Wisconsin Department of Administration
Division of Executive Budget and Finance

Fiscal Estimate - 2015 Session

☒ Original ☐ Updated ☐ Corrected ☐ Supplemental

LRB Number **15-3740/1**	Introduction Number **SB-503**

Description
Individual and corporate income and franchise taxes; sales and use taxes; administration of tax laws; providing an exemption from emergency rule procedures; and requiring the exercise of rule-making authority

Fiscal Effect

State:
- ☐ No State Fiscal Effect
- ☐ Indeterminate
  - ☐ Increase Existing Appropriations
  - ☐ Decrease Existing Appropriations
  - ☐ Create New Appropriations
  - ☐ Increase Existing Revenues
  - ☒ Decrease Existing Revenues
  - ☒ Increase Costs - May be possible to absorb within agency's budget ☐ Yes ☒ No
  - ☐ Decrease Costs

Local:
- ☐ No Local Government Costs
- ☐ Indeterminate
  1. ☐ Increase Costs ☐ Permissive ☐ Mandatory
  2. ☐ Decrease Costs ☐ Permissive ☐ Mandatory
  3. ☐ Increase Revenue ☐ Permissive ☐ Mandatory
  4. ☒ Decrease Revenue ☐ Permissive ☒ Mandatory
  5. Types of Local Government Units Affected
     ☐ Towns ☐ Village ☐ Cities
     ☒ Counties ☐ Others
     ☐ School Districts ☐ WTCS Districts

Fund Sources Affected
☒ GPR ☐ FED ☐ PRO ☐ PRS ☐ SEG ☐ SEGS

Affected Ch. 20 Appropriations

Agency/Prepared By	Authorized Signature	Date
DOR/ Bradley Caruth (608) 261-8984	Michael Wagner (608) 266-6785	1/7/2016

Fiscal Estimate Narratives

DOR 1/7/2016

LRB Number **15-3740/1**	Introduction Number **SB-503**	Estimate Type **Original**
Description Individual and corporate income and franchise taxes; sales and use taxes; administration of tax laws; providing an exemption from emergency rule procedures; and requiring the exercise of rule-making authority		

Assumptions Used in Arriving at Fiscal Estimate

The bill makes several changes to state tax law and the Department of Revenue's (DOR) administration of tax laws. The changes are described below.

FAILURE TO PRODUCE RECORDS

Under current law, DOR may impose certain penalties if a taxpayer fails to produce records and documents requested by DOR to substantiate information required to be shown on a tax return. This bill provides that those penalties may not be imposed until after DOR has issued a summons seeking the records and documents, and the taxpayer has failed to comply with the summons.

The penalty is primarily used as a tool to incentivize compliance with records request rather than as a revenue generator. As such, the limitation on DOR's ability to assess the penalty is likely to reduce penalty collections by a minimal amount annually.

ECONOMIC SUBSTANCE

Under current Wisconsin law, a transaction is defined as having economic substance only if the taxpayer shows that the transaction changes the taxpayer's economic position in a meaningful way, apart from federal, state, local, and foreign tax effects, and the taxpayer has a substantial nontax purpose for entering into the transaction and that the transaction is a reasonable means of accomplishing the substantial nontax purpose. A transaction has a substantial nontax purpose if it has substantial potential for profit, disregarding any tax effects.

Under the bill, current state economic substance provisions would be repealed. Instead, the state would adopt, by reference to Section 7701(o) of the Internal Revenue Code, federal economic substance provisions.

The bill as written would only apply to transactions that have economic substance as it relates to the transaction's federal tax effect. The Internal Revenue Code's economic substance provisions do not apply to state tax effects. There are numerous ways in which taxpayers could structure transactions that would have no federal income tax effect and therefore not be subject to the federal economic substance doctrine, but which could significantly reduce the taxpayer's income that is taxable to Wisconsin. The potential reduction in income and franchise tax revenue could reach $296 million.

The fiscal effect of this provision could be eliminated if the bill is amended to clarify that references to federal taxes in section 7701(o) of the Internal Revenue Code also apply for state tax purposes in the same way the standard applies to federal tax effects.

