General Fund Taxes

Income and Franchise Taxes

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June, 2021 | Joint Committee on Finance | Paper #305

Treatment of Net Tax Reductions under ARPA -- Overview
(General Fund Taxes -- Income and Franchise Taxes)

BACKGROUND

Under the American Rescue Plan Act of 2021 (ARPA), the state is estimated to receive $2.5 billion under the State Fiscal Recovery Fund (SFRF). States and territories are prohibited from using these funds to, either directly or indirectly, offset a reduction in net tax revenue resulting from a change in law, regulation, or administrative interpretation occurring after March 3, 2021. The Act requires the state or territory to repay to the Secretary of the U.S. Treasury an amount equal to the amount of funds used to directly or indirectly offset a reduction in net tax revenue.

On May 10, 2021, the U.S. Treasury issued an interim final rule to implement the SFRF and the Coronavirus Local Fiscal Recovery Fund (LFRF) established under ARPA. This paper describes information regarding the interim final rule as it applies to a reduction in net tax revenue resulting from a change in state law, regulation, or administrative interpretation that may impact monies provided under the SFRF. The LFRF does not have a similar offset provision affecting a municipality's decision to enact a net tax reduction.

Under the guidance provided by Treasury, a covered tax change that occurs during the covered period (after March 3, 2021, and before December 31, 2024) that results in a net tax reduction can be offset by another change during the covered period that results in a net tax increase. As a result, only the net effect of all covered tax law changes that occur during the covered period will be considered (not a single tax law change in isolation).

A modified baseline for state tax revenues must be established between the Department of Administration (DOA) and Treasury. To determine the modified baseline, actual state tax revenues for 2018-19 are increased by an inflation factor (determined by Treasury) throughout the covered period, reduced by the effect of any tax law changes enacted prior to the covered period that would reduce state tax revenues relative to 2018-19. If actual state tax revenues are equal to, exceed, or

are within a de minimus threshold of the modified baseline for any year during the covered period, the recoupment provision for SFRF monies would have no effect. [The de minimus threshold is equal to 1% of the modified baseline.] As a result, the state can enact state tax reductions using state tax revenues that are above the modified baseline. However, if actual state tax collections are below the de minimus threshold, the interim final rule states that Treasury would consider the net tax reduction resulting from all covered tax changes that occurred during the covered period, and would recoup any federal SFRF monies that it determines are used to directly or indirectly offset a net tax reduction.

Based on guidance provided in the interim final rule, in order to reduce the burden on states, the intent of the rule's approach is to incorporate the types of information and modeling already used by states and territories in their own fiscal and budgeting processes. Treasury states that this approach ensures that recipient governments have the information they need to understand the implications of their decisions regarding the use of the SFRF and, in particular, whether states are using the funds to directly or indirectly offset a reduction in net tax revenue, making them potentially subject to recoupment. DOA will be responsible for reporting to Treasury the net revenue reduction of covered tax changes and reporting the eligible uses for the SFRF monies allocated to Wisconsin.

This paper provides information regarding: (a) current estimates for inflation; (b) current estimates for state tax and fee revenues; (c) what sources of revenue Treasury intends to include in its baseline for state tax revenues; (d) the estimated fiscal effects of previously enacted state tax reductions; (e) the estimated modified baseline for state tax revenues; and (f) certain other sources that may be available for the Committee to enact state tax reductions.

DISCUSSION POINTS

1. The interim final rule measures actual changes in state tax revenue relative to a modified baseline, which must be established between the administration and Treasury. The modified baseline is first calculated as state fiscal year 2018-19 actual state tax revenue collections, adjusted for inflation. The inflation adjustment is calculated using the Bureau of Economic Analysis (BEA) implicit price deflator for each year of the covered period.

2. Treasury indicates that it will define state tax revenue for 2018-19 to be based on, but not identical to, the U.S. Census Bureau's definition of state taxes that states report to Census under the Annual Survey of State Government Finances. DOA indicates the preliminary state taxes that will be reported to the U.S. Census Bureau are $19,852.2 million for 2018-19, comprised of: (a) state general fund tax collections (approximately 87% of the total amount reported); (b) motor vehicle fuel taxes (5%); (c) motor vehicle registration and title fees (less debt service) and operator's license fees (3%); and (d) all other state taxes and fees (4%). All other state taxes and fees include various fees collected by state agencies, such as hunting and fishing licensing fees, securities filing fees, business registration fees charged by the Department of Revenue (DOR), and hospital assessments on gross revenues charged by the Department of Health Services. Other state taxes and fees are reduced by the value of addbacks under state accounting procedures for refundable income and franchise tax credits, which are removed under the Census definition of taxes.

3. The interim final rule for the SFRF states that, for purposes of determining the modified baseline, state tax revenue does not include revenue taxed and collected by a different unit of government. State tax law changes that result in a net tax reduction for local property taxes (including changes to property tax credits), local sales taxes, and other local taxes and fees are not included in determining the modified baseline for the SFRF. As a result, decreasing a local tax is not anticipated to trigger the offset provision established by Treasury for the SFRF. However, it is possible that changes to state law impacting revenues provided to counties and municipalities may impact how those governments can spend those federal monies available through the LFRF.

4. The modified baseline is adjusted lower by net tax reductions that occurred prior to the covered period (March 3, 2021). A covered tax change would include a change in law, regulation, or administrative interpretation, including any final legislative or regulatory action, a new or changed administrative interpretation, and a phase-in or taking effect of any statute or rule where the phase-in or taking effect was not prescribed prior to March 3, 2021. Changed administrative interpretations occurring after March 3 would not include corrections to replace prior inaccurate interpretations, and such corrections would instead be treated as changes implementing legislation enacted, or regulations issued, prior to the covered period.

5. The state has enacted a number of state tax law changes prior to March 3, 2021. For example, beginning in tax year 2020, the lowest two individual income tax rates were reduced from 4.00% to 3.54% and from 5.21% to 4.65%, respectively, pursuant to 2019 Act 10. The revenue reduction associated with this law change would reduce the modified baseline, as it was enacted prior to March 3, 2021. However, as of March 3, the Secretary of DOR had not updated the state withholding tables to reflect the new rates and brackets in effect for tax year 2020. Although updating the state's withholding tables at some point in the future would result in a one-time reduction in state tax revenues (because tax years do not align with state fiscal years), it is anticipated that updating state withholding tables to accurately reflect the new rates and brackets would not be considered a covered tax change subject to the recoupment provision. Additional guidance from Treasury would be helpful to confirm this interpretation of its interim final rule.

6. Table 1 shows: (a) the estimated baseline for taxes adjusted for estimated changes to BEA's implicit price deflator index; (b) the estimated fiscal effects of state tax law changes enacted prior to the covered period that have reduced state tax revenues relative to 2018-19; and (c) the resulting modified baseline against which actual tax collections in the 2021-23 biennium would be measured. Additional detail regarding the estimates used in calculating the modified baseline, including estimated changes in the BEA implicit price deflator and net tax reductions used to arrive at the modified baseline, are provided in the attachment. The estimated fiscal effects of previously enacted tax law changes have been adjusted to reflect changes in the BEA implicit price deflator, consistent with how actual state tax revenues for 2018-19 are adjusted.

TABLE 1

Estimated Baseline of Tax Revenues (Millions)

	2018-19	2019-20	2020-21	2021-22	2022-23
Taxes - Inflation-Adjusted Baseline	$19,852.2	$20,137.2	$20,781.6	$21,197.2	$21,642.4
Prior Tax Law Changes	N/A	-325.2	-1,035.8	-868.1	-751.8
Taxes - Modified Baseline	$19,852.2	$19,811.9	$19,745.8	$20,329.1	$20,890.6

7. The interim rule also establishes a de minimus rule prior to evaluating whether actual tax collections below the modified baseline may trigger a review by Treasury. If actual tax collections are within 1% of the modified baseline for that state fiscal year, the recoupment provision would not apply. Table 3 shows current estimates for the 2021-23 biennium for general fund taxes, motor vehicle fuel taxes, and registration/title fees (less debt service) and motor vehicle operators license fees. Other state taxes and fees are estimated to remain flat over the covered period. Table 2 shows the difference between current tax projections and the modified baseline. It is estimated that organic growth in state tax revenues above the modified baseline would allow the Legislature to enact net tax reductions of up to $4,241.7 million during the 2021-23 biennium ($1,948.5 + $2,293.2 = $4,241.7 million). The de minimus amount shown in Table 2 is the amount by which actual collections would have to be below the modified baseline prior to Treasury reviewing the total amount of net tax reductions enacted by Wisconsin that may trigger the federal recoupment provision.

TABLE 2

Estimated State Taxes to be Reported to U.S. Census Bureau in 2021-23 Biennium, Current Law (Millions)

	2021-22	2022-23
General Fund Taxes	$19,610.6	$20,482.8
Motor Vehicle Fuel Taxes	1,021.3	1,031.9
Registration/Title Fees and Operators License Fees	759.9	783.3
Other Taxes and Fees	885.8	885.8
Total	$22,277.6	$23,183.8
Modified Baseline:	$20,329.1	$20,890.6
Difference:	$1,948.5	$2,293.2
Estimated 1% De Minimus Amount	$203.3	$208.9

8. Guidance from Treasury indicates that certain tax law changes are not considered covered tax changes subject to the ARPA recoupment provision. If Wisconsin were to adopt a "recent" federal tax law change for purposes of state income or franchise taxes that would result in a

net revenue reduction, such as ARPA's expansion of the earned income tax credit for 2021, that change would not be considered a covered tax change. Effectively, state adoption of recently enacted federal tax law changes, including future federal tax law changes enacted during the covered period, would further reduce the modified baseline against which actual tax collections would be measured below the amounts shown in Tables 1 and 2. The interim final rule does not define a "recent" federal tax law change. Additional guidance from Treasury would be needed to determine whether state adoption of a federal law change enacted several years ago, such as adopting a provision of the Tax Cuts and Jobs Act of 2017 during the covered period that may result in a state tax reduction, would be considered a covered tax change.

9. Similarly, additional guidance is needed to confirm how Treasury will treat net tax reductions related to refundable credits that may be enacted or expanded by the state. The interim final rule does not specifically address refundable credits, but states that "credits" that result in a net tax reduction will be considered a covered tax change. It is clear that nonrefundable credits enacted or expanded would constitute a covered tax change. Refundable credits, particularly the portion of a refundable credit that is paid in excess of tax liability, are more similar to an expenditure rather than a reduction in tax, as they are paid to claimants regardless of net tax liability and are counted as expenditures under Wisconsin budgeting and accounting practices.

10. For example, in tax year 2018, more than 78% of all refundable tax credit claims awarded by the Wisconsin Economic Development Corporation (WEDC) were paid in excess of tax liability. Refundable credits that are awarded by WEDC are done so via contract, and require WEDC to verify that work is performed consistent with the contract between it and the business before the business is verified as eligible to claim the credit. The process requires an application, contract, and verification process that is similar to requirements of other state agencies that are appropriated monies to issue discretionary grant awards.

11. Based on discussions with the administration, and for purposes of this paper, state enactment of a new refundable credit, or expansion of an existing refundable credit, is assumed to constitute a covered tax change that may count against the modified baseline established by the administration and Treasury, regardless of whether an agency is required to certify a claimant as eligible to claim a credit. As such, estimated net tax reductions resulting from refundable credit tax law changes enacted prior to March 3, 2021, may further reduce the modified baseline. Additional guidance from Treasury would be helpful to confirm this interpretation of its interim final rule.

12. Similar to the tax reductions described above, a number of tax law changes have been enacted prior to March 3, 2021, that expand or create refundable tax credits. The refundable portion of the research credit (up to 10% of the credit computed) was enacted under 2017 Act 59. No credit claims were made during the baseline year of 2018-19. Refundable research credit claims, estimated at $15.3 million GPR in 2021-22 and $18.4 million GPR in 2022-23, could further reduce the baseline against which the Legislature could reduce state tax revenues. Further, prior to the covered period, 2021 Act 1 was enacted. Among other general fund tax law changes, Act 1 was estimated to increase homestead tax credit expenditures by $340,000 annually, beginning in 2021-22. Changes to these (and other) refundable tax credit programs would have to be considered by the administration in determining the modified baseline with Treasury.

13. Certain refundable tax credits are awarded for economic development projects via contract with WEDC. Under the enterprise zone tax credit program, WEDC requested, and the Committee approved, designation of an enterprise zone for MolsonCoors, LLC, and HP. Net tax reductions associated with these zone designations of $5.2 million GPR in 2021-22 and $5.6 million GPR in 2022-23 could be used to further lower the baseline established between the administration and Treasury, as they were designated prior to March 3, 2021. However, future enterprise zone designations occurring after March 3, 2021, can be assumed to count against the revenue baseline.

14. The largest refundable tax credit program enacted prior to March 3, 2021, is the electronics and information technology manufacturing (EITM) zone tax credit program (Foxconn). The EITM zone tax credit program was enacted under 2017 Act 58, and authorized WEDC to award up to $2.85 billion in refundable credits to attract major business operations to Wisconsin. Credits could be awarded over a 15-year period.

15. During deliberation of Act 58, enhanced general fund tax collections associated with the Foxconn development from wages and economic activity from new employees, indirect economic activity, and induced economic activity were used as a rationale to offset the cost of the refundable credits enacted. Under the interim final rule published by Treasury, dynamic scoring cannot be used to offset the static cost of a covered tax change. As such, only the cost of the refundable tax credits can be considered.

16. On November 10, 2017, WEDC entered into a contract to certify three Wisconsin corporations that are affiliated with Hon Hai Precision Industry Co., Ltd (Foxconn) as eligible to receive EITM zone credits. WEDC designated the EITM zone in the Village of Mount Pleasant in Racine County. Under the original contract, credits could be earned beginning with activities performed in 2018. Standard budgeting practices for estimating the timing of EITM zone credit claims are that a 2018 EITM zone tax credit award earned by a business would not be verified by WEDC, and claimed from DOR, until state fiscal year 2019-20. As such, the estimated fiscal effects associated with the Act 58 EITM zone tax credit program were not accounted for in the baseline year of 2018-19. The estimated cost of the Act 58 credits could provide additional flexibility in calculating the modified baseline determined by DOA and Treasury.

17. However, WEDC and DOA determined that the actions of the Foxconn entities through 2020 were insufficient to earn credits under its current contract. WEDC and Foxconn later entered into negotiations to amend the contract, ultimately authorizing an amendment to the contract dated March 17, 2021, which was signed and executed on April 20, 2021, to substantially reduce the amount of EITM zone credits that can be earned. A total of $80.0 million may be earned for activities occurring in 2020 through 2025 under the scaled-down agreement. The designation and duration of the EITM zone and the amount of credits WEDC may award under statute ($2.85 billion) remain unchanged, and future amendments to the current contract or zone may further alter the estimated fiscal effect of the Act 58 credits. Table 3 shows the timing for which, under standard state budgeting procedures, expenditures for tax credit claims were estimated to occur under the original contract compared to the revised contract with Foxconn (assuming the maximum contracted amounts were earned).

TABLE 3

Estimated Timing for Maximum Tax Credit Claims under Contracts between WEDC and Foxconn, Budgeted General Fund Obligation (Millions)

	2021-22	2022-23	2023-24	2024-25
Original Contract, November 10, 2017	$240.7	$276.9	$313.2	$313.5
Revised Contract, April 20, 2021	29.1	8.3	6.3	8.7
Difference	$269.8	$285.2	$319.5	$322.2

Note: Under standard budget practice, credits earned for 2020 anticipated to be claimed in 2021-22.

18. As shown in Table 3, the difference in the maximum amount of credits that could have been claimed under the original and revised contracts is $555 million for the 2021-23 biennium. Changes related to prior fiscal years in which WEDC did not verify credits for Foxconn are not estimated above, as the reduced cost has already been accounted for in the opening balance for the 2021-23 biennium.

19. The administration and Treasury will need to determine how best to estimate by how much, and the timing for which, the Act 58 EITM zone credits could further lower baseline revenues below the amounts shown in Tables 1 and 2. As noted, the interim final rule does not specifically address how Treasury will consider refundable tax credits to impact the modified baseline or be included in covered tax changes. Further, the interim final rule does not address how refundable credits authorized via contract to encourage economic development, or subsequent modifications to an existing contact, will be treated under the recoupment provision. Although tax law changes to refundable tax credits enacted prior to March 3, 2021, are described above, additional guidance from Treasury is needed to determine whether changes to refundable tax credit contracts may impact the modified baseline, and whether subsequent contract changes may be considered under the recoupment provision.

20. The interim rule from Treasury indicates that, if actual state tax collections are below the modified baseline established between the administration and Treasury, the state must identify how the $2.5 billion in ARPA funds were not the source used to directly or indirectly reduce taxes. Other state funding sources, or certain expenditure reductions, may be identified as used for net tax reductions. For example, based on current projections for revenues and expenditures, $2,610 million will be available in the opening balance of the state's general fund for the 2021-23 biennium, and could be identified as a source used for net tax revenue reductions through December 31, 2024.

21. As described above, based on current estimates for revenues and expenditures, organic growth in state tax revenues (adjusted for previously enacted state tax law changes) is anticipated to account for $4,242 million that would be available for state tax and fee reductions in the 2021-23 biennium. If the Committee chose to allocate half of the opening balance for state tax reductions in the 2021-23 biennium, an additional $1,305 million could be identified and used for state tax or fee reductions ($5,547 million total). Pending further guidance from Treasury, tax law changes related to

refundable tax credits enacted prior to March 3, 2021, may further alter the modified baseline.

22. On its website, Treasury states that it is seeking comments on all aspects of the interim final rule on or before July 16, 2021. Future changes to the interim final rule may be prescribed by Treasury that would change the analysis described above. Further, the modified baseline could change relative to the amounts described above if: (a) DOA discovers additional net tax and/or fee reductions enacted prior to March 3, 2021, that could be included in the modified baseline; (b) previous estimates are revised to further reduce (or increase) the modified baseline; or (c) guidance from Treasury alters what is included in its definition of state taxes or law changes that could reduce (or increase) the modified baseline.

