Legislative Fiscal Bureau
One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873
Email: fiscal.bureau@legis.wisconsin.gov • Website: http://legis.wisconsin.gov/lfb

September 26, 2023

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Senate Bill 389: Update State Tax References to the Internal Revenue Code

Senate Bill (SB) 389 would update state tax references to the Internal Revenue Code (IRC) beginning in tax year 2023. SB 389 was introduced on August 11, 2023, and referred to the Senate Committee on Universities and Revenue. Senate Substitute Amendment 1 (SSA 1) to SB 389 was introduced September 12, 2023. That Committee recommended passage of SSA 1 to SB 389, by a vote of 8-0 on September 19, 2023.

BACKGROUND

State individual income tax and corporate income/franchise tax provisions regarding the amount of income subject to taxation are generally referenced to definitions under federal law. State references to federal law 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. References to the IRC 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, net operating loss, tax credits, excise taxes, and subtractions after the computation of federal adjusted gross income (AGI). Therefore, changes to these federal provisions typically have no effect for state tax purposes.

With limited exceptions, changes to federal law take effect for state tax purposes only after action by the Legislature. Each year, DOR typically reviews the federal law changes occurring in the previous year to assist in updating state references to the IRC. Under current law, state tax references generally refer to the code in effect on December 31, 2020. The following federal laws that modified the IRC were enacted during 2021 and 2022: (a) American Rescue Plan Act of 2021 (ARPA); (b) Paycheck Protection Program Extension Act of 2021; (c) Surface Transportation Extension Act of 2021; (d) Further Surface Transportation Extension Act of 2021; (e) Infrastructure Investment and Jobs Act (IIJA); (f) Consolidated Appropriations Act of 2022 (CAA22); (g) Supreme

Court Security Funding Act of 2022; (h) Inflation Reduction Act of 2022 (IRA); and (i) Consolidated Appropriations Act of 2023 (CAA23).

SUMMARY OF SUBSTITUTE AMENDMENT

SSA1 to SB 389 would update references to the IRC under the individual income and corporate income/franchise tax to include most federal tax provisions under the nine federal laws identified above, retroactively and for taxable years beginning after December 31, 2022. This includes technical provisions and law changes which do not affect a taxpayer's liability, as well as the provisions discussed below that would impact tax liability under state law.

However, the substitute amendment would not adopt the ARPA provision related to the exclusion from taxable income of certain forgiven student loans. The substitute amendment, also would not adopt provisions of CAA22 and CAA23 related to the treatment of certain high deductible health plans (HDHPs). [It should be noted that the Legislature is currently deliberating state adoption of these HDHP provisions under SB 364/AB 364.]

The following sections provide a description of the aforementioned tax provisions based on materials currently available, how they relate to Wisconsin tax law, and the estimated fiscal effect of adopting the provisions for state tax purposes. However, provisions that have already been automatically adopted under current law, as well as technical changes to federal law whose acceptance would not impact a person's state tax liability, are not discussed. This memorandum was prepared based on the language in each federal act, and federal fiscal estimates published by the Joint Committee on Taxation (a nonpartisan committee of the U.S. Congress), and information provided by DOR. Subsequent guidance from the U.S. Treasury may alter how the Internal Revenue Service and the state would administer the provisions described below. The fiscal estimates in this memorandum and the description of each provision were prepared in consultation with DOR.

Additionally, retroactive to tax year 2019, the substitute amendment would adopt for state tax purposes Section 1202 of the IRC related to excluding gains realized on the sale of qualified small business stock from taxable income. The substitute amendment would automatically adopt any future changes to Section 1202 of the IRC for state tax purposes.

Qualified Small Business Stock Exclusion

Federal law provides the following percentage exclusions for the gain on qualified small business stock: (a) 50% for stock acquired after August 10, 1993, and on or before February 17, 2009; (b) 75% for stock acquired after February 17, 2009, and on or before September 27, 2010; and (c) 100% for stock acquired after September 27, 2010.

Pursuant to 2013 Act 20 (the 2013-15 biennial budget act), state law allows a 50% exclusion for stock acquired on or after January 1, 2014. State law requires any gain from stock acquired before that date to be included in state taxable income.

The substitute amendment would provide that, retroactive to tax year 2019, the IRC provisions related to qualified small business stock that apply for federal tax purposes also apply for state tax purposes. Any subsequent federal changes to this IRC provision would be automatically adopted for state tax purposes. This provision is estimated to reduce state income and franchise tax revenues by $14.7 million in 2023-24 and $5.5 million in 2024-25.

