



## Legislative Fiscal Bureau

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Joint Committee on Finance

Paper #318

### **Active Duty Military Pay Deduction (General Fund Taxes -- Income and Franchise Taxes)**

[LFB 2021-23 Budget Summary: Page 214, #15]

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#### **CURRENT LAW**

The starting point for determining Wisconsin adjusted gross income (AGI) is federal AGI, which itself is derived from gross income. Gross income includes income from most sources (such as wages/salaries, business, rental, and interest/dividend income, etc.) unless a specific exclusion is provided. Several modifications are made to gross income to arrive at federal AGI, such as additions for alimony received, and subtractions for interest paid on student loans. Numerous state-specific adjustments are then made to federal AGI to arrive at Wisconsin AGI, such as excluding all military retirement benefits received, and adding back interest earned on state/municipal bonds.

Taxable income, the amount of income actually subject to taxation, is determined by subtracting the state's sliding scale standard deduction and personal exemptions from Wisconsin AGI. The state's tax rate and bracket schedule is then applied to taxable income to determine gross tax liability. Taxpayers may apply any nonrefundable credits for which they are eligible to gross tax liability to determine net tax liability. To figure total tax liability (the amount of tax an individual actually pays), any applicable refundable credits may be applied against net tax liability.

Under the state individual income tax, an exclusion is provided for any amount of basic, special, and incentive pay income or compensation (as defined under federal law) received from the federal government by a member of a reserve component of the U.S. Armed Forces or of the National Guard, if that member is called into active duty under certain other provisions of federal law or into special state service, as authorized under federal law. The exclusion applies to amounts paid to the reserve member during the period of time in which the member is on active duty. The deduction does not apply to pay received by reservists during regular weekend and two-week annual training sessions. The exclusion was created under 2003 Act 183, and first took effect for

tax year 2004. In tax year 2019, a total of 1,410 taxpayers claimed nearly \$25.8 million of such exclusions, for an estimated aggregate individual income tax savings of \$1.1 million. A person who claims the exclusion may not claim the armed forces member credit (described below).

Wisconsin also provides an exclusion for income received by an individual who is on active duty in the U.S. armed forces, as defined under federal law, and who dies while on active duty if the individual's death occurred while he or she was serving in a combat zone or as a result of wounds, disease, or injury incurred while serving in a combat zone. The exclusion extends to income received by the individual in the year of death and in the year immediately preceding the year of death if the individual has not filed an income tax return for the year before the year of death. In tax year 2019, there were no claims for this exclusion.

Moreover, Wisconsin offers an income tax exclusion for all federal uniformed services retirement benefits. This exclusion extends to benefits received by survivors, such as surviving spouses and children. In tax year 2019, 18,450 taxpayers claimed exclusions totaling \$427.3 million, for an estimated aggregate individual income tax savings of \$22.5 million.

Also under current law, a nonrefundable state credit of up to \$300 of basic, special, and incentive pay income received from the federal government (as set forth under federal law) is available to members of the U.S. armed forces for services performed while stationed outside the United States. The maximum credit is \$600 for a married couple filing jointly if both spouses meet the definition of an eligible claimant. The armed forces member credit cannot be claimed if the claimant also claims the reserve member exclusion (described above) in the same tax year. In tax year 2019, 3,210 taxpayers claimed approximately \$960,000 of armed forces member credits. Thus, the maximum credit of \$300 was claimed by nearly all claimants.

In addition, Wisconsin provides a refundable credit for 100% of the real and personal property taxes paid on a principal dwelling by an eligible veteran, their spouse, or the unremarried surviving spouse of an eligible veteran. In tax year 2019, 11,404 taxpayers claimed \$35.8 million of veterans property tax credits. This credit is described in greater detail in LFB Paper #330.

Under federal and state law, prior to state-specific adjustments to federal AGI described above, payments received as a member of a military service are generally taxable as wages. Military pay taxable as wages includes active duty pay, reserve training pay, reenlistment bonuses, and armed services academy pay.

However, federal law provides an exclusion from gross income for certain pay related to a combat zone (combat zone exclusion). A combat zone is any area that the President of the United States designates as such by executive order. In addition, certain qualified hazardous duty areas are treated as if they were combat zones. Enlisted members of the Armed Forces and warrant officers may exclude from gross income all pay received for any month during which they served in a combat zone or were hospitalized as a result of serving in a combat zone. For commissioned officers other than commissioned warrant officers, certain limits to the exclusion apply. In addition, the value of GI Bill educational benefits, other in-kind benefits (such as housing), and military allowances are generally not taxable. These federal exclusions apply for state tax purposes. In tax year 2019, these exclusions reduced state individual income tax collections by an estimated \$150 million.