Prepared by: Sean Moran
Attachment

ATTACHMENT

Estimated Implicit Price Deflator, Baseline Revenues, Previously Enacted Net Tax Reductions, and Modified Tax Revenues ($ in Millions)

	2018-19	2019-20	2020-21	2021-22	2022-23
Implicit Price Deflator Index*	111.3	112.9	116.5	118.9	121.4
Index Change from 2018-19		1.6	5.2	7.5	10.0
Percent Change from 2018-19		1.4%	4.7%	6.8%	9.0%

	Actual	Estimated			
	2018-19	2019-20	2020-21	2021-22	2022-23
Baseline Revenues	$19,852.2	$20,137.2	$20,781.6	$21,197.2	$21,642.4

Tax Law Changes Resulting in Net Tax Reduction	2019-20	2020-21	2021-22	2022-23
2017 Act 59: Broadcaster Apportionment Formula	-$10.2	-$10.2	-$10.2	-$10.2
2017 Act 59: Sunset Alternative Minimum Tax	-5.3	-5.3	-5.3	-5.3
2017 Act 59: Sales Tax Exemption for Internet Access	--	-166.0	-166.0	-166.0
2017 Act 176: Low Income Housing Credit	-1.7	-8.2	-14.9	-22.6
2019 Act 9: Reduce Second Income Tax Bracket	-168.9	-152.6	-152.6	-152.6
2019 Act 9: WHEFA Tax Exclusion	0.0	-0.1	-0.3	-0.4
2019 Act 10: Income Tax Rate Reductions	-79.2	-269.4	-256.4	-256.4
2019 Act 10: Audit Liability Relief	-1.2	-1.6	-1.6	-1.6
2019 Act 128: Utility Tax Broadband Exemption	--	--	-2.3	-3.5
Tax Year 2019: Delayed Filing Deadline	-28.0	-3.5	0.0	0.0
2019 Act 181: Temporary Storage Exemption	-0.1	-0.9	-0.9	-0.9
CARES Act: Automatic Tax Provisions Adopted	-21.7	-26.8	7.6	3.5
2019 Act 185: Internal Revenue Code (IRC) Update	-4.5	-47.5	8.2	-0.3
Tax Year 2020: Delayed Filing Deadline	--	-24.0	0.0	0.0
2021 Act 1: IRC Update, DOR Omnibus Bill	--	-272.9	-217.7	-72.6
2021 Act 2: Entity-Level Tax Modifications	--	-0.6	-0.8	-0.9
Total Tax Law Reductions	-$320.6	-$989.5	-$813.0	-$689.6
Adjusted Total Tax Law Reduction**	-$325.2	-$1,035.8	-$868.1	-$751.8

	2018-19	2019-20	2020-21	2021-22	2022-23
Taxes - Modified Baseline	$19,852.2	$19,811.9	$19,745.8	$20,329.1	$20,890.6

*Change in BEA implicit price deflator estimated by Department of Administration.
**Dollar amount for law changes adjusted for changes in BEA implicit price deflator.

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June, 2021 Joint Committee on Finance Paper #306

Internal Revenue Code Update -- ARPA and TCJA (General Fund Taxes -- Income and Franchise Taxes)

[LFB 2021-23 Budget Summary: Page 202, #1]

CURRENT LAW

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. With limited exceptions, changes to federal law take effect for state tax purposes only after action by the Legislature. The Legislature typically reviews the previous year's federal law changes each year to update state references to the federal Internal Revenue Code (IRC). Under current law, state tax references generally refer to the code in effect on December 31, 2020.

BACKGROUND

On March 11, 2021, President Biden signed into law P.L. 117-2, the American Rescue Plan Act of 2021 (ARPA). ARPA follows three other federal acts in response to the coronavirus pandemic: (a) the Families First Coronavirus Response Act (FFCRA); (b) the Coronavirus Aid, Relief, and Economic Security Act (CARES); and (c) the Consolidated Appropriations Act of 2021 (CAA). Two of these federal acts modified IRC references relevant for state tax purposes. The Legislature adopted 2019 Act 185 in response to the federal tax law changes included under CARES. Federal tax law changes modified under the CAA, as well as tax law changes modified under several prior federal acts, were adopted under 2021 Act 1. Certain provisions of ARPA were automatically adopted for state tax purposes, while others would require legislative approval. This paper describes provisions of ARPA that modify IRC references relevant for state tax purposes that would require legislative approval to adopt.

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. The IRC references 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. For example, the expansion of the federal child and dependent care expenses credit under ARPA for tax year 2021 does not affect the state deduction for child and dependent care expenses. Although Wisconsin is tied to the federal credit's definition of employment-related expenses for purposes of the corresponding state deduction, the federal credit modifications included in ARPA do not impact the definition of these expenses, and so do not impact expenses allowed under the state deduction. Changes to federal tax laws under ARPA that the Legislature previously elected not to adopt, such as changes to the federal earned income tax credit (EITC) for individuals without children, are not described in this paper.

The Legislature previously considered and adopted provisions of the Tax Cuts and Jobs Act of 2017 (TCJA) as part of 2017 Act 231. This paper discusses provisions of the TCJA that were not adopted under Act 231 or other legislation, but which were recommended for state adoption under Assembly Bill 68/Senate Bill 111 (AB 68/SB 111).

DISCUSSION POINTS

1. The tax law changes presented in this paper describe the ARPA provisions and TCJA provisions Wisconsin could adopt to conform state definitions of income to the modified federal definitions of income. The paper separately describes ARPA changes the Committee could consider for state adoption that: (a) make permanent changes to the IRC (Alternative A1); (b) make temporary changes to the IRC beginning in tax year 2021 (Alternative A2); and (c) make a temporary change to the IRC for tax year 2020 (Alternative A3). It should also be noted that the Committee could choose to adopt any combination of Alternatives A1, A2, and A3. Alternatively, the Committee could choose not to adopt certain federal tax law changes presented as part of Alternatives A1 and A2. It should be noted that Alternatives A1 and A2 include provisions related to the state EITC, which are also considered for state adoption in LFB Paper #307. If Alternatives A1 and A2 were adopted as presented in this paper, the EITC-related provisions of LFB Paper #307 would not have an additional fiscal impact.

2. State adoption of temporary tax law changes provides simplicity for taxpayers and for DOR tax administration. However, adopting temporary federal tax law changes can present challenges for state governments. Because the federal government does not have a balanced budget requirement, it can issue general obligation debt to implement temporary tax reduction provisions to stimulate economic activity in response to a recession. Conversely, Wisconsin is required to enact a balanced budget each biennium and cannot issue general obligation debt to provide temporary tax relief. Historically, Congress has enacted extensions and/or expansions of temporary tax reduction provisions that would require the Legislature to choose whether to continue maintaining conformity with the IRC provision or to allow that provision to sunset under current law. Extensions of temporary tax provisions can occur after DOR has printed guidance and made its forms available to practitioners for that tax year. In general, adoption of a federal tax provision

that applies retroactively to previous tax years requires a taxpayer to file an amended return to receive the benefit, which can create administrative complexities for taxpayers and DOR.

3. As introduced, AB 68/SB 111 would update references to the IRC under the individual and corporate income/franchise tax to several IRC provisions of the TCJA, as amended by subsequent federal legislation, for tax years beginning after December 31, 2020. This includes: (a) loss limitation for taxpayers other than corporations; (b) amortization of research and experimental expenditures; (c) accounting rules for accrual method taxpayers; (d) limitation on the deduction for business interest; (e) limitation on the deduction for entertainment, amusement, and recreation expenses; (f) limitation on the deduction of Federal Deposit Insurance Corporation (FDIC) premiums; and (g) modification of the limitation on the deduction for highly paid individuals. State adoption of these provisions under AB 68/SB 111 would increase state income and franchise tax revenues by $264.2 million in 2021-22 and $275.9 million in 2022-23. Each of the TCJA provisions are described individually in this paper and can be adopted separately or jointly under Alternatives B1 through B7.

Permanent Tax Provisions of ARPA

4. 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. The disqualified income limit for tax year 2020 is $3,650, and is adjusted each year for inflation. 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. ARPA increases this disqualified income limit to $10,000 beginning in tax year 2021, and specifies that the increased limit is to be indexed for inflation annually thereafter. The state EITC is funded through a sum certain PR appropriation from the temporary assistance for needy families (TANF) program and a sum sufficient GPR appropriation. Therefore, adopting this provision is estimated to increase GPR expenditures by $1.8 million in 2021-22, $1.5 million in 2022-23, $1.3 million in 2023-24, and $1.4 million in 2024-25.

5. 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 is estimated to increase GPR expenditures by $0.1 million on an annual basis, beginning in 2021-22.

6. 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 repeals the election. It is estimated that state adoption of this provision would increase income and franchise tax collections by $7.8 million in 2021-22, $11.1 million in 2022-23, $13.4 million in 2023-24, and $14.2 million in 2024-25 and annually thereafter.

7. The Committee may decide to adopt only those federal provisions of ARPA which are permanent (Alternative A1). Table 1 displays the net fiscal effect of state adoption of the permanent provisions of ARPA, which are estimated to increase the general fund balance by $5.9 million in 2021-22, $9.5 million in 2022-23, $12.0 million in 2023-24, and $12.7 million in 2024-25.

TABLE 1

Fiscal Effect of State Adoption of Permanent ARPA Tax Provisions (Millions)

Provision	2021-22	2022-23	2023-24	2024-25	Source
Increase EITC Disqualified Income Limit	$1.8	$1.5	$1.3	$1.4	GPR
EITC for Certain Separated Individuals	0.1	0.1	0.1	0.1	GPR
Repeal Worldwide Interest Allocation Election	7.8	11.1	13.4	14.2	GPR-Tax
Subtotal GPR-Tax	$7.8	$11.1	$13.4	$14.2	GPR-Tax
Subtotal GPR	$1.9	$1.6	$1.4	$1.5	GPR
Net Increase to State General Fund	$5.9	$9.5	$12.0	$12.7	

Temporary Tax Provisions of ARPA

8. 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. If the state were to adopt this provision, it is estimated that individual income tax revenues would decrease by a minimal amount annually through 2025-26.

9. Under current law, health insurance premium assistance is generally included in gross income. Under separate provisions of ARPA, eligible individuals receiving continuation health care coverage pursuant to the Consolidated Omnibus Budget Reconciliation Act (COBRA) are entitled to premium assistance between April 1, 2021, and September 30, 2021. Under ARPA, the federal government will pay the premiums in full for such individuals during this period. ARPA specifies that any such COBRA premium assistance received is not included in the gross income of the individual. If the state were to conform to this federal exclusion, individual income tax revenues would decrease by an estimated $9.8 million in 2021-22.

10. Under federal law, an employer may participate in a dependent care assistance program, whereby the employer pays (directly or indirectly) for services to care for its employees' dependents (such as through a dependent care flexible spending arrangement). To be eligible for preferential tax treatment, such services must be provided to enable the employees to remain employed. Generally, an individual can exclude from gross income up to $5,000 ($2,500 if filing married-separate) per year of such dependent care assistance benefits. For tax year 2021 only, this limit is increased to $10,500 ($5,250 for married-separate filers). State adoption of this provision is estimated to reduce individual income tax collections by $0.9 million in 2021-22.

11. For EITC claims filed for tax year 2021, ARPA generally allows a taxpayer to use their earned income from tax year 2019 when determining their credit amount, provided their earned income in 2021 is lower than in 2019. A similar provision applicable to tax year 2020 was included in the CAA, and was adopted in state law under 2021 Act 1. Adopting this provision is estimated to increase GPR expenditures by $6.0 million in 2021-22. Because this provision only applies to EITC claims filed for tax year 2021, a minimal increase in GPR expenditures is estimated in 2022-23 and thereafter.

12. ARPA provides $28.6 billion in federal fiscal year 2021 for a new restaurant revitalization grant program, including $5 billion for eligible entities with gross receipts during 2019 of no more than $500,000. Grants are equal to the pandemic-related revenue loss of an eligible entity, up to $10 million per eligible entity, with no more than $5 million for each physical location. Any grant amounts that exceed the actual gross receipts of an eligible entity in 2020 must be returned.

Grants are generally awarded to eligible entities in the order in which applications are received. Eligible entities include most businesses in which the public or patrons assemble for the primary purpose of being served food or drink. Such entities located within an airport terminal are considered eligible. State and municipal owned businesses are not eligible. Entities that own or operate more than 20 locations, regardless of whether they do business under the same name, are not eligible.

Grant proceeds may be used for the following expenses incurred as a direct result of, or during, the COVID–19 pandemic during the period beginning February 15, 2020, and ending December 31, 2021: (a) payroll costs; (b) payments of principal or interest on any mortgage obligation (not including prepayments of principal); (c) rent payments (not including prepayment of rent); (d) utilities; (e) maintenance expenses, including construction to accommodate outdoor seating and walls, floors, deck surfaces, furniture, fixtures, and equipment; (f) supplies, including protective equipment and cleaning materials; (g) food and beverage expenses that are within the scope of the normal business practice of the eligible entity before the covered period; (h) covered supplier costs; (i) operational expenses; (j) paid sick leave; and (k) any other expenses determined to be essential to maintaining the eligible entity.

Eligible recipients must certify in their application for a grant that: (a) the uncertainty of current economic conditions makes the grant request necessary to support the ongoing operations; and (b) they have not applied for or received a shuttered venue grant under the CAA.

ARPA also provides that restaurant revitalization grant proceeds are excluded from gross income for income tax purposes and that otherwise deductible expenses paid directly or indirectly with such grants would be deductible. Further, ARPA provides that distributions to owners of partnerships and S corporations of such excluded amounts are treated as tax exempt income. ARPA directs the Secretary of the Treasury to prescribe rules for determining a partner's distributive share for purposes of determining a partner's or shareholder's basis in the ownership interest of a partnership or S corporation. It is estimated that state adoption of this provision would decrease state tax revenues by an estimated $15.6 million in 2021-22, $7.5 million in 2022-23, $4.1 million in 2023-24, and a minimal amount thereafter.

13. CARES provided for economic injury disaster loan (EIDL) advances to applicants of up to $10,000, which did not have to be repaid. However, program funding ran out in July, 2020. The CAA later extended the program, now referred to as targeted EIDL advances, and provided that such advances are not taxable. ARPA clarifies for income tax purposes that: (a) targeted EIDL advances are not included in gross income; (b) otherwise deductible expenses cannot be denied because they were paid with EIDL advance proceeds; and (c) distributions to owners of pass-through entities, such as partnerships and S corporations, are tax neutral, in that the forgiveness of indebtedness and other financial assistance is treated as an increase in a partner's or shareholder's basis in the ownership interest of a partnership or S corporation. These provisions are not anticipated to have a fiscal effect because provisions of 2021 Act 1 already conformed state law to federal law in making EIDL advances nontaxable.

14. The Committee could choose to adopt the temporary tax provisions of ARPA (Alternative A2). Table 2 depicts the fiscal effects of state adoption of the temporary tax provisions of ARPA which first apply in tax year 2021. These provisions are estimated to reduce the general fund balance by $32.3 million in 2021-22, $7.5 million in 2022-23, and $4.1 million in 2023-24, and are estimated to have a minimal impact on general fund revenues thereafter.

TABLE 2

Fiscal Effect of State Adoption of Temporary ARPA Tax Provisions Beginning Tax Year 2021 (Millions)

Provision	2021-22	2022-23	2023-24	2024-25	Source
Student Loan Forgiveness Exclusion	Minimal	Minimal	Minimal	Minimal	GPR-Tax
Health Insurance Premium Assistance Exclusion	-$9.8	Minimal	Minimal	Minimal	GPR-Tax
Increased Exclusion for Dependent Care Benefits	-0.9	Minimal	Minimal	Minimal	GPR-Tax
Using 2019 Earned Income for 2021 EITC	6.0	Minimal	Minimal	Minimal	GPR
Restaurant Revitalization Grants Exclusion	-15.6	-$7.5	-$4.1	Minimal	GPR-Tax
Clarify Targeted EIDL Advances	Minimal	Minimal	Minimal	Minimal	GPR-Tax
Subtotal GPR-Tax	-$26.3	-$7.5	-$4.1	Minimal	GPR-Tax
Subtotal GPR	$6.0	Minimal	Minimal	Minimal	GPR
Total Impact on State General Fund	-$32.3	-$7.5	-$4.1	Minimal	

Unemployment Compensation Exclusion for Tax Year 2020, ARPA

15. Unemployment compensation payments are generally taxable under federal law. However, for tax year 2020, ARPA provides that the first $10,200 of unemployment payments received in calendar year 2020 are excluded from taxable income, provided the taxpayer's federal AGI (with certain modifications) is less than $150,000. Eligible married-joint filers are able to exclude up to $10,200 of unemployment compensation received by each spouse (up to $20,400 total).

16. It should be noted that this exclusion for unemployment compensation applies only to tax year 2020. If this provision were adopted for state tax purposes retroactively for tax year 2020, most individuals would have to file an amended return to receive the tax benefit. According to DOR, it does not have the ability to systematically identify individual returns it has received and recompute each individual's tax liability for tax year 2020 on the individual's behalf.

17. State adoption of this provision is estimated to reduce individual income tax revenues by $121.0 million in 2021-22 and by a minimal amount thereafter (Alternative A3).

TCJA Provisions

18. Under state law, a net loss is generally defined as the excess of business expenses allowed as deductions in computing net income over the amount of income attributable to the operation of a trade or business in the state. Under both the individual income tax and the corporate income/franchise tax, net losses can be carried forward and used to offset income for the following 20 years. Under the individual income tax, a net operating loss (NOL) can also be carried back to offset net income in the two prior taxable years. However, state law does not allow for carrybacks of net business losses for purposes of the corporate income/franchise tax.

Under the TCJA, as modified by CARES, noncorporate taxpayers' excess losses are limited in tax years 2021 through 2025. ARPA extends the loss limitation for excess losses through December 31, 2026. Excess losses are defined as the aggregate deductions for business purposes that exceed the sum of the noncorporate taxpayer's gross income or gain plus either the inflation-adjusted amount of $500,000 for married-joint filers or $250,000 for other types of filers. Any losses exceeding this amount may only be carried forward for subsequent tax years. The limitation does not apply to excess farm losses. Under CARES, starting in 2021, excess business losses are determined without regard to deductions, gross income, or gains attributable to any trade or business or performing services as an employee, including any federal deduction allowable for NOLs or qualified business income and deductions for losses and certain gains from the sales or exchanges of capital assets. State law has not adopted these provisions of the TCJA.

Adopting the limitation on excess losses for noncorporate taxpayers beginning in tax year 2021 would increase state individual income tax collections by an estimated $72.9 million in 2021-22, $58.2 million in 2022-23, $56.5 million in 2023-24, and $54.6 million in 2024-25 (Alternative B1).

19. Most business expenses associated with the development or creation of an asset that

has a useful life beyond the current year must be capitalized and depreciated over the useful life of the asset. Amortization provisions allow a taxpayer to annually deduct a portion of certain capital expenses that are not ordinarily deductible. Generally, these expenses are not otherwise deductible because: (a) they relate to assets that are not depreciable because the assets have unlimited or indefinite life; or (b) they pertain to organizational or investigative expenses that were incurred before the taxpayer went into business. Generally, the capital expenses which are amortized are deducted in equal monthly amounts over the amortization period, which depends upon the type of asset that is acquired.