EVIDENTIARY STANDARDS

Under current law, for transactions between members of a controlled group (and in tax law generally), the taxpayer bears the burden of establishing by clear and convincing evidence that a transaction or a series of transactions between the taxpayer and one or more members of the controlled group has economic substance. The bill reduces the evidentiary standard related to intercompany transactions for members of a controlled group from "clear and convincing evidence" to a "preponderance of the evidence."

The provision of the bill that changes the standard of evidence for transactions between combined group members would result in a loss of income and franchise tax of an unknown amount. For illustrative purposes, in FY 2015, large-case auditors, who generally focus on combined groups, generated a total of $57 million in corporate income and franchise tax revenue. If the change in evidentiary standard results in a reduction of 10% in the revenue from large-case auditors, corporate income and franchise tax revenue would be reduced by an estimated $5.7 million annually. Lowering the evidentiary standard will increase the Department's administrative expenses. A less clear evidentiary standard makes it more probable that such transactions will not be agreed to in audit, leading to litigation in order to resolve.

MANUFACTURING AND AGRICULTURE CREDIT CHANGES

Under current law, for the purposes of calculating qualified production activity income under the manufacturing and agriculture credit, indirect costs are defined as ordinary and necessary expenses that are deductible as businesses expenses under the Internal Revenue Code. Under the bill, indirect costs would be limited to ordinary business expenses as defined under the Internal Revenue Code as defined in current law s. 71.01(6). As a result, Section 179 expensing would no longer be included in the definition of indirect costs used in calculation of qualified production activities income because Section 179 expensing is governed by current law s. 71.98(4).

The exclusion of Section 179 costs would have the effect of increasing the qualified production activities income, and therefore generally increasing the credit that is calculated subject to other statutory limitations. The provision would reduce income and franchise tax revenue by an estimated $5.3 million annually.

NEXUS RULES

Under current law, DOR has promulgated rules for determining whether a taxpayer has sufficient nexus with the state to allow the state to collect taxes from the taxpayer, and to determine whether the taxpayer has nexus with this state or other states for the purpose of determining apportionment. The bill requires DOR to promulgate rules to establish criteria determining whether a business, service, or property has nexus with the state for the purposes of determining whether a business is taxable and for the purposes of determining apportionment. DOR would be prohibited from considering any criteria not included in the rules.

Because the final form of the nexus rules is unknown, the fiscal effect cannot be determined at this time.

In order to provide some context on the magnitude of potential changes in apportionment, DOR is providing the following information.

If the final rule, per section 17 of the bill, results in a reduction of 1% in the amount of apportionable income (net taxable income before apportionment is applied) for the largest corporations (those with gross receipts over $100 million) it would result in an annual reduction in income and franchise tax revenue of an estimated $6.5 million and an annual reduction in economic development surcharge revenue of an estimated $50,000. If the final rule results in a reduction of 5% in the amount of apportionable income for the largest corporations (those with gross receipts over $100 million) it would result in an annual reduction in income and franchise tax revenue of an estimated $31.0 million and an annual reduction in economic development surcharge revenue of an estimated $250,000.

If the final rule, per section 18 of the bill, results in a reduction of 1% in the numerator of the sales factor for the largest corporations (those with gross receipts over $100 million), which includes throwback sales, it would result in an annual reduction of income and franchise tax revenue of an estimated $6 million and an annual reduction in economic development surcharge revenue of $50,000. If the final rules result in a reduction of 5% in the numerator of the sales factor for the largest corporations, it would result in an annual reduction in income and franchise tax revenue of $30 million annually and a reduction in economic development surcharge revenue of an estimated $230,000.

LUMP SUM CONTRACTS

Under current law, there is a sales and use tax exemption for property, items, and services sold by a contractor as part of a lump sum contract for real property construction activities if the total sales price attributable to the taxable products is less than 10% of the total contract price.

The bill expands the exemption for lump sum contracts to apply to all construction contracts involving real property construction activities if the total sales prices of the taxable products is less than 10% of the total contract price.

The bill also provides that if the prime (general) contractor qualifies for the exemption, the exemption also applies (flows through) to all subcontracts entered into with respect to the real property construction activities.