## **BACKGROUND**

Multiple bills with bipartisan sponsorship have been introduced in the 2021-23 legislative session that target additional exclusions for various types of military income. 2021 Assembly Bill 16/Senate Bill 12 (AB 16/SB 12) would expand the aforementioned current law exclusion for reserve members by providing the exclusion to individuals who are called into active federal service under the provisions of 10 USC 12304b, relating to preplanned missions in support of the combatant commands. The expansion of the exclusion would apply retroactively to income and compensation received on October 1, 2019.

An exclusion from the individual income tax would be created under 2021 AB 39/SB 43, beginning in tax year 2021, for any amount of basic, special, or incentive pay income received from the federal government by an individual who is on active duty in the U.S. armed forces, to the extent such income is not already exempt under the aforementioned current law exclusion for reserve members. AB 39/SB 43 would also sunset the armed forces member credit, beginning in tax year 2021.

## **DISCUSSION POINTS**

1. Every two years, this office prepares an informational paper outlining the individual income tax provisions in each state (including the District of Columbia) with such a tax. Based on that review, 13 states followed federal practice in tax year 2019 by providing the combat zone exclusion described above, but otherwise taxing active duty military pay. Another 16 states, including Wisconsin, conformed to the federal combat zone exclusion while providing additional tax exemptions or credits for active duty military and/or reservists' pay. An additional 13 states (Arizona, Arkansas, Illinois, Iowa, Kentucky, Michigan, Minnesota, Missouri, Montana, New Hampshire, New Mexico, Oklahoma, and Tennessee) excluded military pay from taxation, while Pennsylvania provided an exclusion for persons stationed out-of-state. Military pay, including combat pay, was included in taxable income in New Jersey.

2. The Committee could consider modifying the current law exclusion described above for amounts received by certain reserve members of the U.S. Armed Forces to specify that, beginning in tax year 2021, the exclusion also applies to amounts received by individuals who are called into active federal service under 10 USC 12304b of federal law, relating to preplanned missions in support of the combatant commands. A similar provision is included in AB 16/SB 12.

The Committee could also create an exclusion under the state individual income tax for any amount of pay (as defined under current law provisions governing the National Guard and State Defense Force) received from the state of Wisconsin by a member of the Wisconsin National Guard after being called into state active duty (as defined under these same National Guard and State Defense Force provisions of current law). The new exclusion would apply to amounts paid to the individual for the period of time during which they serve on state active duty, to the extent such amounts are not otherwise excluded under current law (Alternative 1). An individual could not claim this exclusion and the armed forces member credit in the same tax year. In addition, an individual claiming the exclusion for state active duty pay would be required to add back the excluded income to household

income for purposes of the homestead credit (as is required for several other exclusions under current law). Such a proposal was included as part of AB 68/SB 111, and would reduce individual income tax collections by an estimated \$380,000 in 2021-22 and \$150,000 in 2022-23 and annually thereafter. This estimate is lower than the fiscal effect estimated under AB 68/SB 111 (\$430,000 annually).

3. At the time of its introduction, it was estimated that AB 16/SB 12 would extend eligibility for the current law reserve member exclusion to 180 additional claimants. But, as noted, Alternative 1 would not allow these individuals to claim this exclusion and the armed forces member credit in the same tax year. The average tax benefit for these 180 additional claimants under the exclusion is estimated to be higher than the maximum armed forces member credit of \$300 that they would otherwise receive. Therefore, the fiscal effect for Alternative 1 includes an estimated annual reduction in armed forces member credit claims of \$50,000.

4. Moreover, based on data from the Department of Military Affairs, it is evident that state active duty payments in 2020 and 2021 have been considerably higher than the historical average. In a typical year, it is estimated that providing an income tax exclusion for these payments would have a minimal impact on state tax revenues, which is the reason the fiscal effect declines by \$230,000 in 2022-23 relative to 2021-22. It should be noted, however, that the portion of the fiscal effect related to state active duty could vary in subsequent years, depending on the severity and frequency of incidents that require state active duty mobilization.

5. It could be argued that Alternative 1 is a logical extension of the current law exclusion for reserve members. If a policy goal is to provide income tax relief to Armed Forces members who are called to active duty, it could be reasoned that such relief should apply regardless of the specific federal law provisions under which these members are mobilized. Furthermore, one could argue that the exclusion should not provide disparate tax treatment based on whether the pay was received from the state or federal government. By expanding the exclusion to include active duty pay received by the state, Alternative 1 would arguably provide more uniform tax treatment among reserve members who perform active duty service. Moreover, a state active duty pay exclusion could be justified as a way to provide a tax benefit to Wisconsin National Guard members who have been recently mobilized for extraordinary COVID-related deployments.

