Legislative Fiscal Bureau

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January 20, 1998

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Assembly Bill 633/Senate Bill 366: Individual Income Tax Reciprocity with the State of Illinois

Assembly Bill 633 and Senate Bill 366 are identical bills which would authorize payments to the State of Illinois under Wisconsin's individual income tax reciprocity agreement with that state. Assembly Bill 633 was introduced on December 2, 1997, and was referred to the Committee on Ways and Means. The Committee adopted Assembly Amendment 1 and recommended passage of AB 633, as amended, by a vote of 15 to 0. Senate Bill 366 was introduced on November 26, 1997 and was recommended for passage, as amended (by the same amendment), by the Senate Committee on Economic Development, Housing and Government Operations by a vote of 4 to 1.

CURRENT LAW

Under state individual income tax provisions, income may be taxed on the basis of where it is earned or on the basis of the taxpayer's legal residence. In Wisconsin and most other states with an individual income tax, a credit is provided for taxes paid to other states in order to prevent double taxation of the same income.

In addition, reciprocity agreements may be entered into between two states to reduce the filing requirements of persons who live in one state and work in the other state. Under such agreements, the taxpayer is only required to file a return and pay taxes in the state of legal residence. Wisconsin currently has income tax reciprocity agreements with five states: Illinois, Indiana, Kentucky, Michigan and Minnesota. With these agreements, Wisconsin forgoes revenue by not taxing wage and salary income earned in Wisconsin by residents of these states and collects revenue by taxing income earned in these states by Wisconsin residents. Likewise, these

other states do not impose their income tax on earnings of Wisconsin residents and tax income earned in Wisconsin by their residents.

Reciprocity Payment Agreement With Minnesota

The Minnesota-Wisconsin reciprocity agreement has been in effect since 1968. In 1973, a modification of the agreement was negotiated to require compensation payments when the net foregone tax revenues of one state exceed those of the other state. This provision, which was enacted in Chapter 90, Laws of 1973, responded to concerns by Minnesota officials that the original reciprocity agreement led to a substantial revenue loss for that state. The revenue loss was attributable to three factors: (1) significantly more people lived in Wisconsin and worked in Minnesota than vice versa; (2) the Wisconsin border-crossers had somewhat higher income levels; and (3) the tax laws of Minnesota generally resulted in a higher tax liability. The other four income tax reciprocity agreements do not include a compensation provision at this time.

The Minnesota-Wisconsin reciprocity statute provides that the data used to compute the amount of each state's foregone tax revenue be determined by the respective Departments of Revenue on or before November 1 of the year following the close of the previous calendar year. The resulting compensation payment amount must be determined jointly by each state. If an agreement cannot be reached, a three-person board of arbitration is appointed to resolve the difference. The arbitration board must include one member appointed by the Wisconsin Secretary of Revenue and the Minnesota Commissioner of Taxation and a third member named by these two board members. The board may administer oaths, take testimony, subpoena witnesses and require their attendance, require the production of books, papers and documents and hold hearings. The board is allowed to examine tax returns for the purpose of determining the reciprocity loss. The amount determined to be paid by the board is conclusive. Wisconsin will pay no more than 50% of the cost of arbitration.

The reciprocity statute requires interest to be paid on any delinquent compensation payments. In addition, the Secretary of Revenue is authorized to enter into agreements with the state of Minnesota specifying the reciprocity payment due date, conditions constituting delinquency, interest rates and the method of computing interest due on delinquent payments.

The following sections briefly describe the current Minnesota-Wisconsin income tax reciprocity agreement.

Term of Agreement. The agreement contains no expiration date and is continued subject to statutory modification. In addition, the agreement can be revised at any time upon mutual agreement of both states. Thus, under its current provisions, the income tax reciprocity agreement is open-ended and may be unilaterally terminated by either state through legislative repeal.

Calculation of Payments. After a prolonged controversy over the appropriate data and methodology to estimate foregone taxes, a consultant from the Institute of Social Research (ISR)

of the University of Michigan was commissioned to prepare a study on the compensation payable under reciprocity for tax years 1973 through 1977. In addition to estimating the amount of foregone taxes for these years, the ISR study made recommendations regarding the methodology to be used in calculating future compensation payments.

