

STATE OF WISCONSIN
JOINT SURVEY COMMITTEE ON TAX EXEMPTIONS
2023 ASSEMBLY BILL 386

[Introduced by Representative Steffen and cosponsored by Senator Cabral-Guevara]

This report concerns 2023 Assembly Bill 386, relating to lowering the individual income tax rates in the third bracket and increasing and expanding the retirement income subtraction.

GENERAL NATURE OF PROPOSAL

Assembly Bill 386 decreases the individual income tax rate in the third tax bracket from 5.3 percent to 4.4 percent. This would consolidate the third bracket into the second bracket and result in three tax brackets overall. Under the bill, the tax rates and brackets for 2023 would be as follows:

<u>Tax Rate</u>	<u>Single and Head of Household</u>	<u>Married Filing a Joint Return</u>	<u>Married Filing Separate Returns</u>
3.5 %	\$0 to \$13,810	\$0 to \$18,420	\$0 to \$9,210
4.4 %	13,810 to 304,170	18,420 to 405,550	9,210 to 202,780
7.65 %	304,170 and over	405,550 and over	202,780 and over

Assembly Bill 386 also exempts certain retirement account income from being taxed under state law. This exemption would apply to \$100,000 of retirement account income for single filers, and it would apply to \$150,000 of retirement account income for married-joint filers.

Both the decrease in the tax rate and exemption for retirement account income would first apply to taxable years beginning after December 31, 2022.

LEGALITY INVOLVED

The bill raises potential issues relating to the receipt of federal funds through the state fiscal recovery fund (SFRF) created under the American Rescue Plan Act (ARPA). In total, Wisconsin received \$2.53 billion in SFRF funds. ARPA prohibits states from using SFRF funds “to either directly or indirectly offset reduction in [their] net tax revenue” that results from a change in law that “reduces any tax.” [42 U.S.C. s. 802 (c) (2) (A).] This is sometimes referred to as the “tax offset” provision under ARPA.

Treasury Determination

The question posed by the tax offset provision, in relation to Assembly Bill 386, is whether the U.S. Department of the Treasury (the Treasury) would determine there were insufficient funds from other sources to offset the reduction in revenue under the bill. It appears unlikely that the Treasury would make this determination in the current fiscal biennium, as explained below.

In its guidance, the Treasury has stated that a violation of the tax offset provision occurs when there is a reduction in net tax revenue caused by changes in the law and the state cannot identify sufficient funds from sources other than federal relief funds to offset the reduction in net tax revenue. [31 C.F.R. 35.8.] Statements issued by the Treasury in connection with its publication

of the final rule refer to “three sources of funds that may offset a reduction in net revenue” without resulting in a violation, which are: “organic revenue growth, increases in revenue due to policy changes (e.g., an increase in tax rate), and certain cuts in spending.” [See 31 C.F.R. Part 35, Final Rule, Supplementary Information, pg. 316.¹]

The state Department of Administration (DOA) is responsible for reporting reductions in net revenue under ARPA. The department calculates that, as of August 28, 2023, the remaining margin for tax reductions before triggering potential recoupment is around \$113 million for fiscal year 2023-24 and \$319 million for fiscal year 2024-25. However, DOA assumes the general fund surplus cannot be included as available for covered tax reductions. This appears to contradict the Treasury’s suggestion in the supplemental information accompanying the final rule, which is that organic revenue growth may offset revenue reduction, as described above.

If the general fund surplus were taken into account, the remaining margin for tax reductions would be significantly greater. The opening balance of the general fund was estimated at \$6.88 billion, as of July 1, 2023, according to the Legislative Fiscal Bureau (LFB). Because this is more than double the \$2.53 billion SFRF monies received, it would be reasonable to assume the state could identify funding from other sources to offset revenue reduction under Assembly Bill 386 for the current fiscal biennium. The state also maintains a budget stabilization fund, consisting primarily of excess state revenues over budgeted amounts, with a cash balance of \$1.79 billion, as of the end of May, 2023.