Based on information from the 2007 Economic Census, DOR estimates retail trade by specialty contractors in Wisconsin to be $44.3 million for FY16. Assuming a 50% markup on purchases, DOR estimates sales tax revenue would decrease by about $1.1 million ($44.3 million * 50% * 5%).

Local (county and baseball district) sales taxes were 7.2% of state sales tax revenues in FY15. Assuming this percentage does not change, local sales taxes will decrease by about $79,000 ($1.1 million * 7.2%) per year.

MTC AUDIT AUTHORITY

Under current law, DOR is authorized to enter into a contract to participate in the Multi-State Tax Commission (MTC) audit program. Under the bill, that authority would be repealed.

The provisions of the bill related to removing the authority for DOR to participate in MTC audits would reduce income and franchise tax revenue by an estimated net $1.25 million annually.

RELIANCE ON PAST AUDITS

Under current law, individuals or entities subject to audits are not liable for amounts asserted by DOR if the specific tax issue under review was present in a prior audit for the same period and DOR identified or reviewed the tax issue, but did not adjust the taxpayer's treatment of the tax issue. This provision does not cover the treatment of tax issues that were not specifically addressed in the prior assessment or audit determination. Current law also contains exceptions, allowing DOR to revisit assessments for cases in which the taxpayer did not give DOR adequate and accurate information regarding the tax issue in the prior audit determination or if the tax issue was settled in the prior audit determination by a written agreement between DOR and the taxpayer.

The bill removes the current law exceptions, preventing DOR from reexamining audits in cases in which taxpayers conceal or misrepresent relevant tax information. In addition to the direct impact of the safe-haven, this bill effectively discourages taxpayers from fully cooperating with any DOR audits by providing a guarantee that if DOR obtains new information at a later date, it will not adversely affect the taxpayer's liability.

The fiscal effect of the provision is unknown and will depend on the degree to which taxpayers reduce their compliance with DOR audit activities. As an example, if the provision reduces the revenue impact of audits by 5% relative to the three-year period from FY13 to FY15, it would reduce revenue by about $13.3 million annually.

SUMMARY

The provisions of the bill described above reduce revenue by approximately $335 million to $384 million annually using the contextual examples for the unknown costs. To the extent that the contextual examples or the underlying assumptions of the remaining provisions' fiscal estimates understate/overstate the actual impact, the fiscal effect would be different.

Long-Range Fiscal Implications

Wisconsin Department of Administration
Division of Executive Budget and Finance

Fiscal Estimate Worksheet - 2015 Session

Detailed Estimate of Annual Fiscal Effect

☒ Original ☐ Updated ☐ Corrected ☐ Supplemental

LRB Number **15-3740/1**	Introduction Number **SB-503**

Description
Individual and corporate income and franchise taxes; sales and use taxes; administration of tax laws; providing an exemption from emergency rule procedures; and requiring the exercise of rule-making authority

I. One-time Costs or Revenue Impacts for State and/or Local Government (do not include in annualized fiscal effect):

II. Annualized Costs:	**Annualized Fiscal Impact on funds from:**	
	Increased Costs	Decreased Costs
A. State Costs by Category		
State Operations - Salaries and Fringes	$	$
(FTE Position Changes)		
State Operations - Other Costs		
Local Assistance		
Aids to Individuals or Organizations		
TOTAL State Costs by Category	**$**	**$**
B. State Costs by Source of Funds		
GPR		
FED		
PRO/PRS		
SEG/SEG-S		

III. State Revenues - Complete this only when proposal will increase or decrease state revenues (e.g., tax increase, decrease in license fee, ets.)

	Increased Rev	Decreased Rev
GPR Taxes	$	$
GPR Earned		
FED		
PRO/PRS		
SEG/SEG-S		
TOTAL State Revenues	**$**	**$**

NET ANNUALIZED FISCAL IMPACT

	State	Local
NET CHANGE IN COSTS	$	$
NET CHANGE IN REVENUE	$See Text	$

Agency/Prepared By	**Authorized Signature**	**Date**
DOR/ Bradley Caruth (608) 261-8984	Michael Wagner (608) 266-6785	1/7/2016