



Legislative Fiscal Bureau

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Joint Committee on Finance

Paper #316

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

[LFB 2019-21 Budget Summary: Page 136, #4]

CURRENT LAW

State individual income tax and corporate income/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 IRC provisions enacted as of December 31, 2017.

GOVERNOR

Update references to the IRC under the individual and corporate income/franchise taxes. For tax years beginning after December 31, 2013, and before January 1, 2017, create provisions adopting selected IRC provisions in P.L. 115-141, the Consolidated Appropriations Act of 2018, which made technical corrections to the Protecting Americans from Tax Hikes Act of 2015 (P.L. 114-113) and the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (P.L. 114-41). In addition, adopt P.L. 115-141 provisions making technical corrections to the American Jobs Creation Act of 2004 (P.L. 108-357) for purposes of the IRC definition in the 2013 Wisconsin Statutes for tax years beginning after December 31, 2003, and before January 1, 2005. Limit the current law definition of the IRC for tax years beginning after December 31, 2017 to apply only to tax years beginning before January 1, 2019, but specify that selected provisions of the Disaster Tax Relief and Airport Airway Extension Act of 2017 (P.L. 115-63) and the Tax Cuts and Jobs Act of 2017 (P.L. 115-97) first apply for Wisconsin purposes for tax years beginning after December 31, 2017, rather than at the same time as for federal purposes. For tax years beginning after December 31, 2018, create provisions adopting IRC provisions in effect as of

December 31, 2018, with exceptions. Specify that the provisions of federal public laws that directly or indirectly affect the IRC apply for state tax purposes at the same time as for federal tax purposes, with exceptions, and specify that the definition of the IRC does not include amendments to the IRC enacted after December 31, 2018. Repeal obsolete provisions pertaining to tax years beginning after December 31, 2004, and before January 1, 2006. The Department of Administration (DOA) has submitted an errata seeking a technical modification to the bill to achieve this affect.

Increase individual income and corporate income/franchise taxes by an estimated \$187,850,000 in 2019-20, \$174,450,000 in 2020-21, \$250,675,000 in 2021-22, and \$224,625,000 in 2022-23. Most of the fiscal effect is attributable to provisions in the Tax Cuts and Jobs Act of 2017, which results in tax increases estimated at \$189,650,000 in 2019-20, \$175,350,000 in 2020-21, \$251,575,000 in 2021-22, and \$225,525,000 in 2022-23, due to seven provisions not previously adopted in 2017 Wisconsin Act 231: (a) loss limitation for taxpayers other than corporations; (b) amortization of research and experimental expenditures; (c) accounting rules for accrual method taxpayers; (d) limitation on the deduction for business interest; (e) limitation on the deduction for entertainment, amusement, and recreation expenses; (f) limitation on the deduction of Federal Deposit Insurance Corporation premiums; and (g) modification of the limitation on the deduction for highly paid individuals. The remainder of the fiscal effect is attributable to provisions in the Bipartisan Budget Act of 2018 that would reduce general fund tax revenues by an estimated \$1,800,000 in 2019-20 and \$900,000 in 2020-21 and thereafter.

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, personal exemptions, itemized deductions, and tax credits.

2. During the last legislative session, the Legislature adopted IRC provisions in effect as of December 31, 2017, although certain IRC provisions were excluded from the adoption. Since then, three federal laws have been enacted that affect the IRC. These include the Bipartisan Budget Act of 2018 (P.L. 115-123), the Consolidated Appropriations Act of 2018 (P.L. 115-141), and the John S. McCain National Defense Authorization Act for Fiscal Year 2019 (P.L. 115-232). Enacted in 2018, the three acts were federal spending measures pertaining to federal fiscal years 2018 and 2019. These acts also included an assortment of federal tax provisions.

3. The Department of Revenue reports that adopting the provisions in the John S. McCain National Defense Authorization Act would not affect state tax collections. The two other acts included technical provisions relating to preceding tax years. The Consolidated Appropriations Act made technical corrections to IRC provisions that had been enacted in 2015. Wisconsin had previously adopted the 2015 provisions, so the bill would adopt the technical corrections and extend the corrections to tax years 2014, 2015, and 2016. Two provisions that had expired were extended by the

Bipartisan Budget Act through tax year 2017, and the bill would adopt these provisions retroactively for tax year 2017. The preceding provisions are technical in nature and would not have a fiscal effect.