For these reasons, notwithstanding DOA’s estimate, it appears unlikely that the Treasury would determine there were insufficient funds from other sources to offset the revenue reduction under Assembly Bill 386 for the current fiscal biennium. With respect to future fiscal years, beyond the current fiscal biennium, it is unclear whether the tax offset provision under ARPA will continue to apply. The period covered by the tax offset provision ends on the last day of the fiscal year in which all SFRF funds have been expended by a state or returned to the Treasury. [31 C.F.R. 35.3.] If the tax offset provision under ARPA applies in future fiscal years, beyond the current fiscal biennium, the Treasury’s likelihood of making an adverse determination may differ, depending on the amount and source of monies in the general fund at that time.

Federal Court Injunctions

In addition to the fact that an adverse determination from the Treasury appears unlikely, the outcomes in several recent court actions have cast doubt over the federal government’s ability to enforce the tax offset provision under ARPA. Various states have filed lawsuits, individually or in combination with other states, against Treasury Secretary Janet Yellen and the Treasury, in relation to the enforcement of the provision.

Most significantly, the tax offset provision was held unenforceable by the U.S. Court of Appeals for the Eleventh Circuit, in *West Virginia v. U.S. Dep’t of the Treasury*, 59 F.4th 1124 (11th Cir. 2023). The Eleventh Circuit upheld a lower court’s order enjoining enforcement against 13 state plaintiffs. In its decision, the court affirmed that Congress is given spending authority in the Constitution and has the power to condition giving money to states on certain action, but that any conditions must be (among other factors) unambiguous. [Id. at 1140–41.] However, in this case, the court said the provision fails to provide a standard against which a state can assess whether it will reduce or has reduced net tax revenue, and it fails to define what a “direct or

¹ Visit <https://home.treasury.gov/system/files/136/SLFRF-Final-Rule.pdf> to review the Treasury’s supplemental information for 31 C.F.R. Part 35, Final Rule.

indirect offset” means. The court also said the novelty and scope of ARPA compounds those issues because the restriction is targeted at a state’s entire budget. [Id. at 1144–47.]

Ultimately, the Eleventh Circuit found in favor of the plaintiffs and upheld an injunction preventing the tax offset provision from being enforced against the 13 states. As a result, the provision is not enforceable against Alabama, Arkansas, Alaska, Florida, Iowa, Kansas, Louisiana, Mississippi, Montana, New Hampshire, Oklahoma, South Carolina, South Dakota, Tennessee, Texas, Utah, and West Virginia.

Additionally, the U.S. Court of Appeals for the Sixth Circuit upheld an injunction blocking enforcement of the tax offset provision against Tennessee, one of the two state plaintiffs in *Kentucky v. Yellen*, 54 F.4th 325 (6th Cir. 2022). In its ruling on the merits, the Sixth Circuit found that the language of the offset provision was “impermissibly vague.” [Id. at 330.] According to recent news reports, the Treasury has chosen not to appeal this decision.

Finally, in a lawsuit brought by Texas, Mississippi, and Louisiana, a federal district court in Texas upheld an injunction against enforcement of the tax offset provision against those states, in *Texas v. Yellen*, 597 F.Supp.3d 1005 (N.D. Tex. 2022). The court said it granted an injunction because the provision was coercive and commandeering. [Id. at 1012-15.] The U.S. Court of Appeals for the Fifth Circuit granted an appeal, and heard oral arguments on April 3, 2023, but the court has not yet released a decision.

Similarly to these states, if the Treasury sought recoupment of any SFRF funds expended by Wisconsin, as a result of the enactment of the bill, the state could contest the validity of the Treasury’s action in court. This could include arguments against enforcement that have been successful in other jurisdictions.

FISCAL EFFECT

The bill is expected to reduce individual income tax collections by \$1,550 million in fiscal year 2023-24 and \$1,403 million in fiscal year 2024-25, according to LFB estimates based on a simulation by the Department of Revenue.

PUBLIC POLICY INVOLVED

The Joint Survey Committee on Tax Exemptions finds that the tax exemptions under 2023 Assembly Bill 386 are **not good** public policy, on a vote of Ayes, 5; Noes, 4.

09/11/23

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