The current agreement has formally adopted the ISR method of calculating the payments. The calculation uses bench mark figures regarding the proportion of border-crossers and income taxes foregone, with adjustments to reflect total income tax collections in each state and population trends in border counties. Payments are currently based on a benchmark study completed in 1986, based on 1983 income tax returns.

Wisconsin and Minnesota are currently conducting another bench mark study. As part of the study, Wisconsin's 1995 income tax forms included questions for all taxpayers to answer indicating whether they have income from services performed in Minnesota during the tax year and to specify the amount of that income on the return. The Department of Revenue (DOR) has drawn a random sample of state tax returns to estimate the number of Wisconsin residents that earned income in Minnesota and calculate the amount of taxes foregone by Minnesota. The information from the sampled returns will be weighted to reflect all taxpayers. The Minnesota DOR is conducting a similar study of Minnesota residents who earn income in Wisconsin. Under the agreement, after the release of the new bench mark figures, payments could be adjusted for subsequent years, the bench mark year (1995) and the three prior years to reflect the new data, although adjusting payments may not exceed 10% of the original payment.

Administrative Provisions. The agreement requires payment to be made on December 1, or 30 days after data becomes available for the prior tax year, whichever is later. A method to calculate interest due on delinquent and adjusting payments is also included as part of the agreement. Finally, upon the agreement of both states, a third party may be consulted prior to the use of a board of arbitration in the event of an impasse.

Table 1 shows the estimated taxes foregone by Wisconsin and Minnesota, the difference in foregone taxes and the amount of compensation actually paid by Wisconsin since 1990. In some years, the amount paid by Wisconsin is different than the difference in foregone revenues. This occurs because an adjusting payment was made, subject to the 10% limit. The tax year 1996 payment was made in December of 1997, which is in fiscal year 1997-98.

As the table indicates, the reciprocity compensation payment from Wisconsin to Minnesota has increased from approximately $22.7 million to $37.9 million since 1990. However, these payments are largely offset by collections of taxes from Wisconsin residents who work in Minnesota. Therefore, the reciprocity agreement should not be viewed as a loss to the Wisconsin general fund.

TABLE 1
Compensation Payable Under Minnesota-Wisconsin Income Tax Reciprocity

Tax Year	Taxes Foregone by Minnesota	Taxes Foregone by Wisconsin	Difference	Amount Paid by Wisconsin	Payment Date
1990	$32,129,000	$9,410,000	$22,719,000	$22,719,000	Dec., 1991
1991	33,967,000	9,840,000	24,127,000	24,127,000	Dec., 1992
1992	37,551,000	10,728,000	26,823,000	26,893,000	Dec., 1993
1993	38,322,000	11,328,000	26,994,000	26,996,000	Dec., 1994
1994	40,719,000	12,240,000	28,479,000	28,504,000	Dec., 1995
1995	44,951,000	13,042,000	31,909,000	31,887,000	Dec., 1996
1996	52,138,000	14,215,000	37,923,000	37,872,000	Dec., 1997

SUMMARY OF BILLS

The bills would create an individual income tax reciprocity payment provision that would apply to Illinois which would be similar to the payment provision that currently applies to Minnesota. Under the bills, a compensation payment would be made whenever the foregone tax revenues of one state exceed the foregone taxes of the other state.

Under the bills, the data used to compute the amount of each state's foregone tax revenue would be determined by the respective Departments of Revenue on or before December 1 of the year following the close of the previous calendar year. The resulting compensation payment amount would be determined jointly by each state. If an agreement cannot be reached, a three-person board of arbitration would be appointed to resolve the difference. The arbitration board would include one member appointed by the Wisconsin Secretary of Revenue, one by the Illinois Director of Taxation and a third member named by these two board members. The board would be allowed to administer oaths, take testimony, subpoena witnesses and require their attendance, require the production of books, papers and documents and hold hearings. The board would be allowed to examine tax returns for the purpose of determining the reciprocity loss. The amount determined to be paid by the board would be conclusive. Wisconsin would pay no more than 50% of the cost of arbitration.

The bills would require interest to be paid on any delinquent compensation payments related to taxable years beginning after December 31, 1999. In addition, the Secretary of Revenue would be authorized to enter into agreements with the state of Illinois specifying the reciprocity payment due date, conditions constituting delinquency, interest rates and the method of computing interest due on delinquent payments.