4. Since 2000, a number of federal tax provisions have been enacted and renewed on a temporary basis. Over 30 of these provisions expired at the end of 2016 and were not renewed during 2017. The Bipartisan Budget Act (BBA) extended these provisions for one to four years, with the extension retroactive to tax year 2017. Several of the provisions were adjustments to income, but these provisions expired at the end of one year (2017). Many of the other expiring provisions relate to federal tax credits, which are not tied to state tax provisions. Other provisions in the federal act relate to tax relief for hurricane and California wildfire victims or to federal excise taxes. For these reasons, federalizing most of the provisions in the BBA would not affect state tax collections.

5. Nonetheless, there are two provisions in the BBA that would result in a state fiscal effect if adopted by the state. Because some provisions would apply retroactively to tax year 2018, these provisions have a larger tax effect in 2019-20 than in 2020-21. These provisions are estimated to decrease income and franchise tax collections by an estimated \$2,150,000 in 2019-20 and \$1,500,000 in 2020-21:

Qualified Opportunity Zones. Federal law allows states to designate certain low-income census tracts as qualified opportunity zones, and taxpayers may exclude certain capital gains from their taxable income if the gain is reinvested in a qualified opportunity zone within 180 days. The BBA designates each low-income census tract in Puerto Rico as a qualified opportunity zone. Because a limited number of Wisconsin taxpayers are likely to make a qualifying investment, a minimal effect on state revenues is estimated, reducing individual income tax collections by \$1,250,000 in 2019-20 and \$900,000 in 2020-21 and annually thereafter.

Contract Employees Serving in a Combat Zone. The BBA allows contractors or employees of contractors supporting the U.S. Armed Forces in designated combat zones to exclude their foreign earned income for tax purposes even if the individual has an abode in the United States. Adopting this provision would reduce individual income tax collections by an estimated \$900,000 in 2019-20 and \$600,000 in 2020-21 and annually thereafter.

6. A third provision of the BBA directs the IRS to modify existing regulations related to hardship distributions from retirement plans by generally relaxing certain restrictions on taking a hardship distribution. Because contributions to retirement plans are generally made on a pre-tax basis, except for ROTHs, withdrawals are subject to tax. Wisconsin taxpayers making IRS-permitted hardship withdrawals from retirement plans are likely to do so regardless of whether Wisconsin adopts this provision. DOA indicates that this provision would increase individual income tax collections by an estimated \$600,000 in 2019-20 and \$600,000 in 2020-21 and annually thereafter. Because Wisconsin will receive these additional revenues even if the provision is not adopted, this paper does not assign a fiscal effect to this provision. Further, the revenues related to the provision have been incorporated into this office's May, 2019, revenue estimates.

7. A fourth provision under the BBA extends the energy efficient commercial building deduction for one year and would result in an estimated \$400,000 decrease in corporate income/franchise tax collections in 2019-20. This provision is extended under Section 179 of the IRC.

Its adoption by the Legislature is unnecessary because Wisconsin automatically adopts Section 179 changes under an existing statutory provision [s. 71.98(4)]. If the Committee wants to adopt the technical provisions of the Bipartisan Budget Act but exclude the two preceding items (qualified opportunity zones and contract employees serving in a combat zone) from the IRC update due to their fiscal effect, the Committee could adopt Alternative 2.

8. Adopting the Consolidated Appropriations Act is not expected to result in a state fiscal effect because the Act's IRC changes consist of technical corrections to the federal Tax Cuts and Jobs Act of 2017 (P.L. 115-97). Wisconsin adopted many of the Tax Cuts and Jobs Act changes in 2018 when it enacted 2017 Wisconsin Act 231, which also adopted some provisions from the Disaster Tax Relief and Airport Airway Extension Act of 2017 (P.L. 115-63). However, Act 231 did not adopt certain provisions in the Tax Cuts and Jobs Act. The bill would adopt seven provisions from the Tax Cuts and Jobs Act (the Act) that were excluded from Act 231. Each of these provisions is described below.