Federal Provisions that would be Adopted for State Tax Purposes under SSA 1 to SB 389

Earned Income Tax Credit (EITC) - Disqualified Income Limit. The federal EITC is a refundable credit based on income and family size and is calculated based on a percentage of earned income up to certain thresholds. The state EITC is calculated as a percentage of the federal credit that varies based on the claimant's number of qualifying children. The state credit is not available to claimants without qualifying children.

Under federal law, the EITC is denied to individuals having disqualified income in excess of a certain limit. Disqualified income is defined as taxable and nontaxable interest income, dividends, net income from nonbusiness rents and royalties, capital gain net income, and net passive income (if greater than zero) that is not self-employment income. The disqualified income limit was increased under ARPA for federal tax purposes beginning in tax year 2021. The limit is adjusted annually for inflation and is $11,000 for tax year 2023. However, state law has not adopted this ARPA provision, so the disqualified income limit for state tax purposes is $4,050 in tax year 2023. Adopting this provision beginning in tax year 2023 is estimated to increase GPR expenditures by $1.3 million in 2023-24 and $1.4 million in 2024-25.

EITC - Married Filing Separate. Under federal law, married taxpayers must file using the married-joint filing status in order to claim the EITC. However, a provision in ARPA allows an exception to this filing requirement, beginning in tax year 2021, for an individual who: (a) files married-separate; (b) lives with their qualifying child (for purposes of the EITC) for more than half the year; and (c) during the last six months of the relevant tax year, did not live in the same principal dwelling as their spouse (or possesses a divorce or separation instrument relating to their spouse and is not a member of the same household as their spouse at the end of the relevant tax year). State adoption of this provision beginning in tax year 2023 is estimated to increase GPR expenditures by $100,000 in 2023-24 and $200,000 in 2024-25.

Repeal Worldwide Interest Deduction. For taxable years beginning after December 31, 2020, multinational taxpayers were permitted to allocate interest expenses of a domestic group member on a worldwide basis. This altered the computation of the limitation on the foreign tax credit, such that the interest expenses of foreign members of a worldwide affiliated group would have been considered in determining whether interest expenses of domestic members of the group must be allocated to foreign-sourced income. Initially enacted in 2004, federal law had delayed the effective date numerous times. ARPA permanently repealed the election such that it never took effect for federal tax purposes. Wisconsin neither has a state analogue to the foreign tax credit nor follows federal rules regarding taxation of foreign income. Thus, adopting the repeal of this provision for state purposes retroactive to tax year 2021 is estimated to have a minimal revenue impact because most of the income would be otherwise excluded under water's edge rules under state law.

Multiple Declarations of Federally Declared Disasters. Under current federal law, taxpayers affected by a federally-declared disaster, or terroristic or military action, are eligible to receive an extension of certain deadlines, such as the deadline to file a federal income tax return or to pay the associated tax. Prior to the IIJA, this extension period expired 60 days after the latest incident date specified in the initial disaster declaration. The IIJA specifies that, if multiple disaster declarations are issued within a 60-day time period, each declaration is considered a separate period. As a result, the extension period expires 60 days after the latest declaration was issued. The IIJA modifies the definition of a "disaster area" to mean an area in which a major disaster occurs for which the President of the United States provides financial assistance under certain other disaster assistance provisions of federal law. These changes took effect for federal disasters declared after November 15, 2021, and are estimated to decrease state tax revenues by a minimal amount beginning in 2023-24, if adopted for state tax purposes retroactively.

Significant Fires. The IIJA expands the current law provision regarding certain deadline extensions for taxpayers affected by disasters or terroristic or military action (described above) to also include "a significant fire" as a qualifying event for extending such deadlines. The IIJA defines a significant fire as any fire with respect to which fire management assistance is provided under certain other provisions of federal law. This provision first applies to fires for which assistance is provided after November 15, 2021, and is estimated to decrease annual state tax revenues by a minimal amount, if adopted retroactively for state tax purposes, beginning in 2023-24.

Contributions to the Capital of Water and Sewerage Utilities. Federal law provides that, for purposes of income tax, gross income does not include contributions to the capital of the taxpayer. However, a contribution to capital does not include any: (a) contribution in aid of construction or any other contribution as a customer or potential customer; or (b) contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such). Provisions of the IIJA provide a special rule for water and sewerage disposal utilities, effective for taxable years beginning after December 31, 2020, such that any amount of money or other property received from any person (whether or not a shareholder) by a regulated public utility which provides water or sewerage disposal services generally qualifies as a contribution to capital, rather than gross income, if the following two requirements are met: (a) the amount is a contribution in aid of construction (not including amounts paid as service charges for starting or stopping services) or a contribution to the capital of the utility by a governmental entity providing for the protection, preservation, or enhancement of drinking water or sewerage disposal services; and (b) the amount (or any property acquired or constructed with such amount) is not included in the taxpayer’s rate base for rate making purposes. In the case of a contribution in aid of construction which is property other than water or sewerage disposal facilities, certain expenditure rules apply to the amount contributed. Adopting the exclusion from gross income for state tax purposes beginning in tax year 2023 is estimated to reduce income and franchise tax revenues by $1.2 million in 2023-24 and $1.0 million in 2024-25, with the fiscal effect gradually declining to a revenue reduction of $0.3 million in 2031-32.