Under state law, researchers can elect to immediately deduct reasonable research or experimentation expenditures associated with the development or creation of a business asset. Researchers also may elect to amortize such expenditures over a five-year or 10-year period, rather than capitalize such expenditures under uniform capitalization rules.

Under the TCJA, for taxable years beginning after December 31, 2021, research and experimental expenditures must be capitalized and amortized ratably over a five-year period, rather than immediately expensed in the year the expenses were incurred. Expenditures attributable to research conducted outside of the United States must be capitalized and amortized ratably over a period of 15 years. The TCJA also expanded the definition of research or experimental expenditures to include expenditures for software development, as well as depreciation and depletion allowances for property other than land that is depreciated or depleted in connection with research or experimentation. State law has not adopted these provisions of the TCJA.

State adoption of this provision would increase state tax revenues by an estimated $63.2 million in 2021-22 and $101.5 million in 2022-23, $98.6 million in 2023-24, and $95.3 million in 2024-25 (Alternative B2).

20. Generally, under cash accounting, income is included in taxable income when actually or constructively received and deductions are allowed when expenses are paid. By contrast, under accrual accounting, revenue and expenses are recognized as of the time a transaction occurs instead of when the payment is made.

The TCJA requires an accrual method taxpayer to recognize income no later than the taxable year in which such income is taken into account as revenue in an applicable financial statement, with an exception for taxpayers without an applicable or other specified financial statement. The TCJA codifies the current deferral method of accounting for advance payments for goods, services, and other specified items to allow accrual method taxpayers to elect to defer the inclusion of income associated with advance receipt if such income is also deferred for financial statement purposes. The TCJA also repeals special rules that apply to the accrual of interest for original issue discount debt instruments (other than mortgage servicing contracts) that have an applicable financial statement, and the change in accounting for such debt instruments must be taken into account ratably over six taxable years.

State adoption of this provision, beginning in tax year 2021, would increase state tax revenues by an estimated $7.9 million in 2021-22, $3.5 million in 2022-23, $3.3 million in 2023-24, and $3.2 million in 2024-25 (Alternative B3).

21. Wisconsin law allows a deduction for interest on indebtedness incurred in the operation of a trade or business. Interest is defined as compensation for the use or forbearance of money. Only interest on actual indebtedness is deductible. Certain types of interest, such as interest incurred for an obligation that is wholly exempt from tax or interest paid that is attributable to the underpayment of tax, cannot be deducted.

Under the TCJA, beginning in tax year 2018, the federal deduction for business interest differs substantially from state law. The federal deduction was limited to the sum of: (a) business interest income; (b) 30% of the taxpayer's adjusted taxable income; and (c) floor plan financing interest of the taxpayer for the taxable year. For tax years 2018 through 2021, adjusted taxable income is computed without regard to deductions allowable for depreciation, amortization, or depletion. Any deduction disallowed as a result of the limit for business interest may be carried forward indefinitely for use in future years. The following entities are exempt from the deduction limit: (1) taxpayers with average gross receipts of less than $25 million over the prior three taxable years; (2) certain regulated public utilities; (3) most businesses engaged in real property development, construction, rental, leasing, or brokerage activities; and (4) farming businesses, as well as certain agricultural or horticultural cooperatives.

State adoption of this provision, beginning in tax year 2021, would increase state tax revenues by an estimated $99.3 million in 2021-22, $95.3 million in 2022-23, $92.6 million in 2023-24, and $89.4 million in 2024-25 (Alternative B4).

22. Ordinary and necessary business expenses related to the operation of a trade or business that are not deducted elsewhere can be deducted under a general miscellaneous category. Prior to tax year 2018, miscellaneous business expenses under state and federal law generally included: (a) 50% of food and beverages provided to employees and 100% if excluded from the gross income of the employee as a de minimis fringe benefit; and (b) 50% of entertainment expenses that are directly related to a taxpayer's active trade or business.

The TCJA repealed the deduction for entertainment expenses beginning in tax year 2018. Further, the TCJA extended the 50% limit to expenses for food and beverages provided for the convenience of the employer through certain eating facilities for amounts incurred and paid after December 31, 2017, and eliminated the deduction for such expenses paid or incurred after December 31, 2025. However, the CAA temporarily allows the full deduction of food or beverages provided by a restaurant between January 1, 2021, and December 31, 2022.

State adoption of this provision, beginning in tax year 2021, would increase state tax revenues by an estimated $10.0 million in 2021-22, $7.8 million in 2022-23, $7.6 million in 2023-24, and $7.3 million in 2024-25 (Alternative B5).

23. State law conforms to previous federal law, which provided a deduction for FDIC premiums paid without limit. Beginning in tax year 2018, taxpayers under federal law may deduct 100% of FDIC premiums only if such assets are less than $10 billion. Taxpayers with total consolidated assets of $50 billion or more may not deduct FDIC premiums. The applicable percentage of the federal deduction is prorated for taxpayers with assets of between $10 billion and $50 billion (for example, if the taxpayer has $20 billion of such assets, 25% of FDIC premiums are

taxable).

It is estimated that state adoption of this provision would increase state tax revenues by $6.5 million in 2021-22, $6.3 million in 2022-23, $6.1 million in 2023-24, and $5.9 million in 2024-25 (Alternative B6).

24. Under state law, salaries, wages, and other forms of remuneration to officers of the business are deductible expenses. However, a publicly-held corporation cannot deduct compensation in excess of $1.0 million per tax year that is paid or accrued to certain executives. The deduction limitation applies to: (a) compensation to the principal executive officer (or an individual acting in that capacity); and (b) any other employee having total compensation required to be reported to shareholders under SEC rules because the employee is among the four highest compensated officers in the tax year. Compensation subject to the limitation includes cash and noncash benefits paid for services except for certain specified types of remuneration, such as commission-based or performance-based compensation. The $1.0 million limit on deductible compensation is reduced by the amount of excess golden parachute payments that are not deductible under the IRC. The deduction is further limited to $500,000 for compensation paid to certain executives of certain health insurance providers.

Under the TCJA, federal law provides that the limit on excess compensation includes remuneration paid on a commission basis and performance-based compensation. The TCJA also expanded the definition of a publicly held corporation to include all domestic publicly traded corporations, including large private C corporations or S corporations that are not publicly traded. Further, an individual who is a covered employee remains a covered employee subject to the $1.0 million deduction limit with respect to compensation otherwise deductible in subsequent years, including years in which the individual is no longer employed by the corporation and in years after the employee has died (for purposes of compensation paid to beneficiaries).

The TCJA also expanded the definition of a covered employee to include the principal financial officer in addition to the principal executive officer and the three most highly compensated officers (five covered employees). This includes any individual that holds the position of principal executive officer or principal financial officer at any time during the taxable year. Effective for taxable years beginning after December 31, 2026, ARPA further expands "covered employees" to include the next five highest paid employees in each taxable year (such persons are not included in future years unless they remain in the top five highest paid).

It is estimated that state adoption of this provision would increase state tax revenues by $4.4 million in 2021-22, $3.3 million in 2022-23, $3.2 million in 2023-24, and $3.1 million in 2024-25 (Alternative B7).

25. The Committee could choose to adopt the TCJA provisions, as described above, beginning in tax year 2021. Table 3 depicts the fiscal effects for state adoption of these provisions, which are estimated to increase state income and franchise tax revenues by $264.2 million in 2021-22, $275.9 million in 2022-23, $267.9 million in 2023-24, and $258.8 million in 2024-25.

TABLE 3

Fiscal Effect of State Adoption of TCJA Tax Provisions (Millions)

Provision	2021-22	2022-23	2023-24	2024-25	Source
Loss limitation for noncorporate taxpayers other than corporations	$72.9	$58.2	$56.5	$54.6	GPR-Tax
Amortization of research and experimental expenditures	63.2	101.5	98.6	95.3	GPR-Tax
Accounting rules for accrual method taxpayers	7.9	3.5	3.3	3.2	GPR-Tax
Limitation on deduction for business interest	99.3	95.3	92.6	89.4	GPR-Tax
Limitation on the deduction for entertainment and meal expenses	10.0	7.8	7.6	7.3	GPR-Tax
Limitation on deduction for FDIC premiums	6.5	6.3	6.1	5.9	GPR-Tax
Modification of the limitation for highly paid individuals	4.4	3.3	3.2	3.1	GPR-Tax
Total	$264.2	$275.9	$267.9	$258.8	GPR-Tax

ALTERNATIVES

A. Tax Law Changes Under ARPA

1. Adopt the following federal tax provisions of ARPA which are permanent: (a) increase EITC disqualified income limit; (b) EITC for certain separated individuals; and (c) repeal worldwide interest allocation election. Estimate increased income and franchise tax collections of $7,800,000 in 2021-22 and $11,100,000 in 2022-23. Also, estimate increased GPR expenditures of $1,900,000 in 2021-22 and $1,600,000 in 2022-23. [This alternative could be adopted in conjunction with any other alternative.]

ALT A1	Change to Base
GPR-Tax	$18,900,000
GPR	3,500,000

2. Adopt the following temporary federal tax provisions of ARPA that apply beginning in tax year 2021: (a) student loan forgiveness exclusion; (b) health insurance premium assistance exclusion; (c) increased exclusion for dependent care benefits; (d) using 2019 earned income for 2021 EITC; (e) restaurant revitalization grants exclusion; and (f) clarify targeted EIDL advances. Estimate reduced individual income tax collections of $26,300,000 in 2021-22 and $7,500,000 in 2022-23. Estimate increased GPR expenditures of $6,000,000 in 2021-22 and a minimal amount thereafter. [This alternative could be adopted in conjunction with any other alternative.]

ALT A2	Change to Base
GPR-Tax	- $33,800,000
GPR	6,000,000

3. Adopt the federal exclusion from gross income included in ARPA for up to $10,200 of unemployment compensation received in tax year 2020. Estimate reduced individual income tax collections of $121.0 million on a one-time basis in 2021-22. [This alternative could be adopted in conjunction with any other alternative.]

ALT A3	Change to Base
GPR-Tax	- $121,000,000

4. Take no action.

B. Tax Law Changes Under TCJA

1. Adopt the federal tax provision of the TCJA regarding the loss limitation for taxpayers other than corporations, as modified by subsequent federal acts to date. Estimate increased income and franchise tax collections of $72,900,000 in 2021-22 and $58,200,000 in 2022-23. [This alternative could be adopted in conjunction with any other alternative.]

ALT B1	Change to Base
GPR-Tax	$131,100,000

2. Adopt the federal tax provision of the TCJA regarding the amortization of research and experimental expenditures, as modified by subsequent federal acts to date. Estimate increased income and franchise tax collections of $63,200,000 in 2021-22 and $101,500,000 in 2022-23. [This alternative could be adopted in conjunction with any other alternative.]

ALT B2	Change to Base
GPR-Tax	$164,700,000

3. Adopt the federal tax provision of the TCJA regarding the accounting rules for accrual method taxpayers, as modified by subsequent federal acts to date. Estimate increased income and franchise tax collections of $7,900,000 in 2021-22 and $3,500,000 in 2022-23. [This alternative could be adopted in conjunction with any other alternative.]

ALT B3	Change to Base
GPR-Tax	$11,400,000

4. Adopt the federal tax provision of the TCJA regarding the limitation on the deduction for business interest, as modified by subsequent federal acts to date. Estimate increased income and franchise tax collections of $99,300,000 in 2021-22 and $95,300,000 in 2022-23. [This alternative

could be adopted in conjunction with any other alternative.]

ALT B4	Change to Base
GPR-Tax	$194,600,000

5. Adopt the federal tax provision of the TCJA regarding the limitation on the deduction for entertainment, amusement, and recreation expenses, as modified by subsequent federal acts to date. Estimate increased income and franchise tax collections of $10,000,000 in 2021-22 and $7,800,000 in 2022-23. [This alternative could be adopted in conjunction with any other alternative.]

ALT B5	Change to Base
GPR-Tax	$17,800,000

6. Adopt the federal tax provision of the TCJA regarding the limitation on the deduction of FDIC premiums. Estimate increased income and franchise tax collections by an estimated $6,500,000 in 2021-22 and $6,300,000 in 2022-23. [This alternative could be adopted in conjunction with any other alternative.]

ALT B6	Change to Base
GPR-Tax	$12,800,000

7. Adopt the federal tax provision of the TCJA regarding the modification of the limitation on the deduction for highly paid individuals, as modified by subsequent federal acts to date. Estimate increased income and franchise tax collections of $4,400,000 in 2021-22 and $3,300,000 in 2022-23. [This alternative could be adopted in conjunction with any other alternative.]

ALT B7	Change to Base
GPR-Tax	$7,700,000

8. Take no action.

Prepared by: Dan Spika, John Gentry, and Sean Moran
Attachment

ATTACHMENT

State Adoption of Select Federal ARPA and TCJA Provisions
Net Fiscal Effect to General Fund
(Millions)

	2021-22	2022-23	2023-24	2024-25	Source
IRC Provisions -- ARPA Provisions					
Increase EITC Disqualified Income Limit	$1.8	$1.5	$1.3	$1.4	GPR
EITC for Certain Separated Individuals	0.1	0.1	0.1	0.1	GPR
Repeal Worldwide Interest Allocation Election	7.8	11.1	13.4	14.2	GPR-Tax
Student Loan Forgiveness Exclusion	Minimal	Minimal	Minimal	Minimal	GPR-Tax
Health Insurance Premium Assistance Exclusion	-9.8	Minimal	Minimal	Minimal	GPR-Tax
Increased Exclusion for Dependent Care Benefits	-0.9	Minimal	Minimal	Minimal	GPR-Tax
Using 2019 Earned Income for 2021 EITC	6.0	Minimal	Minimal	Minimal	GPR
Restaurant Revitalization Grants Exclusion	-15.6	-7.5	-4.1	Minimal	GPR-Tax
Clarify Targeted EIDL Advances	Minimal	Minimal	Minimal	Minimal	GPR-Tax
Unemployment Compensation Exclusion for 2020	-121.0	Minimal	Minimal	Minimal	GPR-Tax
Subtotal GPR-Tax	-$139.5	$3.6	$9.3	$14.2	
Subtotal GPR	$7.9	$1.6	$1.4	$1.5	
IRC Provisions -- TCJA Provisions					
Loss Limitation for Taxpayers other than Corporations	$72.9	$58.2	$56.5	$54.6	GPR-Tax
Amortization of Research and Experimental Expenditures	63.2	101.5	98.6	95.3	GPR-Tax
Accounting Rules for Accrual Method Taxpayers	7.9	3.5	3.3	3.2	GPR-Tax
Limitation on Deduction for Business Interest	99.3	95.3	92.6	89.4	GPR-Tax
Limitation on the Deduction for Entertainment and Meal Expenses	10.0	7.8	7.6	7.3	GPR-Tax
Limitation on Deduction for FDIC Premiums	6.5	6.3	6.1	5.9	GPR-Tax
Modification of the Limitation for Highly Paid Individuals	4.4	3.3	3.2	3.1	GPR-Tax
Subtotal GPR-Tax	$264.2	$275.9	$267.9	$258.8	
Totals					
GPR-Tax	$124.7	$279.5	$277.2	$273.0	
GPR	7.9	1.6	1.4	1.5	
Net Effect on General Fund Balance	$116.8	$277.9	$275.8	$271.5	

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June, 2021 Joint Committee on Finance Paper #307

Federalize College Savings and EITC Provisions (General Fund Taxes -- Income and Franchise Taxes)

[LFB 2021-23 Budget Summary: Page 215, #17]

CURRENT LAW

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. The Legislature typically reviews the previous year's federal law changes each year to update state references to the federal Internal Revenue Code (IRC). Under current law, state tax references generally refer to the code in effect on December 31, 2020.

With limited exceptions, changes to federal law take effect for state tax purposes only after action by the Legislature. Exceptions occur for certain federal provisions for which the Legislature has decided to adopt "rolling conformity." Any federal law changes affecting provisions for which the state has rolling conformity are automatically adopted for state tax purposes; no additional action on the part of the Legislature is required. The state currently has rolling conformity for provisions relating to expensing of Section 179 depreciable assets and relating to the computation of depletion for certain property placed into service.

Under current law, the federal earned income tax credit (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 federal credit amount on which the state EITC is computed, and eligibility criteria for claiming the state credit, are based on the federal EITC in effect on December 31, 2020. The state credit is not available to claimants without qualifying children.

Two Wisconsin college savings plans administered under section 529 of the IRC are available under current law. Under these programs (referred to herein as "qualified tuition

programs"), any person with a valid Social Security number or taxpayer identification number aged 18 or over may open an account for a beneficiary. The beneficiary may be any person with a valid Social Security number, including the account owner. The beneficiary may use the proceeds of the account at any eligible school (including accredited post-secondary education institutions in the United States, and certain post-secondary institutions abroad). Generally, distributions may be used for a wide range of educational expenses such as: tuition and other fees; up to $10,000 of principal and interest on qualified student loans; educational supplies; expenses related to participation in apprenticeship programs; special needs services; room and board; computers; software; and internet access services.

State law allows a deduction for contributions made by any in-state resident to a Wisconsin-sponsored college savings account, regardless of the claimant's relationship to the beneficiary. For tax year 2020, deductions may be claimed for up to $3,340 (filing single or married-joint) or $1,670 (for a divorced parent or married-separate filer) per beneficiary. This deduction was created under 1999 Act 44 (and subsequently modified several times). Any amounts contributed to a college savings account after December 31, 2013, which incur a federal penalty because they were subsequently not used for qualified higher education expenses, must be added back to taxable income under current law. This addback provision only applies to contributions for which the above state deduction was claimed.

BACKGROUND

The Wisconsin Legislature has frequently chosen to adopt for state tax purposes federal law changes which affect qualified tuition programs, and federal law changes which affect the state EITC. Several recent examples are noted below.

The federal Tax Increase Prevention Act of 2014 included provisions that relate to the definition of qualified tuition programs and that prohibit program contributors and designated beneficiaries from directing investments in such programs more than two times per calendar year. Wisconsin conformed to these provisions under 2015 Act 55.

The federal Tax Cuts and Jobs Act of 2017 permitted college savings account distributions of up to $10,000 per beneficiary per year to be used for tuition expenses at public, private, or religious elementary and secondary schools. Under 2017 Act 231, the state conformed to this federal provision, beginning in tax year 2018.

The federal Further Consolidated Appropriations Act of 2020 (FCAA) expanded the definition of qualified education expenses to allow 529 college savings plan distributions to be used to pay for: (a) expenses associated with registered apprenticeship programs; and (b) principal or interest on qualified student loans of the account's beneficiary or a sibling of the beneficiary, limited to a lifetime maximum of $10,000. Wisconsin conformed to this federal treatment under 2021 Act 1.