9. Loss Limitation for Pass-Through Taxpayers. Under the individual income tax, taxpayers may deduct business losses from their regular income, subject to certain limitations. For example, passive losses and excess farm losses cannot be deducted in the year incurred, but can be carried forward. For tax years 2018 through 2025, the Act limits the amount of business losses by not allowing excess business losses to be deducted. The Act defines excess business loss as the taxpayer's aggregate deductions for business purposes that exceed the sum of the taxpayer's gross income or gain plus \$500,000 for married joint filers or \$250,000 for other types of filers. Excess business losses may be carried forward and claimed under net operating loss provisions, as amended by the Act. Also for tax years 2018 through 2025, the limitation relating to excess farm losses does not apply. Excess farm losses comprise losses occurring in the same year that certain farm subsidies are received, provided the farm is not a C corporation. For purposes of calculating adjusted gross income, the excess business loss limitation created by the Act applies after passive loss rules. Adopting this provision beginning in tax year 2019 would increase state individual income tax collections by an estimated \$70,400,000 in 2019-20, \$66,300,000 in 2020-21, \$61,650,000 in 2021-22, and \$47,700,000 in 2022-23.

10. Amortization of Research Expenses. Most business expenses associated with the development or creation of an asset that has a useful life beyond the current year must be capitalized and depreciated over the useful life of the asset. However, researchers can elect to immediately deduct reasonable research or experimentation expenditures associated with the development or creation of a business asset. Researchers also may elect to amortize such expenditures over a five-year or 10-year period, rather than capitalize such expenditures under uniform capitalization rules. The Act requires research and experimental expenditures to be capitalized and amortized ratably over a five-year period. Expenditures attributable to research conducted outside of the United States must be capitalized and amortized ratably over a period of 15 years. The election to immediately expense such costs was repealed. The Act also expands the definition of research or experimental expenditures to include expenditures for software development, as well as depreciation and depletion allowances for property other than land that is depreciated or depleted in connection with research or experimentation. This provision takes effect in taxable years beginning after December 31, 2021. Because this provision was enacted with a delayed effective date, state adoption of this provision would not affect state tax revenues in the 2019-21 biennium. However, adoption of this provision

would increase state tax revenues by an estimated \$76,850,000 in 2021-22 and \$83,175,000 in 2022-23.

11. Accounting Rules for Accrual Method Taxpayers. Gross income is generally taxable in the tax year in which the money, property, or service is received, with exceptions to permit deferral of gross income related to advance payments. The Act requires an accrual method taxpayer to recognize income no later than the taxable year in which such income is taken into account as revenue in an applicable financial statement, with an exception for taxpayers without an applicable or other specified financial statement. The Act codifies the current deferral method of accounting for advance payments for goods, services, and other specified items to allow accrual method taxpayers to elect to defer the inclusion of income associated with advance receipt if such income is also deferred for financial statement purposes. The Act also repeals special rules that apply to the accrual of interest for original issue discount debt instruments (other than mortgage servicing contracts) that have an applicable financial statement, and the change in accounting for such debt instruments must be taken into account ratably over six taxable years. State adoption of this provision beginning in tax year 2019 would increase tax revenues by an estimated \$10,450,000 in 2019-20, \$7,925,000 in 2020-21, \$5,350,000 in 2021-22, and \$2,775,000 in 2022-23.

12. Limitation on Deduction for Interest. Under state and federal law, interest paid or accrued by a business was generally deductible from taxable income prior to tax year 2018, with certain limitations. However, deductible interest on indebtedness allocable to property held for investment was generally limited to net investment income for the taxable year, provided interest exceeded 2% of AGI. Investment interest that could not be deducted could be carried forward to the following year. A deduction could be disallowed for disqualified interest paid involving related parties or to a taxable real estate investment trust subsidiary if the payor's debt-to-equity ratio exceeded 1.5 to 1.0 and the payor's net interest expense exceeded 50% of AGI.

In general, the deduction for business interest is limited under the Act to the sum of: (a) business interest income; (b) 30% of the taxpayer's adjusted taxable income (ATI); and (c) floor plan financing interest of the taxpayer for the taxable year. Business interest income means any interest paid or accrued on indebtedness allocable to a trade or business, but does not include investment interest or investment income. ATI means taxable income of the taxpayer computed without regard to any: (1) item of income, gain, deduction, or loss not properly allocable to the trade or business; (2) business interest or interest income; (3) net operating loss deduction; and (4) the 20% deduction for certain pass-through income. Wages are not included in ATI. For tax years 2018 through 2021, ATI is computed without regard to deductions allowable for depreciation, amortization, or depletion. Floor plan financing interest includes any interest on indebtedness used to finance any self-propelled vehicles (such as on the floor of a car dealership) and is not subject to the deduction limitation, but not on indebtedness used to finance construction machinery and equipment.

