Act of 2009 raised the limits for van pooling and transit benefits so that they equaled the limit for parking benefits for part of 2009 and all of 2010. The higher limit was extended to 2011 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, and the American Taxpayer Relief Act extended parity for these benefits through 2013. For 2013, the inflation-adjusted limit is $245 per month. Prior to enactment of the American Taxpayer Relief Act, the van pooling and transit limit had been calculated at $125 per month.

Mortgage Insurance Premiums. Amounts paid by individuals as personal interest are generally not deductible for tax purposes, but individuals who itemize their deductions may deduct interest payments on home acquisition loans (mortgages) and on home equity loans, provided the property is used as the taxpayer's principal residence or as a second home and the indebtedness does not exceed $1 million. As a condition for some home acquisition loans, lenders require borrowers to purchase mortgage insurance. Since tax year 2007, mortgage insurance premium payments have been included as deductible interest, subject to an income phase out, for federal tax purposes. The expansion of the home interest deduction to mortgage insurance premiums initially applied only to tax year 2007, but it was extended once to apply to tax years through 2010 and again to apply through 2011. The American Taxpayer Relief Act extends the treatment of mortgage insurance premiums as deductible home interest to tax years 2012 and 2013.

Qualified Conservation Contributions. For taxpayers that itemize their deductions, the contribution of a partial interest in real property does not generally qualify as a charitable contribution. However, if the property is subject to a perpetual easement or restrictive covenant that prevents the property's development and safeguards its natural character or historic significance and the contribution is made to a qualifying organization exclusively for conservation purposes, a deduction is allowed, subject to certain limits. Depending on the type of charitable organization, the limitation equals 20% or 30% of the donor's contribution base for most individuals, but the limitation equals 50% of the donor's contribution base if the taxpayer is a qualified farmer or rancher. The Pension Protection Act of 2006 raised the contribution limitation to 50% for individuals and to 100% for farmers and ranchers, on a temporary basis. Originally, the higher limitations applied for tax years 2006 through 2010, but the limitations were subsequently extended through 2011. The American Taxpayer Relief Act extends the higher limitations to tax years 2012 and 2013.

Charitable Distributions from IRAs. With certain exceptions, distributions from individual retirement accounts (IRAs) are subject to tax. In addition, minimum distributions from IRAs are required after individuals become 70½ years of age. Since 2006, federal law has allowed taxpayers to exclude from gross income charitable contributions of up to $100,000 per year if the contribution is a distribution from an IRA made directly by the trustee of the IRA to the charitable organization. The distribution counts against the minimum required distribution from traditional IRAs. Initially, this provision was limited to tax years 2006 and 2007, but it has been subsequently extended for three two-year periods. Most recently, the American Taxpayer Relief Act extended the provision for tax years 2012 and 2013.

Contributions of Food Inventory. Generally, charitable contributions of ordinary property are limited to the taxpayer's basis in the property, but C corporations may claim an enhanced deduction equal to the lesser of the donated item's basis plus half of its appreciation or two times the basis of the donated item. In any year, the corporation's charitable deduction is limited to 10% of its taxable income, with a five-year carry over allowed. In 2005, the enhanced deduction was extended to noncorporate taxpayers who donate food inventory to charitable organizations and private operating foundations for use in the care of the ill, the needy, or infants. Initially, this provision was limited to part of tax year 2005, but it has been subsequently extended for four two-year periods. Most recently, the American Taxpayer Relief Act extended the provision for tax years 2012 and 2013.

Payments to Controlling Tax-Exempt Organizations. In general, interest, rent, royalties, and annuities paid to a tax-exempt organization from a controlled entity (related through specified levels of stock and other measures of ownership) are treated as unrelated business income of the tax-exempt organization, and, as a result, are subject to taxation. The Pension Protection Act provided that if a payment to a tax-exempt organization by a controlled entity is no more than fair market value, then the payment is excludable from the tax-exempt organization's unrelated business income. The American Taxpayer Relief Act extends the provision two years until December 31, 2013.

Treatment of Certain Dividends of Regulated Investment Companies (RICs). The Act extends a provision allowing a RIC, under certain circumstances, to designate all or a portion of a dividend as an "interest-related dividend" by written notice mailed to its shareholders, not later than 60 days after the close of its taxable year. In addition, an interest-related dividend received by a foreign person generally is exempt from the U.S. 30% gross-basis tax collected through withholding. The Act extends the treatment of interest-related dividends and short-term capital gain dividends received from a RIC to the tax years of the RIC beginning before January 1, 2014.

Including RICs in Definition of Qualified Investment Entity. The Act extends the inclusion of a RIC within the definition of a "qualified investment entity" under the IRC through December 31, 2013.

Exceptions under Subpart F for Active Financing Income. The U.S. parent of a foreign subsidiary engaged in banking, financing, or similar business is eligible for deferral of tax on such a subsidiary's earnings if the subsidiary is predominantly engaged in such business and conducts substantial activity with respect to such business. The subsidiary must pass an entity level income test to demonstrate that the income is active and not passive income. The Act extends the provision for two years through 2013. The extension also applies to certain income of security dealers and certain foreign base company services income.

Look-through Treatment of Payments Between Related Controlled Foreign Corporations. The Act allows deferral for certain payments (interest, dividends, rents, and royalties) between commonly controlled foreign corporations (CFCs). The provision allows U.S. taxpayers to deploy capital from one CFC to another without triggering U.S. tax. The provision is extended through 2013.

Basis Adjustment to Stock of S Corporations Making Charitable Contributions of Property. The Act extends for two years a provision allowing S corporation shareholders to take into account their pro rata share of charitable deductions, even if such deductions would exceed such shareholders' adjusted basis in the corporation.

Reduction in S Corporation Recognition Period for Built-in Gains Tax. If a taxable corporation converts into an S corporation, the conversion is not a taxable event. However, following such a conversion, an S corporation must hold its assets for a certain period in order to avoid a tax on any built-in gains that existed at the time of the conversion. The American Recovery and Reinvestment Act reduced that period from 10 years to seven years for sales of assets in 2009 and 2010. The Small Business Jobs Act reduced that period to five years on sales of assets in 2011. The American Taxpayer Relief Act extends the reduced five-year holding period for sales occurring in 2012 and 2013. In addition, the Act clarifies rules for carry-forwards and installment sales.