Also under the FCAA, qualified individuals whose residence is in a disaster area are permitted to calculate their federal EITC using their earned income from the prior year, instead of their earned income from the current year, provided their earned income from the prior year is

higher. Wisconsin conformed to this provision, beginning in tax year 2021, under 2021 Act 1.

Under the federal Consolidated Appropriations Act of 2020 (CAA), a provision was included which allowed a taxpayer to use their 2019 earned income to calculate their federal EITC for tax year 2020, provided their earned income in 2020 was lower. Wisconsin conformed to this provision under 2021 Act 1.

In general, Wisconsin has adopted all the federal provisions which are relevant to the state EITC to date, save for three provisions of the American Rescue Plan Act of 2021 (ARPA). These three provisions are described and considered for state adoption in LFB Paper #306. Moreover, Wisconsin has adopted all federal provisions relating to section 529 college savings programs to date.

DISCUSSION POINTS

1. 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. In light of this, and because the Legislature has elected to adopt all relevant law changes to this point, the Committee could choose to specify that sections 221 (e) (1) and 529 of the IRC in effect for federal purposes, relating to qualified tuition programs, are automatically adopted for Wisconsin income tax purposes beginning in tax year 2021 (Alternative A1). Such a proposal is included in Assembly Bill 68/Senate Bill 111 (AB 68/SB 111).

2. At the time of introduction of AB 68/SB 111 (February 16, 2021), this provision was estimated to reduce individual income tax revenues by $100,000 on an annual basis, owing to the bill's proposal for state adoption of the federal FCAA provision allowing 529 distributions to be used for apprenticeship programs and student loans, as described above. However, these provisions were adopted retroactive to tax year 2019 for state tax purposes under 2021 Act 1 on February 18, 2021. As a result, Alternative A1, if adopted, would not include this estimated fiscal effect, and would not need to be adopted retroactive to tax year 2019.

3. Alternative A1 also includes a modification to the current law provision (described above) requiring taxpayers to add back to taxable income any amount initially contributed to a college savings account that is subsequently not used for qualified higher education expenses. Alternative A1 would specify that such an addition must be made regardless of when the initial amount was contributed to the account. From a tax policy perspective, it is unclear why a contribution made before January 1, 2014, which is subsequently disqualified upon distribution, would remain eligible for a state tax deduction previously taken. Moreover, expanding the addback provision in this way would simplify DOR's administration of the provision, and would obviate the need for taxpayers to keep a close account of the timing of their contributions to determine if an ineligible distribution was made with monies contributed before or after January 1, 2014. This provision is estimated to increase individual income tax revenues by a minimal amount annually. The Committee could adopt this provision independent of rolling conformity under Alternative A2.

4. It could be argued that rolling conformity provides administrative certainty and simplicity for taxpayers and DOR. For example, the federal law changes to college savings plans

which allow plan distributions to be used for expenses related to apprenticeship programs and for up to $10,000 of student loans, went into effect for federal tax purposes in tax year 2019, but were not signed into state law until February, 2021. Individuals that received distributions for apprenticeship programs in tax year 2019 had to add these distributions back to state taxable income when filing their tax year 2019 returns. If rolling conformity under Alternative A1 had been in effect during the tax year 2019 filing season, individuals would not have had to file, and DOR would not have had to process, amended returns following enactment of 2021 Act 1 in order for taxpayers to claim the tax benefit retroactively. It is also possible that some taxpayers elected not to take a distribution for one of these federally permissible uses in the interim, in order to avoid owing a state tax addback for a disqualified distribution under state law.

5. As noted above, several recent law changes affecting qualified tuition programs have expanded the permissible uses of program funds to include other education-related expenses. If the state had not conformed to these federal law changes, this would have restricted the beneficiary's ability to use account funds for an otherwise federally authorized purpose. It could be argued that individuals who contribute to these federally authorized savings accounts, and the account beneficiaries, could withdraw such monies in compliance with federal law without realizing that they would incur a tax penalty under state law.

6. Moreover, it could be argued that the state should not be the limiting factor in determining what constitutes an eligible use of funds under a federal program. By creating its own 529 college savings programs, Wisconsin signaled its desire to conform to federal tax-advantaged qualified tuition programs for the benefit of state taxpayers. As noted above, the state has so far conformed to all federal law changes made to these programs. Therefore, an argument could be made that the state should ensure this conformity continues automatically, as would be provided under Alternative A1.

7. The state EITC is calculated as a percentage of the federal credit. The state credit is linked to specific provisions of the IRC related to the federal credit. However, each time there is a relevant statutory change to the federal EITC, the state must decide whether to pass legislation adopting the change for purposes of the state EITC. The Committee could decide to provide that changes to the amount of an individual's federal EITC are automatically adopted for purposes of the state credit (Alternative B1). For example, for an individual with three or more qualifying children, future federal law changes would not require that individual to recompute their federal EITC based on provisions previously in effect; the individual could simply multiply 34% by the federal EITC amount they claimed for that tax year.

8. Rolling conformity for the state EITC would not apply to federal changes which do not directly impact the calculation of the credit authorized under state law. For example, the expansion of the federal EITC for adults without qualifying children under ARPA would not be adopted under Alternative B1, since Wisconsin does not offer a credit to such claimants. The estimated fiscal effect shown for Alternative B1 assumes that the three EITC-related provisions of ARPA described under LFB Paper #306 are adopted for state tax purposes under this alternative. However, if the Committee chose to adopt these EITC provisions under LFB Paper #306, Alternative B1 would have no estimated fiscal effect.

9. If rolling conformity under Alternative B1 had been in effect for tax year 2020, DOR could have automatically implemented the federal modification under the CAA, allowing taxpayers to use their 2019 earned income to calculate their 2020 EITC (this was eventually adopted in state law under 2021 Act 1). However, Act 1 was not enacted until after DOR began receiving tax year 2020 returns. Alternative B1 (if in effect previously) would have prevented DOR from having to manually adjust affected taxpayers' returns retroactively, which would have lessened the Department's administrative burden and enabled affected taxpayers to receive their increased credit sooner. Moreover, some DOR staff tasked with manually adjusting returns could have otherwise been performing revenue generating activities to benefit the state's general fund, rather than being diverted to process returns. In this example, rolling conformity would have supported more efficient tax administration by enabling DOR staff to perform the primary activities for which they are employed.

10. In general, if the state does not adopt a federal law change that would otherwise affect a claimant's federal and state EITC, that claimant would then be required to recalculate their state EITC using the federal credit provisions which had applied prior to the relevant law change. Automatic adoption of federal EITC provisions under Alternative B1 can help taxpayers avoid this complexity.

11. On the other hand, the Committee may not wish to tie the state computation of the credit automatically to federal provisions that could significantly increase state expenditures. For example, if the federal government expanded the EITC such that Wisconsin filers with three or more qualifying children could claim additional federal credits of $20 million annually, Alternative B1 would automatically increase state GPR expenditures by $6.8 million (0.34 * $20 million) on an annual basis.

12. An administrative argument for not automatically adopting federal law changes involves the timing of such changes. If a federal law change that affects the current tax year is adopted late in that year (for example, November or December, 2020, for a tax year 2020 law change), DOR would have to spend time and agency resources to republish tax year 2020 forms and guidance that it had already completed. Similarly, federal law changes that occur after a tax filing season has already started require DOR to re-issue applicable forms and guidance, as well as process amended returns for affected taxpayers who have already filed a return for that tax year. Furthermore, federal law changes which apply retroactively cause DOR to incur additional costs to reprogram prior year tax forms and process amended returns.

13. However, the Legislature has recently chosen to adopt all relevant tax law changes, including retroactive changes, affecting qualified tuition plans and the federal EITC amount. If the Committee believes the Legislature will likely continue to adopt these federal tax law changes, it could expedite timely guidance and revised forms from DOR and choose to automatically adopt future federal tax law changes to these provisions. Further, if a particular federal tax law change is passed in the future that the Legislature does not see fit to adopt, the Legislature could pass a state law that negates rolling conformity for purposes of that particular provision. It should also be noted that the Committee could choose to adopt Alternative A1 (or A2) and Alternative B1 concurrently.

ALTERNATIVES

A. Qualified Tuition Programs

1. Beginning in tax year 2021, specify that sections 221 (e) (1) and 529 of the IRC in effect for federal purposes, relating to qualified tuition programs, are automatically adopted for Wisconsin income tax purposes. In addition, modify the current law addition to taxable income of amounts initially contributed to a college savings account, for which a state deduction was previously claimed, that are subsequently not used for qualified higher education expenses. Specify that such an addition must be made regardless of when the initial amount was contributed to the account. Estimate a minimal annual increase in individual income tax collections.

2. Beginning in tax year 2021, modify the current law addition to taxable income of amounts initially contributed to a college savings account, for which a state deduction was previously claimed, that are subsequently not used for qualified higher education expenses. Specify that such an addition must be made regardless of when the initial amount was contributed to the account. Estimate a minimal annual increase in individual income tax collections.

3. Take no action.

B. Earned Income Tax Credit

1. Specify that, beginning in tax year 2021, federal EITC tax law changes which are relevant to the amount of the federal EITC on which the state credit is calculated are automatically adopted for purposes of the state credit. Estimate increased GPR expenditures relative to current law of $7,900,000 in 2021-22 and $1,600,000 in 2022-23. [If the Committee chose to adopt Alternatives A1 and A2 under LFB Paper #306, no fiscal effect would be estimated for this alternative.]

ALT B1	Change to Base
GPR	$9,500,000

2. Take no action.

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June, 2021 | Joint Committee on Finance | Paper #308

Underpayment Interest for Federally Extended Filing Dates
(General Funds Taxes -- Income and Franchise Taxes)

CURRENT LAW

Under current law, individuals (including estates, trusts, and partnerships) and corporations that make estimated tax payments during the tax year generally owe interest if they underpaid their estimated payments for taxes by $500 or more during the tax year. Similar provisions apply to pass-through entities that underpay their estimated withholding payments (for those that are required to make estimated withholding payments). Underpayment interest (UPI) accrues at a rate of 12% per year for the period of the underpayment.

However, UPI does not apply under current law for individuals and corporations if the taxpayer qualifies for a federal extension of time to file their return due to a presidentially declared disaster, or a terroristic or military action. This provision does not apply for pass-through entities.

Current law also allows the Secretary of the Department of Revenue (DOR) to waive UPI (for individuals and pass-through entities) if the Secretary determines that, because of casualty, disaster, or other unusual circumstances, it is not equitable to impose interest. This provision does not apply for corporate filers.

State law specifies that, for individuals, the period of the underpayment means the time period from the due date of the installment until either the 15th day of the 4th month beginning after the end of the taxable year (April 15 for calendar-year filers), or the date of payment, whichever is earlier. For corporations and pass-through entities, the period of underpayment means the time period from the due date of the installment until either the date on which the corporation or pass-through entity is required to file a return for federal income tax purposes, not including any extension, under the Internal Revenue Code (IRC), or the date of payment, whichever is earlier.

Normal (or delinquent) interest accrues on any tax amounts left unpaid after the established periods of underpayment for individuals, corporations, and pass-through entities. Normal interest accrues at a rate of 12% per year, while delinquent interest accrues at a rate of 18% per year. Current law specifies that no normal interest is required during the period of an extension for taxpayers who qualify for a federal extension of time to file due to a presidentially declared disaster, or a terroristic or military action. For corporations and pass-through entities, no interest is required during the extension period and for 30 days after the end of the extension period.

DISCUSSION POINTS

1. The provisions under current law that specify that UPI does not apply for individuals and corporations if the taxpayer qualifies for a federal extension of time to file their return due to a presidentially declared disaster were created under 2009 Act 28. Act 28 also specified that normal interest would not accrue during the extension period in the case that a taxpayer qualified for an extension of time to file due to such a disaster. While Act 28 was enacted in 2009, the federal filing date was not extended for tax year 2009, and these provisions did not play an active role in Wisconsin tax policy until 2020.

2. On March 13, 2020, President Trump declared a national emergency (which remains in effect) in response to the coronavirus pandemic. Following this declaration, the U.S. Department of Treasury and the Internal Revenue Service (IRS) announced on March 21, 2020, that the deadline for filing federal income tax returns was extended from April 15, 2020, to July 15, 2020. Taxpayers who owed final individual income tax or corporate income/franchise tax payments, or owed estimated income tax payments that would have otherwise been due on or after April 15, had until July 15 to make such federal payments, without incurring any interest or penalties, regardless of amounts owed by a taxpayer.

3. Under Wisconsin law, the DOR Secretary provided similar treatment in that state income and franchise taxpayers with federal tax filing due dates on or after April 1, 2020, and before July 15, 2020, had until July 15, 2020, to file their state income and franchise tax returns for tax year 2019, or to make their estimated payments otherwise due during that period, without interest, penalty, or UPI applying until July 15. As a result of the federal actions described above, state law waived all UPI owed on tax year 2019 estimated payments for all taxpayers with a taxable year ending December 31, 2019, and for certain other filers with an original or extended due date on or after April 1 and before July 15, 2020. It is estimated that the suspension of UPI for tax year 2019 reduced state income and franchise tax collections by $31.5 million.

4. On March 17, 2021, Treasury and the IRS again extended federal filing deadlines from April 15, 2021, to May 17, 2021. However, this extension only applied to final individual income tax payments for tax year 2020. The first installment of estimated tax payments for tax year 2021 calendar year filers remained due on April 15, 2021. Therefore, as required under current law, the DOR Secretary waived all UPI on tax year 2020 individual income tax estimated payments for all taxpayers with a tax return due date on or after April 15, 2021 (extended to May 17, 2021). It is estimated that the suspension of UPI for individual income taxpayers for tax year 2020 reduced state tax collections by $24.0 million.

5. While DOR cited current law as its authority for extending income/franchise tax filing deadlines, the statutes were somewhat ambiguous. To address this ambiguity, the Legislature passed 2021 Assembly Bill 18, which was signed into law as 2021 Act 40, on May 21, 2021. Act 40 modifies current law to establish the due date for state individual income tax returns as the date required to file the corresponding federal income tax return, not including any extension, to the IRS. Prior to Act 40, state law specified that individual income tax returns were due on or before April 15, for calendar year filers, or on or before the 15th day of the 4th month following the close of the fiscal year for non-calendar year filers. In contrast, state law for corporations already specified the due date for state corporate income/franchise tax returns as the date required to file the corresponding federal income tax return, not including any extension, to the IRS. Therefore, Act 40 provides consistency between individual and corporate state tax filing deadlines, while also clarifying that any future federal filing extensions are to be adopted by the state for both individual and corporate taxpayers.

6. However, the definition for the period of underpayment, as it relates to UPI, was not similarly updated in statute. For calendar year filers, UPI only accrues for individuals until April 15, regardless of when the individual is required to file for federal income tax purposes. However, for corporations and pass-through entities, UPI accrues until the date in which such taxpayers are required to file for federal income tax purposes. Therefore, if a taxpayer were to qualify for a federal extension of time to file for reasons other than a presidentially declared disaster or terroristic or military action, corporations and pass-through entities would owe UPI that would accrue during the extension period, while individuals would not. After these dates, normal or delinquent interest would accrue if the taxpayer had not yet filed their return.

7. If the Committee desires to provide consistent statutory treatment of UPI for individuals, corporations, and pass-through entities, it could modify the definition for the period of the underpayment for individuals to reference the "date on which the individual is required to file for federal income tax purposes, not including any extension, under the Internal Revenue Code", rather than the "15th day of the 4th month beginning after the end of the taxable year" (Alternative 1). Note that this modification would increase UPI on individuals when the original federal due date is extended for reasons other than a presidentially declared disaster, offset by lower normal or delinquent interest owed under current law (which may have otherwise accrued had the due date not been extended and the taxpayer filed late). Additionally, given the modified language related to individual income tax filing deadlines, as a result of Act 40, this alternative would provide consistency in language and treatment among individual income tax provisions as they apply to UPI and tax return filing dates.

8. Prior to deliberation of Act 28, a 2008 legislative proposal prepared by DOR recommended that state law be amended to prevent normal interest and UPI from accruing during a federal extension period that results from a presidentially declared disaster, or terroristic or military action, to align state treatment of interest accrual with federal treatment of interest accrual. However, rather than only eliminating UPI that would accrue during the extension period under the specified circumstances, Act 28 served to eliminate all UPI for individuals and corporate tax filers, in addition to waiving UPI that would accrue during the extension period, if affected by specified federal tax extensions.

9. As noted, the 2009 Act 28 provision did not affect Wisconsin taxpayers until 2020. If DOR's 2008 recommendation was the true intention of the Act 28 provision, the Committee may wish to modify current law to reflect this intention. The Committee could specify that the provision relating to the federal extension of time to file would only waive UPI that would otherwise accrue during the federal extension period, similar to how the accrual of interest is suspended under federal law, rather than all UPI for the applicable tax year (Alternative 2). The Committee could extend this provision to apply to pass-through entities to provide consistent statutory treatment for all income and franchise tax filers. If this provision had been in effect for tax years 2019 and 2020, the estimated foregone revenue from waiving UPI would have been considerably lower.

10. One possible rationale for the waiver of all UPI, if the taxpayer qualifies for a federal extension of time to file their tax return due to a presidentially declared disaster, is to provide relief to taxpayers who are struggling financially as a result of the disaster. For example, it is possible that some taxpayers who underpaid their tax year 2020 estimated payments did so due to financial hardship resulting from the coronavirus pandemic. However, this was likely not true for underpayments of tax year 2019 estimated payments, as most estimated payments for tax year 2019 were due prior to the start of the coronavirus pandemic. Failure to timely pay the full estimated payments was likely not attributable to hardships resulting from the pandemic for most corporations, and nearly all individuals, in tax year 2019. Therefore, the Act 28 provision resulted in a tax break for individuals and corporations that underpaid their taxes, regardless of the impacts from the coronavirus pandemic, while providing no tax benefit for timely filers.

11. As such, the Committee may wish to consider whether state law should require the waiver of all UPI for taxpayers qualifying for a filing extension due to a presidentially declared disaster, which may eliminate interest for taxpayers who were unaffected by the disaster and did not timely remit payments. As previously mentioned, current law allows the DOR Secretary to waive UPI for individuals and pass-through entities on a case-by-case basis if the Secretary determines that, because of casualty, disaster, or other unusual circumstances, it is not equitable to impose interest. This provision allows the waiver of UPI by the DOR Secretary to be optional for impacted filers, rather than required for all filers.