Under the bills, the maximum amount that could be paid to Illinois for tax year 1998 would be $5.5 million and would be the second draw on anticipated revenue increases. The maximum payment for tax year 1999 would be $8.25 million and would be the first draw on anticipated revenue increases. However, the bills specify that these two payments could not be made unless the Secretary of the Wisconsin DOR and the Illinois Director of Taxation enter into

a written agreement relating to income tax reciprocity that applies to taxable years beginning after December 31, 1997.

The bills would create three appropriations under miscellaneous appropriations. The first would provide $228,900 GPR in 1998-99 in an annual appropriation to fund a bench mark study by DOR of the revenue loss under reciprocity with Illinois. A second would be an annual sum certain appropriation to pay Illinois any losses of income taxes due to reciprocity for taxable years beginning after December 31, 1997, and before January 1, 2000, to which a total of $5.5 million GPR would be appropriated in 1998-99. The third would be a sum sufficient appropriation to pay Illinois any losses of income taxes due to reciprocity and any interest on those payments for taxable years beginning after December 31, 1999. No funding is provided in this appropriation because such payments would not be made until the 2001-03 biennium.

The bills would also create an annual program revenue appropriation under DOR to provide services for the Illinois reciprocity agreement and for publications. Funding for this PR appropriation would be drawn from the GPR monies provided under the bench mark study appropriation.

The provisions of AB 633/SB 366 would first apply to taxable years beginning on January 1, 1998.

Assembly Amendment 1/Senate Amendment 1

The amendments would make modifications to the appropriations. First, the funding for the reciprocity study would be increased from $228,900 to $231,200 under the amendments. In addition, the DOR appropriation to administer the reciprocity payment agreement would be amended so that it could only be used to provide services for the agreement (it could not be used for publications). Finally, the bench mark study appropriation would be amended to specify that the funding would be used to fund only Wisconsin's portion of the study.

FISCAL EFFECT

Department of Revenue Costs

As amended, the bills would provide $231,200 for DOR in order to complete a study to establish a basis for reciprocity payment amounts for tax years 2000 and thereafter. This funding would be used to establish the number of individuals who live in one state and work in the other and the amount of their compensation by conducting a study of 1998 tax returns. The data would be used to calculate the amount of taxes foregone by each state and the resulting payment. This study with Illinois would be similar to the 1995 bench mark study currently being completed with Minnesota.

In its fiscal note to the bills, the Department indicated that the study would take three years to complete and the funding would be used as follows:

	1998-99	1999-2000	2000-01	Total
LTE Salary & Fringe	$46,100	$76,900	$34,700	$157,700
Contractual Services	0	10,500	500	11,000
Data Processing	1,500	11,100	7,800	20,400
Postage, Printing and Supplies & Services	26,700	8,300	7,100	42,100
Total	$74,300	$106,800	$50,100	$231,200

In addition to the study, DOR estimated one-time costs of $9,800 in 1997-98 and annual costs of $9,500 beginning in 1997-98 for printing, distributing and processing new withholding exemption certificates. Wisconsin issues withholding certificates to Wisconsin residents who work in reciprocity states so that Wisconsin income taxes are withheld in lieu of the other state's taxes. Except for individuals who work in Minnesota, these certificates are filed with the employer and only require basic taxpayer information. The certificates for individuals who work in Minnesota request additional information of the taxpayer and employer and must also be filed with DOR. This second type of exemption certificate would be required of Wisconsin residents who work in Illinois if either of the bills are enacted. No funding is provided for these expenses.

As shown in the above table, the Department indicates that three years are needed to complete the study and only $74,300 is needed in 1998-99. However, DOR also indicated that $9,800 in one-time costs would be experienced in 1997-98 and $9,500 in expenses would be incurred annually beginning in 1997-98 related to the exemption certificates. Accordingly, the Committee may wish to adopt an amendment to provide $19,300 in 1997-98 and to reduce the 1998-99 amount from $231,200 to $83,800. The Department could request the remaining funds for the benchmark study as part of the 1999-2001 biennial budget.

