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

2017 Joint Committee on Finance Paper #290

Earned Income Tax Credit -- Disqualified Losses
(General Fund Taxes -- Income and Franchise Taxes)

[LFB 2017-19 Budget Summary: Page 176, #2]

CURRENT LAW

The earned income tax credit (EITC) is offered at both the federal and state levels as a means of providing assistance to lower-income workers. The state EITC is calculated as a percentage of the federal credit. The state, therefore, uses federal definitions and eligibility requirements for purposes of the EITC, except that the state does not provide a credit to individuals without children. Both the federal and state credits are refundable -- if the credit exceeds the amount of tax due, a check is issued for the difference.

The credit is calculated based on family size, filing status, and the amount of earned income (although the credit can also be affected by adjusted gross income -- AGI). Individuals without earned income are not eligible for the credit. The income limits and maximum federal credit amounts are adjusted annually for changes in inflation.

GOVERNOR

Prohibit any individual from claiming the credit if the individual reports a "disqualified loss" greater than $15,000 in the calculation of his or her Wisconsin adjusted gross income, but exclude any individual from the prohibition if the claimant is a farmer, the claimant's primary income is from farming, and the claimant's farming generates less than $250,000 in gross receipts from the operation of farm premises. Define disqualified loss as the sum of the following amounts, exclusive of net gains from the sale or exchange of capital or business assets and exclusive of net profits: (a) net loss from sole proprietorships; (b) net capital loss; (c) net loss from sales of business property, excluding loss from involuntary conversions; and (d) net loss from rental real estate, royalties, partnerships, tax-option corporations, trusts, estates, and real estate mortgage investment conduits. Under the bill, this provision would take effect beginning with tax year 2018.

DISCUSSION POINTS

1. As noted above, the state EITC is calculated as a percentage of the federal EITC. Depending on a claimant's income level, the federal credit is based either on the claimant's earned income or federal AGI. The formula used to calculate the credit employs several income thresholds. The first threshold is known as the maximum credit income. If a claimant's earned income is below this threshold, the credit equals the claimant's earned income multiplied by a credit rate. If a claimant's earned income falls between this threshold and the second income threshold, the claimant receives the maximum allowable credit. After the second income threshold, known as phase-out income, the credit is gradually reduced until it is eliminated for individuals with income over the third income threshold, or maximum income level. After earned income exceeds the second threshold, the credit is calculated using the greater of earned income or AGI.

2. Under the proposal, claimants with losses totaling more than $15,000 would not be eligible for the state credit. The Department of Administration's (DOA) Executive Budget book indicates that the proposal is intended to ensure that the credit is limited to "intended recipients." Currently, some claimants would not be able to claim the credit without losses that reduce their federal AGI to a level below the third income threshold. In 2015, almost 70% of the filers claiming the state credit had AGI or earned income in the phase-out range. Credits were based on earned income for the other 30% of the state credit claimants, and losses claimed by these individuals had no bearing on the amount of state or federal EITC they received.

3. For most claimants, earned income consists of wages, salaries, and tips reported on their tax forms as the first step in calculating federal AGI. For purposes of claiming the EITC, earned income also includes income earned from operating a business as a sole proprietor or as the owner of a partnership or S corporation. Business-related losses comprise most of the losses targeted under this proposal and include losses reported on federal Schedule C by sole proprietorships and Schedule E by partnerships, tax-option corporations, estates, trusts, and real estate mortgage investment conduits, as well as losses from rental real estate and royalties. The Department of Revenue (DOR) has identified 1,590 credit recipients, with losses totaling almost $58 million, who would be disqualified from claiming the credit under the Governor's proposal. Table 1 reports the number of claimants and the amount of losses by type of loss.

TABLE 1

Number of Claimants and Loss Amounts By Type of Loss
Under Proposal to Disqualify State EITC Claimants

Loss Source	Claimants	Percent	Loss Amount	Percent	Avg. Loss
Sole Proprietorships	930	58.5%	$22,902,590	39.5%	$24,626
Schedule E	690	43.4	19,400,940	33.5	28,117
Farm	140	8.8	10,665,060	18.4	76,179
Capital Loss	90	5.7	41,390	0.1	460
Other Loss	180	11.3	4,937,860	8.5	27,433
Total	1,590	100.0%*	$57,947,840	100.0%	$36,445

*Amounts sum to more than 1,590 because some claimants had losses from multiple sources.
Source: Department of Revenue.

4. Except for capital losses, the average loss for each category exceeded the disqualification limit proposed by the Governor, and the largest average loss was farming related. The Governor's disqualified loss proposal does not apply to EITC claimants who are farmers whose primary income is from farming and whose farming generates less than $250,000 in gross receipts in the year to which the claim relates. The U.S. Department of Agriculture defines farms generating less than $250,000 in gross receipts as "small farms." According to the administration, excluding such claimants from the disqualified loss provision was intended to maintain the relief provided by the EITC for small farm claimants who are more likely to need financial assistance.