12. To allow the Secretary to waive UPI on a case-by-case basis, the Committee could take the following actions: (a) modify current law to state that no UPI is required if the Secretary of Revenue determines that, because of casualty, disaster, including a presidentially declared disaster or terroristic or military action, or other unusual circumstances, it is not equitable to impose interest; (b) expand this provision to apply to corporations; and (c) delete the waiver of UPI provisions related to the federal extension of time to file (Alternative 3). Under this alternative, a taxpayer qualifying for a federal extension of time to file would owe UPI, unless the Secretary determines that it is inequitable to impose the interest. However, current law would still suspend normal and delinquent interest that would otherwise accrue during the extension period. Additionally, the alternative would provide consistent treatment of UPI for individuals, corporations, and pass-through entities.

13. Finally, if the Committee is satisfied with how UPI is treated under current law, it could chose to take no action (Alternative 5).

ALTERNATIVES

1. Modify the definition for the period of the underpayment for individuals, estates, trusts, and partnerships, to reference the "date on which the individual is required to file for federal income tax purposes, not including any extension, under the Internal Revenue Code", rather than the "15th day of the 4th month beginning after the end of the taxable year". Specify that this provision first applies to UPI accruing on the effective date of the bill.

2. In addition to Alternative 1, modify the current law provisions that waive UPI for taxpayers qualifying for a federal extension of time to file due to a presidentially declared disaster, or terroristic or military action, to only apply to UPI that would otherwise accrue during the extension period. Adopt this provision to also apply for pass-through entities. Specify that this provision first applies to UPI accruing on the effective date of the bill.

3. In addition to Alternative 1, delete the current law provisions that waive UPI for taxpayers qualifying for a federal extension of time to file due to a presidentially declared disaster, or terroristic or military action. Modify current law related to individuals, estates, trusts, partnerships, and pass-through entities required to make estimated withholding payments to state that no UPI is required if the Secretary of Revenue determines that, because of casualty, disaster, including a presidentially declared disaster or terroristic or military action, or other unusual circumstances, it is not equitable to impose interest. Adopt this provision to also apply for corporate filers. Specify that this provision first applies to UPI accruing on the effective date of the bill.

4. Take no action.

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June, 2021 | Joint Committee on Finance | Paper #309

Individual Income Tax Withholding Table Adjustments (General Fund Taxes -- Income and Franchise Taxes)

CURRENT LAW

Taxable income, the amount of income actually subject to tax, is arrived at by subtracting the state's sliding scale standard deduction and personal exemptions from Wisconsin adjusted gross income. The state's tax rate and bracket structure is then applied to taxable income in order to determine an individual's gross tax liability.

Individuals with earned income (such as wages and salaries) have state income tax amounts withheld from their pay throughout the year. These withheld amounts are based on the individual income tax withholding tables prepared by the Department of Revenue (DOR). The withholding tables display the amount of state income tax to be withheld from the employee's wages by the employer. The amounts vary based on the employee's filing status, wages, and the frequency with which they are paid.

The Department is required "from time to time" to adjust these withholding tables to reflect any statutory changes to individual income tax rates and brackets. The withholding tables must also reflect allowable deductions from gross income, such as the state sliding scale standard deduction.

BACKGROUND

The individual income tax withholding tables were last adjusted on April 1, 2014. As such, the tables currently in effect are based on the tax rate and bracket structure that applied to tax year 2014.

Wisconsin utilizes multiple accounting methods for purposes of budgeting and reporting on

state finances. The modified cash accrual method compares revenues generated against expenditures incurred within a particular fiscal year. This method is employed for state budgetary purposes. Under the modified cash accrual method, the state budget is considered to be balanced if, between July 1 of one year and June 30 of the following year, the opening balance plus revenues equate to expenditures.

Conversely, generally accepted accounting principles (GAAP) dictate that expenditures are to be counted when they are committed, not when they are actually paid. For example, if the state committed $40 million in school aid in May, 2020, but did not remit that aid until July, 2020, GAAP mandates that the $40 million be accounted for in state fiscal year 2019-20, even though the payment was not made until fiscal year 2020-21. By contrast, the modified cash accrual method would account for the $40 million in 2020-21.

DISCUSSION POINTS

1. The Committee could direct the DOR Secretary to promulgate guidance, no later than October 1, 2021, for the individual income tax withholding tables to reflect the income tax rates, brackets, and sliding scale standard deduction in effect for tax year 2022. The withholding table change would take effect on January 1, 2022, and is estimated to reduce individual income tax revenues on a one-time basis by $331.2 million in 2021-22 (Alternative 1).

2. In its Comprehensive Annual Fiscal Report (CAFR) for 2019-20, the Department of Administration reports that the year-end general fund balance under GAAP was $1.5 million. However, the largest negative contribution to the GAAP general fund balance from any state funding commitment in 2019-20 came from the individual income tax (-$1.148 billion). Historically, the ending GAAP-based general fund balance has been negative each year since the state began issuing a CAFR in 1989-90. The individual income tax has consistently been a significant contributor to this deficit.

3. A large component of the individual income tax related portion of the GAAP commitment in 2019-20 is the fact that the withholding tables have not been adjusted since tax year 2014. Several tax law changes have occurred since tax year 2014 that have reduced individual income taxes, such as multiple tax rate reductions and an expansion of the sliding scale standard deduction for married-joint filers. Moreover, the dollar amounts in each tax bracket (as well as the standard deduction parameters) are adjusted for inflation each year under current law, but have not been inflation-adjusted under the withholding tables. Because no such indexing has occurred in the withholding tables since 2014, wages that have merely grown with inflation in the interim would inaccurately suggest for withholding purposes that a comparatively greater amount of tax is owed. For example, for a single individual with $24,000 of taxable income in tax year 2021, all of their income would be taxed within the first two income tax brackets under current law. However, under the current withholding tables, a portion of this same individual's income would be subject to income tax withholding under the third income tax bracket. Moreover, the income tax rates associated with the bottom two brackets are higher under the withholding tables (4.0% and 5.84%) than the rates under current law (3.54% and 4.65%). In general, because state withholding is based on the individual income tax provisions in effect for tax year 2014, the tax amounts that are withheld are larger than if

withholding were based on current law provisions. This process creates larger refunds for individuals when they file their tax returns, but it also reduces the GAAP general fund balance.

4. The GAAP-based general fund balance is reported as of June 30 for any calendar year. By this time, six months of withholding have occurred for the relevant tax year. To the extent that the tax amounts withheld during this period are too high relative to the taxes actually owed under current law, the GAAP deficit is widened by this difference. Some caution that carrying a large GAAP-based deficit overestimates the soundness of the state's financial position, which is typically examined using the modified cash accrual method. The ending general fund balance under the modified cash accrual method of accounting is balanced from the perspective of cash available in the state's general fund, but it does not consider the pending liability associated with individual income tax refunds that must be paid in the subsequent fiscal year.

5. In addition to reducing the GAAP deficit, adjusting the withholding tables would allow taxpayers to better realize the effect of recent tax cuts throughout the year. Because state income tax withholding under Alternative 1 would be reduced to reflect the current law rates and brackets, taxpayers would have more money remaining in each paycheck. This could help households smooth their consumption throughout the year, instead of potentially postponing certain purchases until receipt of a greater tax refund after filing their income tax return. Though the withholding table adjustment would generally lead to lower refunds, taxpayers who prefer to receive larger refunds could simply adjust their withholding to have additional tax amounts withheld from each paycheck.

6. Any adjustment to the withholding tables requires information technology (IT) resources to implement the necessary software changes. If an employer outsources these IT functions to an outside vendor, the employer is subject to that vendor's timeline for completing the necessary changes. Moreover, the employer must alter its internal payroll procedures to accommodate the new withholding tables. For these reasons, DOR advocates that employers need at least three months advance notice to effectively implement a withholding table adjustment. Alternative 1 would ensure employers have a minimum lead time of three months to accommodate the withholding table change prior to the effective date of the change on January 1, 2022.

7. The main drawback of adjusting the withholding tables is the significant one-time cost to the state's general fund. It should be noted that, absent other tax law changes, this one-time cost will continue to increase each year that the tables are not adjusted. As noted above, the withholding table adjustment under Alternative 1 would reduce individual income tax revenues by an estimated $331.2 million on a one-time basis in 2021-22. However, this revenue reduction would be offset in 2022-23 because refunds owed to taxpayers would decrease by an amount equivalent to the reduced withholding amounts during the preceding 12-month period. Therefore, the one-time revenue reduction associated with any withholding table change represents a temporary reduction in cash flow, which is then compensated in the subsequent fiscal year through lower refunds. However, for state budgetary purposes under the modified cash accrual accounting method, this one-time revenue reduction must still be accounted for because of differences in timing between the state fiscal year and the tax year. The effect of this timing difference is that the reduction in withholding amounts in the final six months of state fiscal year 2021-22 resulting from a withholding table change effective January 1, 2022, is not offset by lower refunds in that same fiscal year, but rather is offset in the next

fiscal year (2022-23).

ALTERNATIVES

1. Direct the DOR Secretary to promulgate guidance no later than October 1, 2021, updating the individual income tax withholding tables to reflect the tax rates, brackets, and sliding scale standard deduction in effect for tax year 2022. Specify that these withholding table changes first take effect on January 1, 2022. Estimate a one-time reduction in individual income tax revenues of $331,200,000 in 2021-22.

ALT 1	Change to Base
GPR-Tax	-$331,200,000

2. Take no action.

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June, 2021 | Joint Committee on Finance | Paper #310

Family Caregiver Tax Credit
(General Fund Taxes -- Income and Franchise Taxes)

[LFB 2021-23 Budget Summary: Page 204, #4]

CURRENT LAW

Taxable income, the amount of income actually subject to the individual income tax, is derived by subtracting the state's sliding scale standard deduction and personal exemptions from Wisconsin adjusted gross income (AGI). The state's tax rate and bracket structure is then applied to taxable income to compute gross tax liability. Net tax liability results from subtracting any applicable nonrefundable credits from gross tax liability.

In general, nonrefundable credits must be claimed within four years of the unextended due date of the income tax return to which the claim relates. Nonresidents and part-year residents of Wisconsin are generally not eligible to claim these credits. Most credits are not allowed for a tax year covering a period of less than 12 months, except for a tax year that was closed because of the death of the taxpayer. Generally, current law provisions which apply to the individual income tax relating to the enforcement authority of the Department of Revenue (DOR), and to assessments, refunds, appeals, collection, interest, and penalties, also apply to nonrefundable credits.

BACKGROUND

The Family Caregiver Alliance (FCA), a research and policy organization that provides services to family caregivers, defines a family caregiver as "any relative, partner, friend, or neighbor who has a significant personal relationship with, and provides a broad range of assistance for, an older person or an adult with a chronic or disabling condition." According to estimates from the American Association of Retired Persons (AARP), there are 53 million family caregivers in the United States. The median age of a family caregiver is 51 years old, and approximately three out of every five caregivers are women. AARP reports that 61% of family caregivers are employed

for at least some time during the year. Of those employed, 60% work full-time, while another 15% work at least 30 hours.

In February, 2019, Governor Evers signed Executive Order #11, which created the Governor's Task Force on Caregiving. The taskforce concluded its work on February 25, 2021, and commissioned a report outlining several policy recommendations. In its report, the taskforce highlighted the projected aging of the Wisconsin population, noting that between 2015 and 2040, the population aged 65 and older in Wisconsin is estimated to grow by 640,000 (or 72%). Individuals aged 65 and older comprised 15% of the Wisconsin population in 2015, but are projected to comprise 24% of the state population by 2040. Per the report, this demographic trend will contribute to a growing shortage of caregivers because more elderly people are likely to need care, and because a considerable share of current caregivers are older and will need to stop their caregiving duties as they age. AARP research finds that 34% of current caregivers belong to the "Baby Boomer" generation (born 1946 to 1964) and 7% of current caregivers were born in 1945 or earlier. Moreover, the taskforce report cautions that a continuing shortage of professional caregivers in Wisconsin (such as home health aides) heightens the burden placed on family caregivers to provide care.

DISCUSSION POINTS

1. The Governor's caregiving taskforce posited that the COVID-19 pandemic and its economic fallout would be especially harmful for family caregivers and care recipients, citing that nearly 60% of caregivers are low-wage workers. These workers were disproportionately likely to suffer job losses during the pandemic. Research from the National Alliance for Caregiving (NAC) on the economic impact of the Great Recession on caregivers returned similar findings. Particularly, 43% of caregivers experienced a reduction in pay or hours worked as a result of that economic downturn, and 15% reported losing their job outright. It could be argued that providing an income tax credit for caregiving expenses would help cushion the continuing negative economic impacts of the pandemic recession in 2021 on family caregivers.

2. FCA reports that family caregivers provided $375 billion (in 2007 dollars) of care services to individuals. Moreover, the FCA estimates that the average family caregiver foregoes almost $660,000 of income over their lifetime ($25,000 in Social Security benefits, $67,000 in other retirement benefits, and $566,000 in foregone wage earnings) to provide care for their family members, at least some of whom would otherwise need governmental support for their care. The FCA reports that 549,000 family caregivers provided more than $5.8 billion of caregiving services in Wisconsin in 2014. This dollar value represents the estimated cost of replacing services provided by family caregivers with professional services. It could be argued that, because family caregivers provide services that help reduce government spending, and simultaneously forego the receipt of certain government benefits themselves, the government has a strong incentive to provide targeted financial assistance to these caregivers.

3. In Wisconsin in particular, there is a continued shortage of professional caregiving services. The Wisconsin Survival Coalition of Disability Organizations reports that there is a growing shortfall of direct care providers in the state, and that this has put additional strain on family caregivers

to fill the resulting gaps in care. Survival Coalition finds that 95% of people with disabilities and their families who were surveyed faced difficulties securing caregiving services. Moreover, 45% of survey respondents reported being unable to secure at least seven shifts of caregiving services per month. During the public hearings held on Assembly Bill 68/Senate Bill 111, several speakers gave testimony in support of additional funding and support for family caregivers in Wisconsin.

4. To provide additional support to these family caregivers, the Committee could consider creating a nonrefundable individual income tax credit, beginning in tax year 2021, for 50% of the qualified expenses incurred by a family caregiver to benefit a qualified family member (Alternative 1a). If such a credit were implemented beginning in tax year 2021, individual income tax revenues would decline relative to current law by an estimated $121.4 million in 2021-22 and $118.0 million in 2022-23 and annually thereafter. A qualified family member would mean an individual who: (a) is 18 years of age or older during the relevant tax year; (b) requires assistance with one or more daily living activities, as certified in writing by a physician; and (c) is the claimant's family member (defined as a spouse or an individual related by blood, marriage, or adoption within the 3rd degree of kinship). The maximum credit that a claimant could claim each tax year would equal $500 ($250 for married-separate filers) per qualified family member. A similar credit (though double the maximum amount) was proposed by the Governor's Task Force on Caregiving. Per the administration, the $500 maximum credit amount was selected in order to reduce the overall cost of the credit.

Qualified expenses for purposes of the credit would mean amounts paid by a claimant in the relevant tax year for items that relate directly to the care or support of a qualified family member, including: (a) the improvement or alteration of the claimant's primary residence to enable or assist the qualified family member to be mobile, safe, or independent; (b) the purchase or lease of equipment to enable or assist the qualified family member to carry out one or more activities of daily living; and (c) the acquisition of goods or services, or support, to assist the claimant in caring for the qualified family member, including employing a home care aide or personal care attendant, adult day care, specialized transportation, legal or financial services, or assistive care technology. However, qualified expenses would not include: (1) general food, clothing, or transportation expenses; (2) ordinary household maintenance or repair expenses that are not directly related to, or necessary for, the care of the qualified family member; or (3) any amount that is paid, reimbursed, or eligible for reimbursement by insurance or other means. Individuals who incur expenses for the same qualified family member would be required to allocate their respective credit amount based on their share of the total expenses incurred on behalf of that family member. Current law provisions governing DOR enforcement and administrative authority related to tax credits, as well as procedures for claiming such credits, would also apply to the proposed caregiver credit.

5. If the Committee desires to increase the progressivity of, and reduce the cost of, the credit, the Committee could stipulate that the credit phases out for taxpayers with federal AGI between $75,000 and $85,000, or between $150,000 and $170,000 for married-joint filers (Alternative 1b). Such a phaseout could be structured so that the credit which the claimant would otherwise be eligible to receive would be reduced by the amount by which their federal AGI exceeds the threshold over the total threshold amount. For example, a married-joint filer with $160,000 of federal AGI would experience a 50% reduction in their credit amount (excess = $160,000 - $150,000 = $10,000. Total threshold amount = $170,000 - $150,000 = $20,000. Phase-out amount = $10,000 / $20,000 = 50%). A credit with such a phase-out provision was included in AB 68/SB 111, and is estimated to reduce

individual income tax revenues relative to current law by $100.4 million in 2021-22 and $102.5 million in 2022-23 and annually thereafter.

6. The fiscal estimates presented in this paper are based on data from NAC, AARP, and the Transamerica Institute (a nonprofit health coverage research organization), as well as a simulation of Wisconsin tax year 2019 individual income tax data by DOR. Based on these sources, an estimated 276,000 taxpayers would be eligible for the credit under Alternative 1a in tax year 2021, and their average credit is estimated to be $419, for a total estimated cost of $115.6 million in tax year 2021. An estimated 250,000 taxpayers would be eligible for the credit under Alternative 1b in tax year 2021, and their estimated average credit would equal $402, for a total estimated cost of $100.4 million in tax year 2021. Alternatives 1 through 4 all include an "a" and "b" option. The "a" option would provide the proposed credit to all individuals regardless of income, whereas the "b" option would phase out the credit for taxpayers with federal AGI between $75,000 and $85,000, or between $150,000 and $170,000 for married-joint filers (the same phaseout as was proposed in AB 68/SB 111).

7. Under Alternative 1b, if two siblings performed caregiving duties for their mother and each incurred $1,500 of expenses (assume $3,000 of total eligible expenses were spent caring for their mother) each would be eligible to claim half of the maximum $500 credit ($250 each). However, if one sibling has a federal AGI of $80,000 as a single filer, their $250 credit would be reduced to $125, reducing the total credit amount to $375 between the two siblings. In order to allow the other sibling to claim the remaining $125 for eligible expenses incurred, the Committee could provide that the siblings could submit to DOR an alternative credit allocation that allows them to claim (in aggregate between both siblings) the full credit amount of $500 for which they are eligible based on total qualified expenses incurred per qualified family member.