Exempt Facility Bonds - Carbon Dioxide Capture Facilities and Broadband Projects. Interest earned on obligations that is tax-exempt under federal law generally must be added back to taxable income under state law. The IIJA provided that interest earned on obligations issued for qualified broadband projects after November 15, 2021, and for qualified carbon dioxide capture facilities after

December 31, 2021, is exempt from federal income tax. Adoption of these provisions for state tax purposes beginning in tax year 2023 would decrease estimated individual income tax collections by $0.3 million in 2023-24 and 2024-25 and by $0.4 million in 2025-26.

College Savings Plan Rollovers to Roth Accounts. For distributions taken on or after January 1, 2024, a provision of CAA23 enables 529 account beneficiaries to roll amounts remaining in a 529 account over to a Roth individual retirement account without penalty upon distribution, up to a lifetime maximum of $35,000. To receive this preferential treatment, the 529 account must have been open for at least 15 years, and the Roth account must be maintained for the benefit of the beneficiary. No amounts which were contributed within five years of the distribution date may be rolled over. Annual individual retirement account contribution limits also apply to any amounts rolled over from a 529 account. For tax year 2023, the aggregate limit for contributions to any individual retirement account is $6,500, with an additional $1,000 allowed for taxpayers aged 50 and over. Concurrent state adoption of this provision would reduce estimated individual income tax collections by $0.8 million in 2023-24 and $2.0 million in 2024-25, growing to a revenue reduction of $3.0 million in 2027-28.

Aviation Fuel Credit - Definition of Gross Income. Provisions of the IRA create a sustainable aviation fuel credit ($1.25 per gallon) for certain fuel mixtures sold or used after December 31, 2022, and before January 1, 2025. The credit does not apply for state purposes, but the credit amount affects the computation of federal gross income. Conforming state law to the definition of federal gross income by adopting this provision would have a minimal revenue effect.

Energy Efficient Commercial Buildings. Effective beginning in tax year 2023, provisions of the IRA increased the availability and size of the energy-efficient commercial buildings deduction under Section 179D of the IRC from $1.80 per square foot to up to $5.00 per square foot for certain eligible properties. Further, the IRA also set a special rule allowing real estate investment trusts to reduce earnings and profits in the year the energy-efficient components are placed into service (for retrofit property, the year of final certification). Previously, real estate investment trusts had to reduce earnings and profits ratably over a five-year period. The provisions relating to the deduction for energy efficient commercial buildings are adopted automatically pursuant to current law. However, the state is not federalized to federal definitions for earnings and profits (which determine whether a distribution by a corporation is a dividend and/or taxable income). Adopting the provision allowing real estate investment trusts to reduce earnings in the year the components are placed into service, instead of ratably, is estimated to have a minimal effect on state revenues.

Elective Payment of Applicable Credits. Provisions of the IRA allow certain organizations (such as tax-exempt entities and state, local, and tribal governments), for taxable years beginning after December 31, 2022, to elect to treat certain federal tax credits for energy property/renewable energy as if they were payments of tax. As a result, payments in excess of tax liability can be refunded to these organizations. Taxpayers who are not tax-exempt entities are allowed a one-time transfer of these tax credits to an unrelated taxpayer. Any payments received in exchange for the transfer of credits are excluded from income, and any amounts paid in order to obtain a transferred credit cannot be deducted from income. Wisconsin has not adopted these federal credits, and thus the provisions relating to refunds do not apply for state tax purposes. Further, any payments received in exchange for transferring the credits are not excludable and amounts paid to receive a credit are not deductible under current state law. However, adopting the IRA provisions relating to the treatment of payments made/received for transfer of the credits would enable these tax-exempt organizations to transfer the credits without incurring state tax liability. It is estimated that adopting these provisions would have a minimal effect on state revenues.