Reciprocity Payment Amounts

The maximum payment amounts of $5.5 million in 1998-99 and $8.25 million in 1999-2000 in the bills reflect 50% and 75%, respectively, of approximately $11.0 million that Illinois estimates to be its annual revenue loss under reciprocity. In making this estimate, Illinois used 1990 U.S. Census data that indicated there were 33,389 Wisconsin residents who commuted to Illinois and 9,102 Illinois commuters to Wisconsin. The calculation also assumed the average annual income of all commuters was $25,000. Based on these assumptions, Illinois estimated that Wisconsin forgoes taxes of $13 million from Illinois residents who work in Wisconsin and that Illinois forgoes taxes of $24 million from Wisconsin residents who work in Illinois. The difference of $11 million ($24 million less $13 million) is the estimated revenue loss to Illinois and the basis of the payments for 1998-99 and 1999-2000.

By limiting the first two reciprocity payments to $5.5 million and $8.25 million, it appears that these payments will be less than the projected difference ($11 million) in foregone tax revenues. In a December 9, 1997, memorandum to the Assembly Ways and Means Committee, DOR examined whether these payment amounts would exceed the actual compensation owed if they were later adjusted according to the results of the 1998 bench mark study. The Department concluded that the difference in foregone tax revenues is likely to be higher than $5.5 million and $8.25 million. This estimate was made using different assumptions than used by Illinois regarding the number of commuters and their average wage. Although a reliable estimate cannot be made without the completion of the bench mark study, DOR estimated a difference in foregone tax revenues of between $9.5 million and $29.0 million.

Under the bills, the first payment to be made based on the results of the 1998 bench mark study will be for tax year 2000. This payment would be made in December of 2001 or the 2001-02 fiscal year. Since the payment of $8.25 million for tax year 1999 would be made in 1999-2000, there would be no payment made in fiscal year 2000-01. Once payments based on the bench mark study begin, it is anticipated that they will be between $9.5 million and $29.0 million annually.

As noted, if the bills are enacted Wisconsin's expenditures would increase by between $9.5 million and $29 million on an annualized basis. However, the State of Illinois has indicated that it will terminate its reciprocity agreement with Wisconsin if the bills are not passed. Therefore, if the bills are not adopted and reciprocity with Illinois is terminated, Wisconsin's income tax revenues would decrease by approximately the same amount (between $9.5 million and $29 million) since taxes would not be collected on the wages of Wisconsin residents working in Illinois. As a result, although the bills would increase expenditures as compared to current law, the bills have a revenue neutral fiscal effect as compared to the loss of the reciprocity agreement.

First and Second Draw on Anticipated Revenue Increases Provision

Under 1997 Act 27 (the 1997-99 biennial budget), a mechanism was established to allocate up to $195 million in additional general fund balances to fund previously-unfunded employe compensation increases ($20 million) and to decrease the size of school aid payment delays ($175 million). This mechanism is based on a comparison of estimated net balances under Enrolled AB 100 with reestimated net balances as certified by the Legislative Fiscal Bureau and reviewed by the Joint Committee on Finance.

Under this procedure, if there is an additional net balance, the first $20 million would be transferred to the Committee's supplemental GPR appropriation and used to fund the cost of the increases in employe compensation and fringe benefits. The next $75 million would be transferred to the property tax relief fund and used to "buy out" a corresponding delay in 1997-98 school aid payments into the 1998-99 fiscal year. Finally, the next $100 million would be transferred to the property tax relief fund and used to "buy out" a corresponding delay in 1998-99 school aid payments into the 1999-2000 fiscal year.

Under the bills, the $5.5 million maximum payment for tax year 1998 (to be paid in 1998-99) would be the second draw on anticipated revenue increases and the $8.25 million maximum payment for tax year 1999 (to be paid in 1999-2000) would be the first draw on anticipated revenue increases. The drafting instructions for SB 366 indicate that the intent was for a first draw of $20 million for compensation reserves, but for the second draw to be for the $5.5 million reciprocity payment, prior to the draw for the property tax relief fund. In addition, the instructions specify that the $8.25 million reciprocity payment would be made prior to any payments to the property tax relief fund.

The Committee may wish to remove the "second draw" and "first draw" language from the bills because it is not known how the provision would work and it may not be enforceable. First, the language in the bills refers to draws on anticipated revenue increases, while this term is not defined in either the bills or the statutes, and the Act 27 provision refers to estimated net balances. Second, the Act 27 language would not be amended to account for the reciprocity payments. The timing of the reciprocity payments and the Act 27 "buy out" procedure may not coincide. For example, the intent is for the 1998-99 payment of $5.5 million to be the second draw after the $20 million compensation reserve "buy out." However, the compensation reserve payment may be made in the 1997-98 fiscal year. In addition, the Act 27 provision does not provide for "buy out" payments in fiscal year 1999-2000, the year that the $8.25 million payment would be the first draw on additional revenues. Finally, it is not known how the "first and second draw" provision could be enforced if other legislation is enacted prior to passage of the bills.