8. A general critique of phase-out provisions is that they increase the marginal effective rate of taxation paid by taxpayers with incomes inside the phase-out range. For example, a taxpayer filing married-joint with $155,000 of federal AGI and $1,000 of eligible caregiver expenses would normally be subject to a top marginal state tax rate of 6.27%. This taxpayer would receive the full $500 credit under Alternative 1a, and would continue to be subject to the 6.27% rate. However, with the phaseout included in Alternative 1b, such a taxpayer would only receive a $375 credit, and would thereby experience an increase of 2.5% in their marginal effective tax rate ($125 / $5,000 = 2.5%). In other words, the taxpayer incurs an additional $2.50 of tax for each $100 they earn over the phase-out threshold of $150,000 under Alternative 1b. As a result, a married-joint taxpayer with federal AGI of $155,000 would pay a top marginal effective tax rate of 6.27% under Alternative 1a, but would pay a top marginal rate of 8.77% under Alternative 1b (6.27% + 2.5%). On the other hand, phase-outs are useful as a mechanism for controlling the cost of tax provisions, and for increasing their progressivity. Each alternative to the proposed caregiver credit presented in this paper includes an option to retain or remove the phase-out provision that was included in AB 68/SB 111.

9. According to survey research conducted by the Transamerica Institute, the likelihood of family caregivers being employed increases with household income. For example, the survey reports that 26% of family caregivers with household income of $25,000 or less are employed, compared to 41% of caregivers with income between $25,000 and $50,000, 62% of caregivers with income between $50,000 and $100,000, and 70% of caregivers with household income of $100,000 or more. Furthermore, 21% of family caregivers with household income below $25,000 have quit their job

because of their caregiving duties, compared to 10% of family caregivers with comparatively higher incomes. This is perhaps one reason why the median hours spent performing caregiving duties per month by those with household income of $25,000 or less is approximately double the median monthly hours spent by family caregivers in any other income group. These data suggest that the negative association between caregiving and employment is especially pronounced for family caregivers with lower levels of household income. Because Alternative 1b phases out the credit at higher incomes, a greater share of tax relief would be directed to these lower-income individuals, who are more likely to be working fewer hours or to be unemployed as a result of their caregiving.

10. The same survey data from the Transamerica Institute find that an estimated 15% of all family caregivers self-report that their financial well-being is poor, and an additional 29% of caregivers report that their financial well-being is fair. Nearly half (49%) of all caregivers state that paying off some form of debt (mortgage, credit card, student loans) is a personal financial priority. Moreover, 22% of primary family caregivers indicate that their financial circumstances have worsened since assuming caregiver responsibilities. Transamerica reports that the median monthly amount of expenses incurred by family caregivers is $150 ($1,800 per year), and 75% of caregivers report that they receive no sources of financial assistance for their caregiving duties.

11. Data from a 2007 study by the NAC suggest that the average annual caregiver expenses that would be eligible for the proposed credit could be as high as $2,570 ($3,325 in 2021 dollars). If the Committee wishes to provide a credit which better accounts for the median or mean caregiver-related expenditures incurred, it could increase the maximum credit amount which may be claimed each tax year (Alternatives 2a and 2b). A maximum credit of $1,000 per qualified family member ($500 for married-separate filers) is considered under Alternative 2, which is the same amount proposed by the Governor's Task Force on Caregiving. Alternative 2a would decrease individual income tax collections relative to current law by an estimated $213.9 million in 2021-22 and $208.0 million in 2022-23 and annually thereafter. Alternative 2b would decrease individual income tax collections by an estimated $173.9 million in 2021-22 and $177.6 million in 2022-23 and annually thereafter.

12. The FCA highlights specific financial challenges which can result from being a family caregiver, such as: (a) an overall strain on household resources due to the potential loss of income for both care recipient and caregiver; (b) lack of access to employer-provided medical care which would otherwise provide a subsidy for caregiving duties; (c) a reduction in savings resulting from significant caregiver-related expenses; and (d) lower retirement contributions owing to lower levels of discretionary income. According to FCA, these effects can compound upon each other to exacerbate financial difficulties for caregivers. AARP reports that 28% of caregivers have stopped saving, and 23% of caregivers have assumed more debt, as a result of their caregiving.

13. To help offset these financial challenges, the FCA recommends that refundable tax credits be offered to family caregivers. Refundable credits are so named because if the credit amount exceeds the claimant's tax liability, the balance is refunded to the claimant. Unlike nonrefundable credits, refundable credits are available to individuals with no net income tax liability, who tend to be lower-income individuals. In tax year 2019, for example, 33% of taxpayers with Wisconsin AGI of $25,000 or less had a net tax liability. By contrast, over 99% of taxpayers with Wisconsin AGI of $100,000 or more in tax year 2019 had a net tax liability.

14. Data from the NAC confirm that lower-income individuals are more likely than higher-income individuals to experience financial constraints as a result of caregiving. Their survey research finds that, on average, individuals with the lowest incomes spent the greatest proportion of their income (over 20%) on caregiving expenses, relative to higher-income individuals. Moreover, low-income individuals were most likely (49%) to report that their financial situation deteriorated as a result of their caregiving duties. If the Committee wishes to ensure that tax relief is successfully provided to these lower-income caregivers, it could consider making the caregiver credit refundable (Alternatives 3a and 3b). Such an approach would increase the number of eligible credit recipients and, in some cases, increase the applicable credit amount that could be claimed, relative to a nonrefundable credit. Refundable credits are generally paid from a sum sufficient appropriation and recorded as GPR expenditures, rather than reductions in tax revenue. Therefore, Alternative 3a would increase state GPR expenditures relative to current law by an estimated $157.3 million in 2021-22 and $152.9 million in 2022-23 and annually thereafter, and Alternative 3b would increase GPR expenditures by an estimated $134.4 million in 2021-22 and $137.2 million in 2022-23 and annually thereafter.

15. Alternatively, the Committee may still wish to provide a nonrefundable tax credit to family caregivers, but at a lower cost to the state's general fund. There are several ways the Committee could choose to reduce the cost of the credit, such as by: (a) reducing the percentage of expenses reimbursed (compared to 50%); (b) decreasing the maximum credit amount; (c) imposing a phase-out which begins to apply at lower incomes and/or that phases out the credit over a smaller range of incomes (this would imply a higher effective marginal tax rate for individuals with incomes inside the phase-out range); or (d) some combination therein. Though the Committee could select any method it prefers to reduce the cost of the credit, this paper considers the fiscal effect of lowering the reimbursement percentage from 50% to 25% with and without an income-based phase-out (Alternatives 4a and 4b). Alternative 4a is estimated to reduce individual income tax collections relative to current law by $114.9 million in 2021-22 and $111.7 million in 2022-23 and annually thereafter, while Alternative 4b is estimated to reduce individual income tax collections by $94.5 million in 2021-22 and $96.5 million in 2022-23 and annually thereafter.

16. In certain instances, a family caregiver may be eligible to claim the proposed caregiver credit and the current law deduction for child and dependent care expenses (discussed in detail in LFB Paper #311) for the same expenditures. For example, if a caregiver hires a home health aide to help care for certain qualified family members (such as a spouse who is mentally or physically incapable of self-care) while the caregiver is at their job, these expenses would be eligible for the caregiver credit and the child and dependent care expenses deduction. In general, effective tax policy discourages providing this sort of double tax benefit on the same income (just as it attempts to avoid taxing the same income twice). If the Committee desired to provide a similar caregiver credit to those described in this paper, it may also wish to disallow claiming the proposed credit and the current law child and dependent care expense deduction for the same expenses (Alternative 5). It is estimated that such a provision would increase individual income tax revenues relative to current law by $200,000 on an annual basis. Alternative 5 can be selected in addition to any other alternative presented in this paper.

17. Of the surrounding states, Iowa allowed an individual to claim an income tax deduction in 2019 for up to $5,000 of expenses incurred to care for a disabled relative living in the individual's

home. Iowa also provided a deduction in tax year 2019 for the full amount of state supplementary assistance payments (intended for low-income and disabled residents) received by individuals who provided unskilled, in-home, health-care-related services to family members. As a matter of tax policy, some experts generally prefer tax credits over deductions to income. Deductions treat taxpayers differently depending on the taxpayer's income and tax bracket. For example, a $5,000 deduction from income for caregiver expenses would provide a tax reduction of $177 to a taxpayer whose taxable income falls entirely within the state's 3.54% tax bracket, and a $383 tax reduction to a taxpayer whose last $5,000 of income is subject to the state's 7.65% marginal tax rate. Based on the same $5,000 expense, a 6% tax credit would result in a $300 tax benefit regardless of the taxpayer's income, thereby providing more uniform treatment to taxpayers.

18. However, critics of tax credits in general may argue that they are a flawed way to provide economic support to a particular group. They might contend that a caregiver credit, like that discussed in this paper, disguises what is functionally an at-home health care subsidy program as a tax credit. In their view, this can obscure the underlying goal of providing for a care recipient's health and wellbeing by framing the policy as tax relief for caregivers. They caution that supplanting appropriated expenditures with tax reductions for similar policy goals can complicate lawmakers' and citizens' ability to make informed decisions on the policy merits of such a program. If the Committee wishes to provide economic support to caregivers to aid them in ensuring the health of their family members, they may not wish to provide a tax credit (Alternative 6). Instead, they might propose to spend a similar amount on an alternative program that is more explicitly targeted to caregivers and care recipients.

19. For example, taxpayers could submit to DOR a report of their eligible caregiver expenses, and DOR could then issue grants to these caregivers for 50% of such expenses, up to a $500 maximum grant ($250 for married-separate filers) per qualified family member. Although DOR is presented as the agency to administer the grant program under this alternative, existing taxpayer data would not assist the Department in verifying caregiver claims and the Committee could choose any agency it believes is best suited to administer the program. DOR has indicated that additional funding and staff would be necessary to carry out such a grant program.

20. If the Committee chooses to create a grant program to reimburse eligible family caregiver expenses, the grants and administrative costs to the Department could be paid from a sum sufficient GPR appropriation under DOR. The Committee could require that, prior to making a grant or incurring an expenditure from this appropriation, DOR submit to the Committee a plan for implementing the program, including associated costs and positions needed to administer the program and to review applications received under the program. After receiving the plan, the Co-chairpersons of the Committee could either: (a) direct DOR to implement the plan; or (b) convene a meeting of the Committee within 14 days after the plan is submitted to approve, or modify and approve, the plan. The Department would have to implement the plan, as approved by the Committee, and could not utilize the sum sufficient appropriation to pay for administrative costs beyond the amount authorized by the Committee.

ALTERNATIVES

Nonrefundable Caregiver Credit of up to $500

1. Provide a nonrefundable individual income tax credit beginning in tax year 2021 for 50% of the qualified expenses incurred by a family caregiver to benefit a qualified family member. Specify that qualified expenses would not include any amount that is paid, reimbursed, or eligible for reimbursement by insurance or other means. Stipulate that the maximum credit that a claimant could claim each tax year equals $500 ($250 for married-separate filers) per qualified family member. [The credit is described in greater detail under Discussion Point #4.] In addition:

a. Specify that the credit is made available to all claimants regardless of their federal AGI. Decrease individual income tax collections by an estimated $121,400,000 in 2021-22 and $118,000,000 in 2022-23 and annually thereafter.

ALT 1a	Change to Base
GPR-Tax	- $239,400,000

b. Specify that the credit phases out for married-joint taxpayers with federal AGI between $150,000 and $170,000, and for all other filers with federal AGI between $75,000 and $85,000. In a situation where multiple claimants could claim creditable expenses on behalf of the same qualified family member, and at least one (but not every) claimant is affected by the phaseout, provide that the claimants could submit to DOR a credit allocation enabling (in aggregate between all claimants) the full credit amount for which they are eligible to be claimed based on total qualified expenses incurred for a qualified family member. Estimate decreased individual income tax collections of $100,400,000 in 2021-22 and $102,500,000 in 2022-23 and annually thereafter.

ALT 1b	Change to Base
GPR-Tax	- $202,900,000

Nonrefundable Caregiver Credit of up to $1,000

2a. Adopt Alternative 1a, but stipulate that the maximum credit that a claimant could claim each tax year equals $1,000 ($500 for married-separate filers) per qualified family member. Estimate decreased individual income tax collections of $213,900,000 in 2021-22 and $208,000,000 in 2022-23 and annually thereafter.

ALT 2a	Change to Base
GPR-Tax	- $421,900,000

2b. Adopt Alternative 1b, but stipulate that the maximum credit that a claimant could claim each tax year equals $1,000 ($500 for married-separate filers) per qualified family member. Estimate decreased individual income tax collections of $173,900,000 in 2021-22 and $177,600,000 in 2022-

23 and annually thereafter.

ALT 2b	Change to Base
GPR-Tax	- $351,500,000

Refundable Caregiver Credit of up to $500

3a. Adopt Alternative 1a, but make the credit refundable. Estimate increased GPR expenditures of $157,300,000 in 2021-22 and $152,900,000 in 2022-23 and annually thereafter.

ALT 3a	Change to Base
GPR	$310,200,000

3b. Adopt Alternative 1b, but make the credit refundable. Estimate increased GPR expenditures of $134,400,000 in 2021-22 and $137,200,000 in 2022-23 and annually thereafter.

ALT 3b	Change to Base
GPR	$271,600,000

Nonrefundable Caregiver Credit of up to $500 for 25% of Expenses

4a. Adopt Alternative 1a, but specify that the credit is based on 25%, rather than 50%, of the qualified expenses incurred by a family caregiver to benefit a qualified family member. Estimate decreased individual income tax collections of $114,900,000 in 2021-22 and $111,700,000 in 2022-23 and annually thereafter.

ALT 4a	Change to Base
GPR-Tax	-$226,600,000

4b. Adopt Alternative 1b, but specify that the credit is based on 25%, rather than 50%, of the qualified expenses incurred by a family caregiver to benefit a qualified family member. Estimate decreased individual income tax collections of $94,500,000 in 2021-22 and $96,500,000 in 2022-23 and annually thereafter.

ALT 4b	Change to Base
GPR-Tax	-$191,000,000

Disallow Combining Caregiver Credit and Current Law Child Care Expense Deduction

5. Prohibit an individual from claiming the family caregiver tax credit, or a caregiver grant, and the current law child and dependent care expense deduction (or the child and dependent care credit if adopted under LFB Paper #311) for the same expenses. Estimate increased individual income tax collections relative to current law of $200,000 on an annual basis. [This alternative would only result in a fiscal effect if adopted in conjunction with another alternative in this paper.]

ALT 5	Change to Base
GPR-Tax	$400,000

Create Caregiver Grant Program

6. Take no action on creating a credit for caregiver expenses. Instead, authorize DOR to create and administer a grant program whereby family caregivers report their eligible expenses to the Department. Specify that qualified expenses would not include any costs which are eligible to be reimbursed by a third party. Require DOR to submit to the Joint Committee on Finance a plan for implementing the program, including associated costs and positions needed to administer the program and to review applications received under the program. Require the Co-chairpersons of the Committee, after receiving the plan, either to: (a) direct DOR to administer the plan; or (b) convene a meeting of the Committee within 14 days after the plan is submitted to approve, or modify and approve, the plan. Require the Department to implement the plan as approved by the Committee, and prohibit DOR from utilizing the sum sufficient appropriation to pay for administrative costs beyond the amount authorized by the Committee. Create a sum sufficient GPR appropriation to pay grants and administrative costs incurred by the Department to administer the program. Estimate increased GPR expenditures relative to current law of $100,400,000 in 2021-22 and $102,500,000 in 2022-23 and annually thereafter.

ALT 6	Change to Base
GPR	$202,900,000

7. Take no action.

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June, 2021 Joint Committee on Finance Paper #311

Child and Dependent Care Expenses Tax Credit
(General Fund Taxes -- Income and Franchise Taxes)

[LFB 2021-23 Budget Summary: Page 209, #7]

CURRENT LAW

Federal law provides a nonrefundable individual income tax credit for child and dependent care expenses that are paid for the purpose of enabling a taxpayer to be gainfully employed. The maximum amount of expenses that can be claimed for the federal credit (maximum creditable expenses) is $3,000 if the claimant has one qualifying child or dependent and $6,000 if the claimant has more than one qualifying child and/or dependent. The credit is calculated as a percentage of eligible expenses (reimbursement percentage), with the reimbursement percentage ranging from 35% to 20%, depending on the claimant's federal adjusted gross income (AGI). For tax year 2020, the maximum reimbursement percentage of 35% begins to phase down once federal AGI exceeds $15,000. The minimum reimbursement percentage (20%) is provided once a taxpayer's federal AGI reaches $43,000.

Expenses related to child and dependent care are deductible from income for state tax purposes. The deduction equals up to $3,000 for one qualified individual and up to $6,000 for more than one qualified individual. The deduction is based on the expenses claimed for purposes of the aforementioned federal credit, and must be deducted for the same taxable year as the year to which the claim for the federal credit relates.

Eligible claims for the federal credit must satisfy several tests, including a qualifying person test. Under the federal provisions, a qualifying person includes: (a) the claimant's qualifying child, who is the claimant's dependent and who was under the age of 13 when the care was provided; (b) the claimant's spouse who was physically or mentally not able to care for himself or herself and lived with the claimant for more than half the year; and (c) a person who was physically or mentally

not able to care for himself or herself, lived with the claimant for more than half the year, and, with certain exceptions, was the claimant's dependent.

The following federal tests must also be met to claim the child and dependent care credit: (a) with an exception related to being a student, the individual claiming the credit (and the individual's spouse, if married) must have earned income during the year; (b) the child and dependent care expenses must be paid so that the individual claiming the credit (and the individual's spouse, if married) can work or look for work; (c) the payments for the child and dependent care must be made to someone who cannot be claimed as a dependent of the individual claiming the credit or the individual's spouse; (d) in general, the claimant's filing status must be single, head-of-household, qualifying widow(er) with dependent child, or married filing jointly; and (e) the care provider must be identified on the claimant's tax return. In addition, if a claimant excludes or deducts dependent care benefits provided by a dependent care benefit plan, the total amount excluded or deducted under such a plan must be less than the dollar limit for qualifying expenses under the credit. This dollar limit ($3,000 for one qualifying individual or $6,000 for more than one qualifying individual) is reduced by the amount of such dependent care benefits.

BACKGROUND

Federal law has provided a child and dependent care tax credit since 1976. The state's child and dependent care deduction took effect in tax year 2011. The deduction was phased in over a four-year period starting in tax year 2011 (at which time the maximum deduction was $750 or $1,500 for taxpayers with two or more qualifying dependents). The maximum deduction increased each year until reaching the current amounts in tax year 2014. Over this four-year period, the maximum deduction amount increased by $750 each year (or $1,500 each year for taxpayers with two or more qualifying dependents).