Credit for Small Employer Pension Plan Startup Costs. Federal law provides a three-year credit for small employers (having fewer than 100 employees) for up to 50% of certain administrative costs up to an annual maximum of $5,000. Effective for taxable years beginning after December 31, 2019, CAA23 clarifies that the credit applies to employers that join an existing plan. Effective for taxable years beginning after December 31, 2022, the federal credit for small business pension plan startup costs increased to up to 100% of administrative costs for employers having 50 or fewer employees. Further, CAA23 provides additional credit of up to $1,000 per employee equal to the applicable percentage of eligible employer contributions, which phases out for employers having between 51 to 100 employees.

Under federal law, a taxpayer may elect to take the credit, but may not both claim the credit and a deduction for the same expenses. Thus, under current state law, a taxpayer would need to make an adjustment to federal gross income on the Wisconsin income/franchise tax return to allow a deduction for these expenses. According to DOR, if the federal provisions were adopted, the taxpayer could have the option of making a different election for state tax purposes (such that they could claim the credits for federal purposes and take deductions for state purposes). These provisions would have a minimal effect on state tax revenues.

Deferral of Tax for Certain Sales of Employer Stock to Employee Stock Ownership Plan (ESOP) Sponsored by a Tax-Option (S) Corporation. An ESOP enables employees to own a portion or all of their employer. Effective for taxable years beginning after December 31, 2027, CAA23 would allow the owner of employer stock issued by an S corporation to defer 10% of the long term capital gain from the sale of that stock to an ESOP (if it owns at least 30% of the corporation's stock). This provision would reduce state tax revenues beginning in 2027-28 by $0.7 million, with the reduction growing to $5.1 million in 2031-32.

Achieving a Better Life Experience (ABLE) Age Requirement. Under federal law, a qualified ABLE program may be established by any state for the purpose of meeting the qualified disability expenses of a designated beneficiary, generally an individual whose blindness or disability occurred before age 26. In general, federal law permits up to $17,000 of contributions (total from all contributors) in tax year 2023 to be deposited into an ABLE account per designated beneficiary per calendar year. The maximum annual contribution limit is indexed to adjustments made to the annual exclusion amount under the federal gift tax. Wisconsin has adopted the federal tax treatment of ABLE accounts and allows a state deduction for any eligible contribution deposited by an account owner, or any other person, for the year in which a contribution is made into any state's federally qualified ABLE account.

CAA23 increases the age limit for the initial occurrence of the blindness or disability of a qualified ABLE account beneficiary from 26 to 46, beginning in tax year 2026. Concurrent state adoption of this provision is estimated to reduce individual income tax collections by $0.3 million in 2026-27, growing to a revenue reduction of $2.5 million in 2031-32.

Limitation on Deduction for Qualified Conservation Contributions. Under federal law, "qualified conservation contributions" are charitable donations of real property interests designated for purposes of conservation. Provisions of CAA23 specify that, in general, contributions made after December 29, 2022, by a pass-through entity will not be treated as a qualified conservation contribution if the amount exceeds 2.5 times the sum of each owner's relevant basis in the pass-through entity. Certain exceptions are provided for family partnerships, contributions to preserve certified historic structures, and when a three-year holding period has been met. If the deduction is disallowed and tax is due, the taxpayer is subject to underpayment interest. Also, if the deductions are disallowed, they are treated as a tax avoidance transaction. Adoption of this provision (retroactively to contributions made on December 30, 2022) would increase state revenues by $8.2 million in 2023-24 and $6.4 million in 2024-25, with the effect declining to an increase of $3.3 million in 2027-28.

Federal Provisions that would Not be Adopted for State Tax Purposes under SSA 1 to SB 389

Student Loan Forgiveness. With certain exceptions, forgiven student loans are generally considered taxable income under federal law. ARPA stipulates that any forgiven student loan that was expressly provided for postsecondary educational expenses and meets certain other requirements is excluded from taxable income for tax years 2021 through 2025. The fiscal effect of adopting this provision is assumed to be minimal following court decisions (*Biden v. Nebraska* and *Department of Education v. Brown*) which vacated the federal student loan discharge program that would have discharged up to $10,000 (or up to $20,000 for Pell Grant recipients) of student loan debt for borrowers that satisfy certain income limits. In the summer of 2023, the U.S. Supreme Court ruled on both cases, and struck down the federal student loan discharge program as not being authorized under federal law. Subsequently, the Biden Administration announced modifications to income-driven repayment plans that could lead to an expedited loan forgiveness timeline for certain borrowers. To the extent additional student loan forgiveness programs occur as a result of this ARPA provision, the fiscal effect of adopting the exclusion for certain forgiven loans could increase.