Written Agreement Prior to Payments

The bills specify that the $5.5 million payment in 1998-99 and the $8.25 million payment in 1999-2000 could not be made unless the Secretary of the Wisconsin DOR and the Illinois Director of Taxation enter into a written agreement relating to income tax reciprocity. The Committee may wish to amend this provision to make it apply to the entire reciprocity payment provision rather than just the first two payments.

Impact of Ending Reciprocity

The state of Illinois is arguing that it is losing revenue under the current agreement because there are more Wisconsin residents working in Illinois than Illinois residents working in Wisconsin. Illinois has stated that it will end reciprocity with Wisconsin unless Wisconsin enters into a payment agreement. Illinois made the same request of the state of Indiana; Indiana refused to make a payment and reciprocity between Illinois and Indiana subsequently ended.

A primary benefit of the current Wisconsin-Illinois income tax reciprocity agreement is that border-crossing taxpayers are required to file a return and pay income taxes only in their state of residence. Without reciprocity such taxpayers would have the additional inconvenience and record-keeping requirements of filing a second return. This may also result in Wisconsin border-crossers having to make estimated tax payments to Wisconsin since Illinois' taxes are

lower than Wisconsin's. However, the end of reciprocity would generally not result in a higher tax liability for Wisconsin residents because Wisconsin income taxes are typically higher and a credit would be provided for taxes paid to Illinois. This differs from the effect of ending reciprocity with Minnesota, which would generally increase taxes for Wisconsin residents because Minnesota's income taxes are typically higher than Wisconsin's.

It should be noted, however, that ending reciprocity with Illinois would generally result in higher taxes for Illinois residents who work in Wisconsin because Wisconsin typically imposes a higher income tax than Illinois, which would not be fully offset by Illinois' credit for taxes paid to Wisconsin. Therefore, the payment agreement contemplated in the bills would maintain the simplified taxfiling requirements for Wisconsin residents, but would generally not affect their tax liability. Illinois residents would benefit more by maintaining reciprocity because their taxes would increase if the agreement is rescinded.

The end of reciprocity may increase taxes of certain Wisconsin residents with wage income from Illinois and a loss (such as a business or farm loss) from the home state. This could happen because Illinois would not allow the loss to offset the amount of wage income.

The Department also indicated in its fiscal note that if reciprocity with Illinois is terminated, additional administrative costs of approximately $119,800 annually would be incurred beginning in 1998-99. These costs would be associated with additional tax returns being filed by Illinois residents who work in Wisconsin, the processing of the credit for taxes paid to Illinois and the processing of estimated tax payments.

Prepared by: Kelsie Doty

MO# ~~(in jacket)~~ Senate + Assem Amendments 1

1 BURKE	(Y)	N	A
DECKER	(Y)	N	A
JAUCH	(Y)	N	A
SHIBILSKI	(Y)	N	A
COWLES	(Y)	N	A
PANZER	(Y)	N	A
SCHULTZ	(Y)	N	A
ROSENZWEIG	(Y)	N	A
2 GARD	(Y)	N	A
OURADA	(Y)	N	A
HARSDORF	(Y)	N	A
ALBERS	(Y)	N	A
PORTER	(Y)	N	A
KAUFERT	(Y)	N	A
LINTON	(Y)	N	A
COGGS	(Y)	N	A

AYE 16 NO 0 ABS 0

MO# passage as amended — for both bills

2 BURKE	(Y)	N	A
DECKER	(Y)	N	A
JAUCH	(Y)	N	A
SHIBILSKI	(Y)	N	A
COWLES	(Y)	N	A
PANZER	(Y)	N	A
1 SCHULTZ	(Y)	N	A
ROSENZWEIG	(Y)	N	A
GARD	(Y)	N	A
OURADA	(Y)	N	A
HARSDORF	(Y)	N	A
ALBERS	(Y)	N	A
PORTER	(Y)	N	A
KAUFERT	(Y)	N	A
LINTON	(Y)	N	A
COGGS	(Y)	N	A

AYE 16 NO 0 ABS 0