DISCUSSION POINTS

1. For tax year 2021 only, the American Rescue Plan Act of 2021 (ARPA) expands the federal child and dependent care tax credit as follows. The Act increases the maximum creditable expenses from $3,000 to $8,000 for claimants with one qualifying dependent, and from $6,000 to $16,000 for claimants with two or more qualifying dependents. In addition, ARPA raises the maximum reimbursement percentage from 35% to 50%, and increases the federal AGI level at which the percentage begins to phase down from $15,000 to $125,000. As a result of these expanded parameters, the maximum credit for tax year 2021 is increased for claimants under the initial phase-out income with one qualifying dependent from $1,050 to $4,000, and for such claimants with two or more qualifying dependents from $2,100 to $8,000. In addition, the credit is made refundable for U.S. resident taxpayers. ARPA reduces the minimum reimbursement percentage (currently 20%) for tax year 2021 by one percentage point for every $2,000 of federal AGI in excess of $400,000. Therefore, the credit is disallowed for a claimant with $440,000 or more of federal AGI.

2. The Committee could decide to create a nonrefundable state individual income tax credit for child and dependent care expenses beginning in tax year 2021 (Alternative 1). Such a credit could

be set equal to 50% of the amount of the federal child and dependent care expenses tax credit (set forth under the Internal Revenue Code, or IRC) that a claimant is eligible to claim on the claimant's federal income tax return for the same tax year. To avoid providing a double tax benefit on the same income, the current law deduction for household and dependent care expenses would be sunset concurrently, beginning in tax year 2021.

No state child and dependent care expenses tax credit would be allowed unless it were claimed within four years of the unextended due date of the income tax return to which the claim relates. Nonresidents and part-year residents of Wisconsin would be prohibited from claiming the credit. No credit could be allowed for a tax year covering a period of less than 12 months, except for a tax year that was closed because of the death of the taxpayer. Current law provisions which apply to the individual income tax and relate to DOR's enforcement authority, and to assessments, refunds, appeals, collection, interest, and penalties, would also apply to this credit. Couples who are married at the end of a tax year would be required to claim the credit as married-joint filers for that tax year, except married persons living apart and treated as single under the IRC could claim the credit as if a single or head-of-household claimant.

A similar proposal is included in Assembly Bill 68/Senate Bill 111, and was estimated to decrease individual income tax collections by $9.8 million annually in 2021-22 and 2022-23. However, that proposal was introduced prior to the passage of ARPA, so it did not consider the expanded federal credit parameters for tax year 2021. Alternative 1 is based on these expanded federal credit parameters for tax year 2021, and is now estimated to reduce individual income tax revenues by $31.3 million in 2021-22 ($21.5 million higher than previously estimated).

3. As a matter of tax policy, some experts generally prefer tax credits over deductions from income. Deductions treat taxpayers differently depending on the taxpayer's income and tax bracket. For example, a $2,000 deduction from income would provide a tax reduction of $71 to a taxpayer whose taxable income falls entirely within the state's 3.54% tax bracket, and a $153 tax reduction to a taxpayer whose last $2,000 of taxable income is subject to the state's 7.65% marginal tax rate. Based on the same $2,000 expense, a 6% tax credit would result in a $120 tax reduction regardless of the taxpayer's income, thereby providing more uniform treatment to taxpayers incurring the same expense amount.

4. Each of the state's largest nonrefundable tax credits for individuals is based on a single credit rate -- 12% for the property tax/rent credit, 5% for the itemized deduction credit, and 3% for the married couple credit. While the proposed credit would be calculated using a single credit rate of 50% of the federal credit, the state credit would be based on the federal child and dependent care credit, which uses 16 separate credit rates. The temporary expanded parameters for the federal credit were described above. Under the permanent credit parameters beginning in tax year 2022, these percentages phase down from 35% for claimants whose federal AGI is below $15,000, to 20% for claimants whose federal AGI is over $43,000. Based on $6,000 in eligible expenses, the maximum state credit would equal $1,050 for a claimant with federal AGI of $15,000 or less and $600 for a claimant with federal AGI of more than $43,000. As a result of the sliding scale in the federal credit rate, a lower-income taxpayer with the same eligible child or dependent care expenses as a higher-income taxpayer would receive a larger state credit under the credit structure proposed in this paper.

5. The credit under Alternative 1 would reduce individual income tax collections by an estimated $50.2 million in tax year 2021 and $28.7 million in tax year 2022. Because the proposal would sunset the current law deduction for child and dependent care expenses, which already reduces state tax revenue by an estimated $18.9 million annually, the net effect of the proposed credit would be to reduce individual income tax collections relative to current law by an estimated $31.3 million in tax year 2021 and $9.8 million in tax year 2022.

6. Attachment 1 reports the estimated distribution of taxpayers with a tax decrease under Alternative 1 for tax year 2021 and tax year 2022. An estimated 109,970 taxpayers in tax year 2021, and 106,840 taxpayers in tax year 2022, would experience a tax decrease. The average tax reduction would equal $285 in tax year 2021 and $91 in tax year 2022. For tax year 2021, claimants with Wisconsin AGI of $100,000 or more would receive a larger average tax reduction ($364) than claimants with AGI under $100,000 ($209). This is most likely the result of those claimants having a higher number of eligible children and/or higher average child care costs. For tax year 2021, taxpayers with AGI of less than $100,000 represent 51.2% of the taxpayers with a tax reduction, and they would receive 37.7% of the total tax decrease. Taxpayers with AGI of $100,000 or more would receive 62.3% of the estimated tax decrease and represent 48.8% of the taxpayers with a tax decrease in tax year 2021. The small percentage of filers receiving a tax decrease (just over 3% in both years) is due to the credit being limited to taxpayers with children who are under 13 years of age and in daycare, or to taxpayers with a spouse or dependent with certain disabilities.

7. Biennially, this office reviews the income tax provisions in each state with an individual income tax. For tax year 2019, this review reveals that six states, including Wisconsin, offered a deduction for child and dependent care expenses based on the federal definition of eligible expenses or otherwise modeled after the federal credit. Idaho, Maryland, and Virginia structured their deduction similarly to Wisconsin's deduction, while Massachusetts offered a higher limitation on deductible expenses -- up to $4,800 for one child and $9,600 for two or more children. Montana allowed a deduction for individuals who care for a dependent under the age of 15, provided the individual's Montana AGI is below certain thresholds. Maryland also provided a refundable credit for individuals with federal AGI below specified thresholds.

8. A tax credit for child and dependent care expenses was offered in 23 states in tax year 2019. Generally, these states' credits are calculated either as a percentage of the federal credit or as a percentage of eligible federal expenses, although there is considerable variation in the percentages employed. Several states employ multiple percentages.

9. Child and dependent care tax credits are refundable in 11 of the 23 states that offered a credit in tax year 2019. Making the proposed credit refundable (Alternative 2) would increase the cost of the credit by $6.1 million in 2021-22 and $2.8 million annually beginning in 2022-23. The average tax reduction in tax year 2021 would be about $35 higher than under a nonrefundable credit. Also, there would be 7,080 additional claimants. Generally, these are filers with no net tax liability under current law.

10. Refundable credit claims are paid from sum sufficient GPR appropriations. Therefore, the cost of the credit under Alternative 2 would be reflected as an increase in GPR expenditures, estimated at $56.4 million in 2021-22 and $31.5 million in 2022-23. Because Alternative 2 would

also sunset the child and dependent care deduction offered under current law beginning in tax year 2021, individual income tax collections would increase by an estimated $18.9 million in 2021-22 and 2022-23 compared to current law. Therefore, the estimated net effect of Alternative 2 on the state's general fund would be a decrease relative to current law of $37.4 million in 2021-22 and $12.6 million in 2022-23.

11. It should be noted that the tax year 2021 fiscal estimates for Alternatives 1 and 2 are based on 2018 federal tax data from the Internal Revenue Service. Because Alternatives 1 and 2 include expenditure limits for tax year 2021 which are different from the limits that typically apply to the federal credit, the state aggregate statistics are not sufficient to produce the estimates. This differs from the fiscal estimate for Alternative 3, and the tax year 2022 fiscal estimates for Alternatives 1 and 2, which are based on 2018 state aggregate taxpayer data.

12. Due to the COVID-19 pandemic, there is additional uncertainty involved in using tax year 2018 data to represent child care expenses incurred in tax year 2021. Some taxpayers may have incurred additional child care expenses due to pandemic-induced school closures, while others may have been able to supervise their children while they worked from home, thereby incurring fewer expenses. The aggregate impact of behavioral changes on child care expenses during 2020 and 2021 is unclear. For these reasons, additional caution should be applied when interpreting the fiscal estimate in 2021-22 for Alternatives 1 and 2.

13. Attachment 2 displays the estimated distribution of taxpayers with a tax decrease under Alternative 2 for tax year 2021 and tax year 2022. An estimated 117,050 taxpayers in tax year 2021 and 114,460 taxpayers in tax year 2022 would experience a tax decrease. The average tax reduction would equal $320 in tax year 2021 and $110 in tax year 2022. Taxpayers with Wisconsin AGI of $100,000 or more would receive a larger average tax reduction ($365) than taxpayers with AGI under $100,000 ($281) in tax year 2021. This is most likely the result of those claimants having a higher number of eligible children and/or higher average child care costs. However, in tax year 2022, as the lower expenditure limits and lower income phaseout thresholds in effect for tax year 2020 are resumed under the federal credit, filers with AGI under $100,000 would receive a larger average tax reduction ($126) than filers with AGI of $100,000 or more ($94). As under Alternative 1, the small percentage of filers receiving a tax decrease (fewer than 4% in both years) is due to the credit being limited to taxpayers with children who are under 13 years of age and in daycare, or to taxpayers with a spouse or dependent with certain disabilities.

14. The Committee could choose to specify that the expanded federal parameters provided under ARPA for tax year 2021 do not apply to the credit provided under Alternative 1 or 2 (whichever the Committee selects to adopt). If the expanded federal credit parameters were not applied to the credit under Alternative 1 for tax year 2021, the cost of the credit would decrease by $21.5 million in 2021-22 relative to the fiscal effect currently shown for Alternative 1. If the expanded federal credit parameters were not applied to the credit under Alternative 2 for tax year 2021, the cost of the credit would decrease by $24.8 million in 2021-22 relative to the fiscal effect currently displayed for Alternative 2.

15. Under Alternatives 1 and 2, the child and dependent care credit would be limited to between 109,970 and 117,050 taxpayers with employment-related child and dependent care expenses

in tax year 2021. As noted above, these claimants would comprise fewer than 4% of all tax filers in either alternative. The proposed credit would not be available to families in which the caregiver refrains from seeking employment in order to provide care for a child or dependent, or to families with children who are 13 years of age or older. One way to broaden the scope of the credit would be to extend the credit to all filers with children or dependents.

16. A separate federal tax credit, called the child tax credit, may be claimed by individuals with children under 17 years of age, provided the taxpayer can claim the children as dependents. The credit equals $2,000 per child and phases out for claimants with incomes above $400,000 for married-joint filers and $200,000 for all other filers. The credit consists of both nonrefundable and refundable components. A nonrefundable credit of $500 is also provided for each of the claimant's other dependents, such as children 17 years of age or older and other relatives of the taxpayer. These provisions represent a temporary expansion of the federal credit, which was authorized under the federal Tax Cuts and Jobs Act of 2017 (TCJA).

17. There were approximately 1.52 million dependents claimed by Wisconsin taxpayers in tax year 2019, which implies that about $3.0 billion in federal child tax credits were claimed by Wisconsin filers that year. Because converting the child and dependent care deduction to a credit is estimated to reduce individual income tax revenues by $9.8 million annually beginning in 2022-23, a state child tax credit at that funding level would only equal about 0.3% of the initial federal credit (prior to its division between nonrefundable and refundable) or about $6 per dependent. Taxpayers may regard such a small credit as more of a nuisance to calculate than as a tax benefit. Another reason not to base a state credit on the federal child tax credit is that the expansion of the federal credit under the TCJA (described in the preceding discussion point) was authorized on a temporary basis for tax years 2018 through 2025. The expansion of the credit was tied to the TCJA's elimination of personal exemptions for the same time period.

18. Under Wisconsin's individual income tax, a $700 personal exemption is provided for each taxpayer and taxpayer's spouse, as well as for each individual claimed as a dependent. For an individual with income subject to the state's 6.27% tax rate, a $700 personal exemption would equate to a $44 tax reduction. An additional $250 exemption is provided for each taxpayer who has reached the age of 65 before the end of the tax year (a $16 tax reduction if taxed at the 6.27% rate). By eliminating the personal exemption for dependents (which is estimated to reduce individual income tax revenues by $54 million in tax year 2021 under current law), and combining this tax savings with the $9.8 million related to the ongoing cost of the credit under Alternative 1, a nonrefundable state child tax credit of $50 per dependent could be provided, beginning in tax year 2021 (Alternative 3). The personal exemption for filers and their spouses, and the additional personal exemption for persons 65 years of age or older, would not be eliminated since that would cause individuals without children to experience a tax increase. Also, a credit of $50 per dependent would not employ an income phaseout. Incorporating an income phaseout could allow for a higher per child credit rate at the same overall cost, but would also cause some taxpayers to experience a tax increase. Alternative 3 would retain the current law child and dependent care expense deduction.

19. Attachment 3 displays the distribution of taxpayers receiving a tax decrease under Alternative 3. An estimated 694,450 taxpayers, or 21.7% of all tax filers, would experience tax

decreases totaling $11.0 million. The average tax reduction would equal $16. Claimants with Wisconsin AGI of less than $100,000 would receive a larger average decrease ($18) than claimants with AGI of $100,000 or more ($12). Claimants with AGI of less than $100,000 represent 65.8% of the taxpayers with a tax reduction, and they would receive 74.6% of the total tax decrease. Claimants with AGI of $100,000 or more would receive 25.4% of the estimated tax decrease and represent 34.2% of the taxpayers with a tax decrease.

20. The cost of the credit would be reduced by an estimated $159,000 due to about 24,000 taxpayers who would experience a tax increase, equaling $7 on average. For these taxpayers, the tax reduction resulting from the $700 personal exemption exceeds the tax reduction resulting from a $50 tax credit. These would be taxpayers who are subject to the state's 7.65% marginal tax rate, the top tax bracket, since a tax benefit of $50 represents only 7.14% of a $700 reduction in income. With the offset provided by this tax increase, the net effect of this alternative would be to reduce individual income tax collections by an estimated $10.8 million annually, beginning in 2021-22.

21. It should be noted that Alternative 3 in LFB Paper #320 would provide a refundable individual income tax credit of $30, beginning in tax year 2021, for each of a taxpayer's children who are under the age of three. That credit is intended to approximate the annual average sales tax paid for diapers. If such a credit were provided to all eligible taxpayers regardless of their income, GPR expenditures would increase by an estimated $5.2 million annually. This proposal, together with the nonrefundable child tax credit under Alternative 3 of this paper, would provide an estimated $15.2 million of individual income tax relief annually, and would provide a total credit of $80 to taxpayers with children under the age of three.

22. As a policy distinction, some tax experts object to tax credits (and tax expenditures in general) because they characterize as tax reductions what are functionally spending increases. Generally, tax credits are designed to incentivize certain behaviors. In this case, the federal child and dependent care expenses credit is primarily intended to encourage individuals with dependents to seek child care so that they can be employed. By running a credit through the income tax system to subsidize what are ultimately work-related expenses, it could be argued that the federal government is operating a workforce spending program by means of a tax cut. Some experts argue that such an approach obscures the true nature of the tax credit as a spending program, which can then complicate lawmakers' and citizens' ability to make informed decisions on the policy merits of such a program. They might contend that, if the goal is to subsidize taxpayers with children in order for them to be employed, a better approach might be to provide funding directly to employers so that they can provide, or otherwise subsidize, child care services for their employees. If the Committee similarly decides that a tax credit for child care expenses is not the optimal way to assist parents with children to remain employed, it could decide to take no action on providing such a credit (Alternative 4).

ALTERNATIVES

1. Create a nonrefundable state individual income tax credit for child and dependent care expenses beginning in tax year 2021. Set the credit equal to 50% of the amount of the federal child and dependent care expenses tax credit under the IRC that a claimant is eligible to claim on the claimant's federal income tax return for the same tax year. Sunset the current law deduction for child

and dependent care expenses beginning in tax year 2021. Estimate decreased individual income tax collections relative to current law of $31,300,000 in 2021-22 and $9,800,000 in 2022-23. [For additional detail, see discussion point #2.]

ALT 1	**Change to Base**
GPR-Tax	- $41,100,000

2. Adopt Alternative 1. However, create the credit as a refundable state individual income tax credit for child and dependent care expenses beginning in tax year 2021. Relative to current law, estimate the net cost of the credit at $37,400,000 in 2021-22 and $12,600,000 in 2022-23, comprised of: (a) increased GPR expenditures of $56,300,000 in 2021-22 and $31,500,000 in 2022-23; and (b) increased individual income tax collections of $18,900,000 in 2021-22 and 2022-23.

ALT 2	**Change to Base**
GPR	$87,800,000
GPR-Tax	37,800,000

3. Maintain the child and dependent care expenses deduction under current law. Create a nonrefundable state child tax credit and sunset the $700 personal exemption for dependents under the individual income tax, beginning in tax year 2021. Set the credit equal to $50 per qualifying dependent, for each dependent whom the claimant supports during the tax year and who may be claimed as a dependent on the claimant's state individual income tax return. Limit the credit to claims filed within four years of the unextended due date for which the tax return was due. Prohibit claims for a period of less than 12 months, except by reason of the taxpayer's death. Require couples who are married at the end of a tax year to claim the credit as married joint filers for that tax year, except permit married persons living apart and treated as single under the IRC to claim the credit as if a single or head-of-household claimant. Require claimants to comply with identification requirements under the IRC for receiving the federal child tax credit in order to receive the state credit. Authorize DOR to administer the credit under general statutory provisions related to the income tax. Decrease individual income tax collections relative to current law by an estimated $10,800,000 in 2021-22 and 2022-23.