Any deduction disallowed as a result of the limit for business interest may be carried forward indefinitely for use in future years. The deduction limit for partnerships and S corporations is computed at the entity level, and special rules apply, generally to prevent double counting of the deduction limit at the entity-level and at the partner or shareholder level. The following entities are exempt from the deduction limit: (a) taxpayers with average gross receipts of less than \$25 million

over the prior three taxable years; (b) certain regulated public utilities; (c) most businesses engaged in real property development, construction, rental, leasing, or brokerage activities; and (d) farming businesses, as well as certain agricultural or horticultural cooperatives. A farming business that claims this exemption must use straight line depreciation for property that has a recovery period of ten years or more. Adopting this provision beginning in tax year 2019 at the state level would increase state tax revenues by an estimated \$87,000,000 in 2019-20, \$83,500,000 in 2020-21, \$89,900,000 in 2021-22, and \$78,225,000 in 2022-23.

13. Limitation on Employers Deduction for Entertainment, Amusement, and Recreation Expenses. Deductions are not allowed for expenses related to activities that are considered entertainment, amusement, or recreation, or expenses for a facility (like aircraft) used for such purpose. However, prior to 2018, taxpayers could deduct certain expenses equal to: (a) 50% of entertainment expenses that are directly related to a taxpayer's active trade or business; and (b) 50% of food and beverages provided to employees. The Act repeals the deduction allowed under "a." Under state and federal de minimis fringe benefit provisions prior to the Act, food and beverages provided to employees through an eating facility operated by the employer that is located on or near the employer's business premises and that meets certain requirements could be deducted by the employer. The Act limits the deduction to food and beverages provided for the convenience of the employer and reduces the deductible amount to 50% for amounts incurred and paid after December 31, 2017. However, for amounts paid or incurred after December 31, 2025, such expenses cannot be deducted. It is estimated that state adoption of these provisions would increase tax revenues by an estimated \$10,050,000 in 2019-20, \$8,225,000 in 2020-21, \$8,350,000 in 2021-22, and \$6,375,000 in 2022-23.

14. Limitation on FDIC Premium Deduction. Under the Act, beginning in tax year 2018, bank and financial institution payments of Federal Deposit Insurance Corporation (FDIC) premiums are no longer deductible if paid or incurred by a taxpayer with total consolidated assets of \$50 billion or more. For taxpayers with such assets of less than \$10 billion, FDIC premiums are 100% deductible. For taxpayers with such assets of between \$10 billion and \$50 billion, the applicable percentage of the deduction is prorated over that range (for example, if the taxpayer has \$20 billion of such assets, 25% of FDIC premiums are taxable). State adoption of this provision beginning in tax year 2019 would increase tax revenues by an estimated \$7,250,000 in 2019-20, \$5,800,000 in 2020-21, \$5,875,000 in 2021-22, and \$4,575,000 in 2022-23.

15. Limitation on Deduction for Highly Paid Individuals. Salaries, wages, and other forms of remuneration to officers of a business are deductible. However, deductible compensation expenses in the case of a "publicly held corporation" are limited to no more than \$1 million per year for each "covered employee." A covered employee generally means the principal executive officer and the three most highly compensated officers as of the last day of the tax year (four covered employees). Certain types of remuneration are not included when calculating the deduction limit. The Act generally expands applicability of the \$1 million deduction limit by:

a. Expanding the definition of a publicly held corporation to include all domestic publicly traded corporations, including large private C corporations or S corporations that are not publicly traded;

b. Including remuneration paid on a commission basis and performance-based compensation;

c. Expanding the definition of a covered employee to also include the principal financial officer, in addition to the principal executive officer and the three most highly compensated officers (five covered employees);

d. Including any individual that holds the position of principal executive officer or principal financial officer at any time during the taxable year; and

e. Requiring that an individual who is a covered employee, beginning in tax year 2017, remains a covered employee subject to the \$1 million deduction limit with respect to compensation otherwise deductible in subsequent years, including years in which the individual is no longer employed by the corporation and in years after the employee has died.

As a result, the number of covered employees under the Act may exceed five, and deferred compensation paid to a covered employee, or the beneficiary of a covered employee, is subject to the \$1 million deduction limit. A transition rule applies that grandfathers written binding contracts in effect on November 2, 2017. However, a contract is considered a new contract if it is renewed or if there has been a material modification to its terms. State adoption of this provision beginning in tax year 2019 would increase tax revenues by an estimated \$4,500,000 in 2019-20, \$3,600,000 in 2020-21, \$3,600,000 in 2021-22, and \$2,700,000 in 2022-23.