6. On the other hand, the Committee may believe that all income earned while on active duty should be exempt from state income taxation. They may reason that the service these individuals perform for their country merits additional take-home compensation. In this case, the Committee could decide to create an individual income tax exclusion, beginning in tax year 2021, for all basic, special, and incentive pay income received from the federal government by a member of the U.S. Armed Forces while that member is serving on active duty, to the extent such income is not already exempt under current law (Alternative 2). Such a provision could replace and sunset the current law armed forces member credit described above (which provides a similar, but more limited benefit), beginning in tax year 2021.

7. Alternative 2 is identical to AB 39/SB 43 (described above) and is estimated to reduce individual income tax revenues by \$20 million annually. It is estimated that 18,000 claimants would be eligible for the exclusion under Alternative 2. This represents an estimated 0.6% of all individual income tax filers in Wisconsin. Their average tax benefit would be \$1,111.

8. Critics might counter that the tax relief provided under Alternative 2 exceeds what is reasonable and necessary. They might point to the various tax preferences provided to military members under current law (noted above), and argue that these are sufficient to acknowledge the services these individuals provide. Individuals that join the military and National Guard do so voluntarily, and are compensated for their service. Other individuals who choose to work in other dangerous professions with a high injury and/or mortality rate, such as police officers, firefighters, ironworkers, logging workers, and roofers, typically do not receive comparable preferential tax treatment for their compensation.

9. These opponents may also argue that, from a tax policy perspective, income tax exclusions are flawed in general because they treat taxpayers differently depending on the taxpayer's income and tax bracket. For example, \$5,000 of active duty pay under Alternative 2 would provide a tax reduction of \$177 to a taxpayer whose taxable income falls entirely within the state's 3.54% tax bracket, but would provide a \$383 tax reduction to a taxpayer whose last \$5,000 of taxable income is subject to the state's 7.65% marginal tax rate.

10. As noted above, multiple bills have been introduced that are substantially similar to Alternatives 1 and 2. The Committee may wish to deliberate on these proposals independent of the state budget process, and so may decide to take no action on Alternatives 1 or 2 (Alternative 4).

11. On the other hand, the Committee could choose to adopt Alternatives 1 and 2 together. Alternative 1 would generally exclude from taxable income active duty pay received from the state, and would generally exclude active duty pay received from the federal government by reserve members of the Armed Forces. Alternative 2 would exclude all active duty pay received from the federal government, regardless of whether the recipient is normally a reserve or active duty member. As a result, if both alternatives were adopted concurrently, the component of Alternative 1 related to active duty pay received from the federal government would not lead to an additional revenue reduction. Moreover, as mentioned previously, the state active duty component of Alternative 1 is estimated to reduce individual income tax collections in 2021-22, but is expected to have only a minimal revenue impact thereafter. Therefore, if both alternatives were adopted together, state individual income tax collections would decline by an estimated \$20.2 million in 2021-22, and \$20.0 million annually thereafter (Alternative 3).

## **ALTERNATIVES**

1. Beginning in tax year 2021, modify the current law exclusion for amounts received from the federal government by certain reserve members of the U.S. Armed Forces by specifying that the exclusion also applies to amounts received by individuals who are called into active federal service under 10 USC 12304b of federal law, relating to preplanned missions in support of the combatant commands. In addition, create an exclusion under the state individual income tax for any amount of pay (as defined under current law provisions governing the National Guard and State Defense Force) received from the state of Wisconsin by a member of the Wisconsin National Guard after being called into state active duty, for the period of time during which the individual serves on active duty, to the extent such amounts are not already excluded under current law. Prohibit an individual from claiming this exclusion and the armed forces member credit in the same tax year. In addition, specify that an

individual claiming the exclusion for state active duty pay must add back the excluded income to household income for purposes of the homestead credit. Estimate reduced individual income tax collections relative to current law of \$380,000 in 2021-22 and \$150,000 in 2022-23 and annually thereafter.

<b>ALT 1</b>	<b>Change to Base</b>
GPR-Tax	-\$530,000

2. Beginning in tax year 2021, create an individual income tax exclusion for all basic, special, and incentive pay income received from the federal government by a member of the U.S. Armed Forces while that member is serving on active duty, to the extent such income is not already exempt under current law. Sunset the current law armed forces member credit beginning in tax year 2021. Estimate reduced individual income tax collections relative to current law of \$20,000,000 annually, beginning in 2021-22.

<b>ALT 2</b>	<b>Change to Base</b>
GPR-Tax	-\$40,000,000

3. Adopt Alternative 1 and 2 together. Estimate reduced individual income tax collections relative to current law of \$20,200,000 in 2021-22 and \$20,000,000 in 2022-23 and annually thereafter.

<b>ALT 3</b>	<b>Change to Base</b>
GPR-Tax	-\$40,200,000

4. Take no action.

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