5. DOR estimates that approximately 1,590 EITC claimants would lose their credit under the Governor's proposal, resulting in an annual expenditure reduction estimated at $820,000. Among those claimants, the average credit equals $516. Table 2 reports the estimated distribution of claimants and amounts affected by the proposal by income category. Over half of the claimants have a Wisconsin AGI of $20,000 or less, and these claimants' credits comprise over 60% of the credits affected by the proposal.

TABLE 2

Distribution of Claimants and Amounts Affected by Disqualified Loss Proposal

Wisconsin AGI	Claimants	Percent	Credit Reduction	Percent	Average
Under $5,000	442	27.8%	-$263,720	32.2%	-$597
$5,000 to 10,000	108	6.8	-57,610	7.0	-533
10,000 to 15,000	137	8.6	-69,690	8.5	-509
15,000 to 20,000	177	11.1	-104,850	12.8	-592
20,000 to 25,000	186	11.7	-113,630	13.9	-611
25,000 to 30,000	167	10.5	-84,100	10.3	-504
30,000 to 35,000	137	8.6	-55,900	6.8	-408
35,000 to 40,000	98	6.2	-33,580	4.1	-343
40,000 to 45,000	79	5.0	-18,610	2.3	-236
45,000 to 50,000	39	2.5	-9,970	1.2	-256
50,000 and Over	20	1.3	-8,040	1.0	-402
Total	1,590	100.0%	-$819,700	100.0%	-$516

Source: Department of Revenue

6. The Governor proposed a related provision in the budget bill that would have required individuals claiming the homestead tax credit to include disqualified losses in excess of $15,000 in their household income for purposes of calculating the tax credit. This provision would have reduced the cost of the homestead credit by an estimated $470,000 per year and affected the credits of an estimated 860 claimants. An estimated 360 claimants would have had their credit reduced and an estimated 500 claimants would have been disqualified from receiving the credit. On May 18, 2017, the Committee voted to modify the Governor's proposal by deleting the $15,000 threshold and requiring homestead credit claimants to include all disqualified losses in their household income for purposes of calculating the credit.

7. The homestead credit differs from the state EITC. The homestead credit utilizes a formula authorized in state law that is based on each claimant's property tax as a percentage of the claimant's household income. As such, legislators have considerable discretion in modifying the formula as well as the factors used in that formula.

8. Based on the Committee's homestead action, the Committee could modify the definition of AGI to include disqualified losses for purposes of calculating the EITC. However, formula modifications like the one adopted for the homestead credit would add considerable complexity to calculating the state EITC. The state EITC is federalized, and state law authorizes claimants to calculate their state credit as a percent of their federal credit. This limits state EITC modifications to relatively simple changes such as authorizing a different credit rate. The proposed modification concerning disqualified losses is slightly more complex, but is administrable. Claimants with such losses would be required to total them, if losses are reported under more than

one of the designated categories, and determine if the total is greater than $15,000. If so, the individual would not be allowed to claim the credit.

9. Although administrable, one shortcoming of the disqualified loss proposal is that it creates a "cliff effect." That is, individuals with losses totaling $15,000 would be allowed to claim the credit, while individuals with losses totaling $15,001 would be ineligible for the credit, even though the amount of loss differs by only $1. Compared to the estimated 1,590 claimants becoming ineligible for the credit under the Governor's proposal, the estimated number of claimants becoming ineligible would increase to 1,730 under a $14,000 loss threshold and decrease to 1,470 under a $16,000 loss threshold. While the proposed $15,000 loss threshold would reduce the credit's cost by an estimated $820,000 annually, the estimated reduction would increase to $890,000 under a $14,000 threshold and decrease to $760,000 under a $16,000 threshold. These different loss thresholds are intended to illustrate the cliff effect, rather than be offered as alternatives to the Governor's proposal.

10. The Chapter 20 appropriation schedule in the budget bill includes a GPR expenditure reduction of $820,000 in both 2017-18 and 2018-19, but the bill specifies that the disqualified loss provision related to eligibility for the state EITC would first apply to tax year 2018. A DOA errata submission indicates that the provision was intended to take effect in tax year 2017 and requests the Committee to make that change so that the provision would be in effect both for tax year 2017 and 2018.

ALTERNATIVES

1. Approve the Governor's proposal to prohibit any individual from claiming the state EITC if the individual reports a disqualified loss greater than $15,000 in the calculation of his or her Wisconsin AGI. Modify the proposal to specify that this treatment would first apply in tax year 2017, rather than 2018. Reduce credit expenditures by an estimated $820,000 in 2017-18 and 2018-19, relative to base level funding.

ALT 1	**Change to**	
	Base	**Bill**
GPR	-$1,640,000	$0

2. Delete the Governor's proposal.

ALT 2	**Change to**	
	Base	**Bill**
GPR	$0	$1,640,000

Prepared by: Rick Olin