HDHPs - Remote Care. Federal law allows taxpayers to create a health savings account (HSA) if they meet certain requirements, such as that the individual: (a) is covered under an HDHP; and (b) cannot be claimed as a dependent on another individual's tax return. Contributions to an HSA by the employee and their employer, and the associated interest earnings, are deductible from gross income, as are account distributions if used to pay for qualified medical expenses. CAA22 provides that, for plan months beginning after March 31, 2022, and before January 1, 2023, a health plan may still be considered an HDHP even if it fails to require a deductible for telehealth and other remote care services. This extends a provision initially enacted under CARES that was adopted for state tax purposes under 2019 Act 185. CAA23 extends the preceding provision of CAA22 to plan years beginning after December 31, 2022, and before January 1, 2025. [Separate bills, SB 364 and AB 364, would adopt these telehealth-related provisions of CAA22 and CAA23 on a stand-alone basis. Those bills are estimated to reduce individual income tax collections relative to current law by $1.7 million in 2023-24, $0.7 million in 2024-25, and a minimal amount in 2025-26.]

FISCAL EFFECT

DOR submitted a fiscal estimate for SSA 1 to SB 389 on September 13, 2023. DOR estimates that the substitute amendment would reduce revenues by $11.4 million in 2023-24 and $4.1 million in 2024-25. However, as shown in the Attachment, the net fiscal effect of the provisions described above has been reestimated by this office. It is estimated that the substitute amendment would decrease income and franchise tax revenues by $8.8 million in 2023-24 and $2.4 million in 2024-25, with the revenue decrease growing each year thereafter to $13.5 million in 2031-32 and 2032-33. State adoption of the federal EITC provisions would increase state tax credit expenditures by $1.4 million GPR in 2023-24 and $1.6 million GPR in 2024-25. In the 2023-25 biennium, these provisions are estimated to decrease the general fund balance by $10.2 million in 2023-24 and $4.0 million in 2024-25.

DOR indicates that it has begun drafting tax forms and programming (along with third-party software developers) for tax year 2023, and that it will print tax forms and instructions on October 15, 2023. Depending on the date of enactment, the proposed tax changes under the substitute amendment could require DOR to incur costs to re-print forms and delay the date for individuals to file their tax returns for the 2023 tax year. DOR also notes that, if the programming of forms and instructions cannot be completed within this time frame, the start of income tax filing season could be delayed, which may in turn delay taxpayers' ability to file their returns and claim any refunds for which they are eligible.

Prepared by: John D. Gentry and Sean Moran
Attachment

ATTACHMENT

SSA 1 to SB 389: Estimated Fiscal Effect for State Adoption of Certain Federal Tax Provisions (Millions)

	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30	2030-31	2031-32	2032-33	
EITC - Disqualified Income Limit	$1.3	$1.4	$1.4	$1.4	$1.4	$1.4	$1.4	$1.4	$1.4	$1.4	GPR
EITC - Married Filing Separate	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	GPR
Total GPR	$1.4	$1.6	$1.6	$1.6	$1.6	$1.6	$1.6	$1.6	$1.6	$1.6	
Qualified Small Business Exclusion	-$14.7	-$5.5	-$5.5	-$5.5	-$5.5	-$5.5	-$5.5	-$5.5	-$5.5	-$5.5	GPR-Tax
Contributions to the Capital of Water and Sewerage Utilities	-1.2	-1.0	-0.9	-0.8	-0.6	-0.5	-0.5	-0.4	-0.3	-0.3	GPR-Tax
Exempt Facility Bonds	-0.3	-0.3	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	GPR-Tax
College Savings Plan Rollovers to Roth Accounts	-0.8	-2.0	-2.4	-2.8	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0	GPR-Tax
Deferral of Tax for Certain Sales of ESOP Sponsored by S Corporation	N/A	N/A	N/A	N/A	-0.7	-1.7	-2.7	-3.7	-5.1	-5.1	GPR-Tax
ABLE Age Requirement	N/A	N/A	N/A	-0.3	-0.7	-1.0	-1.4	-1.9	-2.5	-2.5	GPR-Tax
Limitation on Deduction for Qualified Conservation Contributions	8.2	6.4	5.5	3.8	3.3	3.3	3.3	3.3	3.3	3.3	GPR-Tax
Total GPR-Tax	-$8.8	-$2.4	-$3.7	-$6.0	-$7.6	-$8.8	-$10.2	-$11.6	-$13.5	-$13.5	
Net Effect to General Fund	-$10.2	-$4.0	-$5.3	-$7.6	-$9.2	-$10.4	-$11.8	-$13.2	-$15.1	-$15.1	

Note: State adoption of federal tax provisions that are estimated to have a minimal fiscal effect are not shown.