16. The preceding provisions related to the Tax Cuts and Jobs Act would increase individual and corporate income/franchise tax collections by an estimated \$189,650,000 in 2019-20, \$175,350,000 in 2020-21, \$251,575,000 in 2021-22, and \$225,525,000 in 2022-23. If the Committee agrees with the 2017 Legislature's decision to exclude these provisions from state tax provisions, the Committee could remove them from the proposal, either selectively or en masse (Alternative 3). Excluding all seven items from the definition of the Internal Revenue Code would decrease state income and franchise tax collections by an estimated \$365,000,000 in the biennium, relative to the bill. Relative to current law, removing the items from the bill would not affect state income and franchise tax collections.

17. The fiscal effects of the individual IRC provisions identified in the preceding descriptions sum to lower totals in both years than the amounts reported by DOA. As a result, adopting all of the provisions identified in this paper would increase state tax collections by an estimated \$361,350,000 in the 2019-21 biennium, or \$950,000 less than the \$362,300,000 amount originally estimated.

18. On May 1, 2019, DOA submitted an errata seeking a technical modification to the IRC provisions. Under current law, the IRC definition excludes a federal provision requiring estimated tax payments for insurance companies. The bill's creation of the IRC definition for tax years beginning after December 31, 2018, would continue that exclusion. However, the IRC provision was repealed by the Tax Cuts and Jobs Act. The technical modification would delete the bill's references to the repealed IRC provision and would not have a fiscal effect.

ALTERNATIVES

1. Approve the Governor's recommendation to update state income and franchise tax references to the Internal Revenue Code, including the technical modification submitted by DOA. Reestimate increased general fund tax revenues of \$187,500,000 in 2019-20 and \$173,850,000 in 2020-21 under the bill.

ALT 1	Change to	
	Base	Bill
GPR-Tax	\$361,350,000	-\$950,000

2. Approve the Governor's recommendation to update state income and franchise tax references to the Internal Revenue Code, including the technical modification submitted by DOA, except exclude sections in the Bipartisan Budget Act of 2018 (P.L. 115-123) related to qualified opportunity zones (section 41115) and civilians serving in a combat zone (section 41116). The retirement plan provisions related to hardships (sections 41113 and 41114) would be adopted since those provisions have no fiscal effect. Relative to the bill, this alternative would increase state tax collections by an estimated \$1,800,000 in 2019-20 and \$900,000 in 2020-21. The Tax Cuts and Jobs Act changes described in this paper would be adopted, increasing income and franchise tax collections by an estimated \$365,000,000 in the biennium, reflected as Change to Base.

ALT 2	Change to	
	Base	Bill
GPR-Tax	\$365,000,000	\$2,700,000

3. Approve the Governor's recommendation to update state income and franchise tax references to the Internal Revenue Code, including the technical modification submitted by DOA, except exclude the following sections in the Tax Cuts and Jobs Act of 2017 (P.L. 115-97). Relative to the bill, excluding all of the sections would decrease state tax collections by an estimated \$190,000,000 in 2019-20 and \$175,950,000 in 2020-21. The Bipartisan Budget Act changes described in this paper would be adopted, decreasing income and franchise tax collections by an estimated \$3,650,000 in the biennium, reflected as Change to Base. Exclude the following sections of P.L. 115-97 from the definition of the Internal Revenue Code under the state income and franchise tax (GPR-Tax change to bill):

- a. Section 11012, relating to loss limitation for pass-through taxpayers (-\$136,700,000);
- b. Section 13206, relating to amortization of research expenses (\$0);
- c. Section 13221, relating to accounting rules for accrual method taxpayers (-\$18,375,000);
- d. Section 13301, relating to limitation on the deduction for interest (-\$170,500,000);
- e. Section 13304 (a), (b), and (d), relating to limitation on the deduction for entertainment,

amusement, and recreation expenses (-\$18,275,000);

f. Section 13531, relating to limitation on FDIC premium deduction (-\$13,050,000); and

g. Section 13601, relating to the limitation on the deduction for highly paid individuals (-\$8,100,000).

ALT 3	Change to	
	Base	Bill
GPR-Tax	-\$3,650,000	-\$365,950,000

4. Take no action (the Change to Bill reflects reversing DOA's original fiscal effect).

ALT 4	Change to	
	Base	Bill
GPR-Tax	\$0	-\$362,300,000

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