ALT 3	**Change to Base**
GPR-Tax	- $21,600,000

4. Take no action.

Prepared by: Dan Spika
Attachments

ATTACHMENT 1

Distribution of Taxpayers under Proposal to Replace the Child and Dependent Care Deduction with a Nonrefundable Credit, Tax Year 2021 and 2022

Tax Year 2021

Wisconsin Adjusted Gross Income	Count	% of Count	Amount of Decrease	% of Decrease	Average Decrease	Count of All Returns	% of All Returns in AGI Class
	Taxpayers Receiving a Tax Decrease						
Under $5,000	--	--	--	--	--	452,530	--
5,000 to 10,000	--	--	--	--	--	222,780	--
10,000 to 15,000	240	0.2%	-$500	<0.1%	-$2	189,920	0.1%
15,000 to 20,000	1,450	1.3	-189,770	0.6	-131	173,570	0.8
20,000 to 25,000	2,290	2.1	-343,350	1.1	-150	175,870	1.3
25,000 to 30,000	3,620	3.3	-866,940	2.8	-239	180,040	2.0
30,000 to 40,000	8,080	7.3	-1,448,200	4.6	-179	337,360	2.4
40,000 to 50,000	5,760	5.2	-677,460	2.2	-118	265,160	2.2
50,000 to 60,000	7,550	6.9	-1,636,000	5.2	-217	198,250	3.8
60,000 to 70,000	6,440	5.9	-1,331,080	4.3	-207	157,280	4.1
70,000 to 80,000	6,170	5.6	-1,518,600	4.9	-246	125,480	4.9
80,000 to 90,000	6,730	6.1	-1,645,860	5.3	-245	106,980	6.3
90,000 to 100,000	7,990	7.3	-2,136,550	6.8	-267	92,800	8.6
100,000 to 125,000	17,360	15.8	-4,333,360	13.8	-250	176,430	9.8
125,000 to 150,000	13,020	11.8	-5,157,750	16.5	-396	109,060	11.9
150,000 to 200,000	12,140	11.0	-4,580,230	14.6	-377	106,220	11.4
200,000 to 250,000	5,370	4.9	-2,387,900	7.6	-445	44,680	12.0
250,000 to 300,000	1,820	1.7	-949,510	3.0	-522	22,590	8.1
300,000 to 500,000	2,470	2.2	-1,413,700	4.5	-572	33,320	7.4
500,000 to 1,000,000	1,230	1.1	-562,450	1.8	-457	16,180	7.6
1,000,000 and over	240	0.2	-130,000	0.4	-542	7,550	3.2
Total	109,970	100.0%	-$31,309,210	100.0%	-$285	3,194,050	3.4%

- An estimated 109,970 tax filers, or 3.4% of all filers in tax year 2021, would receive a tax decrease under Alternative 1.
- The total tax decrease is estimated at $31.3 million in tax year 2021, and the estimated average tax decrease for taxpayers with a tax reduction is $285.
- Filers with Wisconsin AGI of $100,000 or less are estimated to comprise 51.2% of all filers with a tax decrease, and are estimated to receive 37.7% of the total decrease. Their average decrease is estimated at $209. Filers with Wisconsin AGI of $100,000 or more are estimated to comprise 48.8% of all filers with a tax decrease, and to receive 62.3% of the total decrease. Their average tax decrease is estimated at $364.
-The estimated average tax decrease relative to current law is largest for filers with Wisconsin AGI of $125,000 or more ($418). This is likely because these taxpayers have comparatively higher child/dependent care expenses relative to their lower-income counterparts.
- Filers not receiving a tax decrease would include those without an eligible dependent, those who are not employed/looking for work, and nonresidents/part-year residents.

Based on a simulation of tax year 2021 by the Wisconsin Department of Revenue.

Tax Year 2022

Wisconsin Adjusted Gross Income	Count	% of Count	Amount of Decrease	% of Decrease	Average Decrease	Count of All Returns	% of All Returns in AGI Class
	Taxpayers Receiving a Tax Decrease						
Under $5,000	--	--	--	--	--	454,110	--
5,000 to 10,000	--	--	--	--	--	222,820	--
10,000 to 15,000	110	0.1%	-$4,190	<0.1%	-$38	189,960	0.1%
15,000 to 20,000	1,020	1.0	-91,300	0.9	-90	172,890	0.6
20,000 to 25,000	2,830	2.6	-380,970	3.9	-135	177,130	1.6
25,000 to 30,000	4,270	4.0	-691,210	7.1	-162	182,560	2.3
30,000 to 40,000	7,870	7.4	-923,790	9.5	-117	343,510	2.3
40,000 to 50,000	5,430	5.1	-391,650	4.0	-72	268,980	2.0
50,000 to 60,000	4,690	4.4	-317,760	3.3	-68	200,050	2.3
60,000 to 70,000	5,390	5.0	-375,640	3.9	-70	158,230	3.4
70,000 to 80,000	6,150	5.8	-445,450	4.6	-72	124,050	5.0
80,000 to 90,000	7,050	6.6	-535,100	5.5	-76	105,830	6.7
90,000 to 100,000	7,450	7.0	-590,130	6.1	-79	92,130	8.1
100,000 to 125,000	17,550	16.4	-1,520,310	15.6	-87	176,590	9.9
125,000 to 150,000	12,590	11.8	-1,241,830	12.7	-99	110,330	11.4
150,000 to 200,000	12,510	11.7	-1,210,910	12.4	-97	108,190	11.6
200,000 to 250,000	5,160	4.8	-480,370	4.9	-93	46,420	11.1
250,000 to 300,000	2,410	2.3	-231,060	2.4	-96	23,370	10.3
300,000 to 500,000	3,000	2.8	-230,600	2.4	-77	34,530	8.7
500,000 to 1,000,000	1,120	1.0	-72,940	0.7	-65	16,830	6.7
1,000,000 and over	240	0.2	-16,550	0.2	-69	7,820	3.1
Total	106,840	100.0%	-$9,751,760	100.0%	-$91	3,216,330	3.3%

- An estimated 106,840 tax filers, or 3.3% of all filers in tax year 2022, would receive a tax decrease under Alternative 1.
- The total tax decrease is estimated at $9.8 million in tax year 2022, and the estimated average tax decrease for taxpayers with a tax reduction is $91.
- Filers with Wisconsin AGI of $100,000 or less are estimated to comprise 48.9% of all filers with a tax decrease, and are estimated to receive 48.7% of the total decrease. Their average decrease is estimated at $91. Filers with Wisconsin AGI of $100,000 or more are estimated to comprise 51.1% of all filers with a tax decrease, and to receive 51.3% of the total decrease. Their average tax decrease is estimated at $92.
- The estimated average tax decrease relative to current law is largest for filers with Wisconsin AGI of $20,000 to $40,000 ($133). This is due in part to the fact that, because these filers are subject to a lower effective tax rate than their higher-income counterparts, the current law deduction is less valuable for them than for higher-income claimants.
- Filers not receiving a tax decrease would include those without an eligible dependent, those who are not employed/looking for work, and nonresidents/part-year residents.

Based on a simulation of tax year 2022 by the Wisconsin Department of Revenue.

ATTACHMENT 2

Distribution of Taxpayers under Proposal to Replace the Child and Dependent Care Deduction with a Refundable Credit, Tax Year 2021 and 2022

Tax Year 2021

Wisconsin Adjusted Gross Income	Count	% of Count	Amount of Decrease	% of Decrease	Average Decrease	Count of All Returns	% of All Returns in AGI Class
	Taxpayers Receiving a Tax Decrease						
Under $5,000	490	0.4%	-$273,010	0.7%	-$557	452,530	0.1%
5,000 to 10,000	1,090	0.9	-853,400	2.3	-783	222,780	0.5
10,000 to 15,000	1,450	1.2	-736,120	2.0	-508	189,920	0.8
15,000 to 20,000	2,170	1.9	-980,390	2.6	-452	173,570	1.3
20,000 to 25,000	3,980	3.4	-1,778,200	4.8	-447	175,870	2.3
25,000 to 30,000	3,870	3.3	-1,718,510	4.6	-444	180,040	2.1
30,000 to 40,000	9,030	7.7	-2,032,960	5.4	-225	337,360	2.7
40,000 to 50,000	5,780	4.9	-915,320	2.4	-158	265,160	2.2
50,000 to 60,000	7,570	6.5	-1,744,860	4.7	-230	198,250	3.8
60,000 to 70,000	6,460	5.5	-1,337,100	3.6	-207	157,280	4.1
70,000 to 80,000	6,400	5.5	-1,561,330	4.2	-244	125,480	5.1
80,000 to 90,000	6,730	5.7	-1,645,860	4.4	-245	106,980	6.3
90,000 to 100,000	8,110	6.9	-2,166,210	5.8	-267	92,800	8.7
100,000 to 125,000	17,360	14.8	-4,336,860	11.6	-250	176,430	9.8
125,000 to 150,000	13,020	11.1	-5,161,260	13.8	-396	109,060	11.9
150,000 to 200,000	12,380	10.6	-4,707,050	12.6	-380	106,220	11.7
200,000 to 250,000	5,370	4.6	-2,387,900	6.4	-445	44,680	12.0
250,000 to 300,000	1,830	1.6	-954,770	2.6	-522	22,590	8.1
300,000 to 500,000	2,480	2.1	-1,420,760	3.8	-573	33,320	7.4
500,000 to 1,000,000	1,240	1.1	-565,100	1.5	-456	16,180	7.7
1,000,000 and over	240	0.2	-130,000	0.3	-542	7,550	3.2
Total	117,050	100.0%	-$37,406,970	100.0%	-$320	3,194,050	3.7%

- An estimated 117,050 tax filers, (3.7% of all filers in tax year 2021), would receive a tax decrease under Alternative 2.
- The total tax decrease is estimated at $37.4 million in tax year 2021, and the estimated average tax decrease for taxpayers with a tax reduction is $320.
- Filers with Wisconsin AGI of $100,000 or less are estimated to comprise 53.9% of all filers with a tax decrease, and are estimated to receive 47.4% of the total decrease. Their average decrease is estimated at $281. Filers with Wisconsin AGI of $100,000 or more are estimated to comprise 46.1% of all filers with a tax decrease, and to receive 52.6% of the total decrease. Their average tax decrease is estimated at $365.
-The estimated average tax decrease relative to current law is largest for filers with Wisconsin AGI of $15,000 or less ($615). Because the credit under Alternative 2 is refundable, these filers (many of whom do not have a net tax liability) benefit more from use of the credit compared to the nonrefundable credit under Alternative 1.
- Filers not receiving a tax decrease would include those without an eligible dependent, those who are not employed/looking for work, and nonresidents/part-year residents.

Based on a simulation of tax year 2021 by the Wisconsin Department of Revenue.

Tax Year 2022

Wisconsin Adjusted Gross Income	Count	% of Count	Amount of Decrease	% of Decrease	Average Decrease	Count of All Returns	% of All Returns in AGI Class
	Taxpayers Receiving a Tax Decrease						
Under $5,000	800	0.7%	-$252,750	2.0%	-$316	454,110	0.2%
5,000 to 10,000	1,080	0.9	-354,550	2.8	-328	222,820	0.5
10,000 to 15,000	1,660	1.5	-521,460	4.1	-314	189,960	0.9
15,000 to 20,000	2,500	2.2	-707,060	5.6	-283	172,890	1.4
20,000 to 25,000	3,740	3.3	-907,960	7.2	-243	177,130	2.1
25,000 to 30,000	4,560	4.0	-883,160	7.0	-194	182,560	2.5
30,000 to 40,000	8,350	7.3	-1,077,840	8.5	-129	343,510	2.4
40,000 to 50,000	5,550	4.8	-427,890	3.4	-77	268,980	2.1
50,000 to 60,000	4,750	4.1	-332,090	2.6	-70	200,050	2.4
60,000 to 70,000	5,460	4.8	-394,130	3.1	-72	158,230	3.5
70,000 to 80,000	6,210	5.4	-463,790	3.7	-75	124,050	5.0
80,000 to 90,000	7,120	6.2	-550,780	4.4	-77	105,830	6.7
90,000 to 100,000	7,490	6.5	-601,990	4.8	-80	92,130	8.1
100,000 to 125,000	17,690	15.5	-1,559,990	12.3	-88	176,590	10.0
125,000 to 150,000	12,690	11.1	-1,270,290	10.0	-100	110,330	11.5
150,000 to 200,000	12,670	11.1	-1,256,740	9.9	-99	108,190	11.7
200,000 to 250,000	5,260	4.6	-505,900	4.0	-96	46,420	11.3
250,000 to 300,000	2,450	2.1	-241,290	1.9	-98	23,370	10.5
300,000 to 500,000	3,050	2.7	-241,420	1.9	-79	34,530	8.8
500,000 to 1,000,000	1,130	1.0	-75,290	0.6	-67	16,830	6.7
1,000,000 and over	250	0.2	-17,390	0.1	-70	7,820	3.2
Total	114,460	100.0%	-$12,643,760	100.0%	-$110	3,216,330	3.6%

- An estimated 114,460 tax filers, or 3.6% of all filers in tax year 2022, would receive a tax decrease under Alternative 2.
- The total tax decrease is estimated at $12.6 million in tax year 2022, and the estimated average tax decrease for taxpayers with a tax reduction is $110.
- Filers with Wisconsin AGI of $100,000 or less are estimated to comprise 51.8% of all filers with a tax decrease, and are estimated to receive 59.1% of the total decrease. Their average decrease is estimated at $126. Filers with Wisconsin AGI of $100,000 or more are estimated to comprise 48.2% of all filers with a tax decrease, and to receive 40.9% of the total decrease. Their average tax decrease is estimated at $94.
-As in tax year 2021, the estimated average tax decrease relative to current law is largest under Alternative 2 for filers with Wisconsin AGI of $15,000 or less ($319).
- Filers not receiving a tax decrease would include those without an eligible dependent, those who are not employed/looking for work, and nonresidents/part-year residents.

Based on a simulation of tax year 2022 by the Wisconsin Department of Revenue.

ATTACHMENT 3

Distribution of Taxpayers with a Tax Decrease under Proposal to Replace the Personal Exemption for Dependents with a Nonrefundable $50 State Child Tax Credit, Tax Year 2021

	Taxpayers Receiving a Tax Decrease					Count	% of All
Wisconsin Adjusted Gross Income	Count	Percent of Count	Amount of Tax Decrease	Percent of Decrease	Average Decrease	of All Returns	Returns in AGI Class
Under $5,000	2,320	0.3%	-$5,070	<0.1%	-$2	452,530	0.5%
5,000 to 10,000	2,930	0.4	-14,220	0.1	-5	222,780	1.3
10,000 to 15,000	4,290	0.6	-56,820	0.5	-13	189,920	2.3
15,000 to 20,000	13,890	2.0	-392,250	3.6	-28	173,570	8.0
20,000 to 25,000	27,660	4.0	-922,390	8.4	-33	175,870	15.7
25,000 to 30,000	36,240	5.2	-1,057,900	9.6	-29	180,040	20.1
30,000 to 40,000	75,980	10.9	-1,886,140	17.1	-25	337,360	22.5
40,000 to 50,000	65,020	9.4	-1,288,210	11.7	-20	265,160	24.5
50,000 to 60,000	54,290	7.8	-614,500	5.6	-11	198,250	27.4
60,000 to 70,000	49,210	7.1	-547,950	5.0	-11	157,280	31.3
70,000 to 80,000	44,230	6.4	-499,280	4.5	-11	125,480	35.2
80,000 to 90,000	41,830	6.0	-476,980	4.3	-11	106,980	39.1
90,000 to 100,000	39,010	5.6	-445,530	4.0	-11	92,800	42.0
100,000 to 125,000	82,480	11.9	-952,140	8.7	-12	176,430	46.7
125,000 to 150,000	56,290	8.1	-658,860	6.0	-12	109,060	51.6
150,000 to 200,000	56,550	8.1	-670,600	6.1	-12	106,220	53.2
200,000 to 250,000	23,560	3.4	-283,910	2.6	-12	44,680	52.7
250,000 to 300,000	11,460	1.7	-141,420	1.3	-12	22,590	50.7
300,000 to 500,000	7,210	1.0	-90,330	0.8	-13	33,320	21.6
500,000 to 1,000,000*	--	--	--	--	--	16,180	--
1,000,000 and over*	--	--	--	--	--	7,550	--
Total	694,450	100.0%	-$11,004,500	100.0%	-$16	3,194,050	21.7%

*Data are suppressed to preserve taxpayer confidentiality.

- An estimated 694,450 tax filers, or 21.7% of all filers in tax year 2021, would receive a tax decrease under Alternative 4.
- The total tax decrease is estimated at $11.0 million in tax year 2021, and the estimated average tax decrease for taxpayers with a tax reduction is $16.
- Filers with Wisconsin AGI of $100,000 or less are estimated to comprise 65.8% of all filers with a tax decrease, and are estimated to receive 74.6% of the total decrease. Their average decrease is estimated at $18. Filers with Wisconsin AGI of $100,000 or more are estimated to comprise 34.2% of all filers with a tax decrease, and to receive 25.4% of the total decrease. Their average tax decrease is estimated at $12.
- Filers with Wisconsin AGI between $15,000 and $40,000 are estimated to receive the largest average tax decrease among all filers with a decrease ($28).
- Filers not receiving a tax decrease would include those without an eligible dependent, nonresidents and part-year residents, and those with no net tax liability.

Based on a simulation of tax year 2021 by the Wisconsin Department of Revenue.

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June, 2021 | Joint Committee on Finance | Paper #312

Flood Insurance Premiums Tax Credit
(General Fund Taxes -- Income and Franchise Taxes)

[LFB 2021-23 Budget Summary: Page 214, #14]

CURRENT LAW

Gross tax liability is calculated by applying the state's tax rate and bracket schedule to taxable income. Total tax liability (the amount of income tax that an individual actually pays) is arrived at by subtracting any applicable tax credits (nonrefundable and refundable) from gross tax liability. Most state credits for individuals are nonrefundable, in that the amount claimed cannot exceed a claimant's tax liability. State statutes outline the order in which tax credits are to be claimed.

BACKGROUND

According to the U.S. Department of Homeland Security, 90% of all natural disasters occurring in the United States involve flooding. The Department of Homeland Security reports that flooding is the costliest form of natural hazard in the U.S. in terms of loss of life, property damage, and monetary loss.

Flood insurance is offered publicly through the National Flood Insurance Program (NFIP), under the purview of the Federal Emergency Management Agency (FEMA), as well as through numerous private insurers. The Congressional Research Service reports that premiums for private flood insurance totaled $644 million in 2018. When compared to the $3.5 billion of NFIP premiums written in 2018, private flood insurance represented 15.5% of the value of all flood insurance premiums in that year. NFIP insurance is backed by the federal government, provided the affected communities adhere to the requisite floodplain management regulations. According to the Insurance Information Institute (III), there were 5.03 million NFIP policies active in 2019.

NFIP policyholders can retain "building coverage", which covers (among other categories) major appliances, permanent installations, and plumbing, electrical, and heating systems. Individuals utilizing NFIP can also purchase "contents coverage", which covers items and home appliances that are not permanent fixtures in the dwelling, as well as valuables and other personal belongings. For residential properties, the coverage limit is $250,000 for building coverage, and $100,000 for contents coverage. The two types of coverage are purchased separately, and each has associated deductibles.

Rates for NFIP flood insurance vary significantly based on the FEMA-determined flood risk in the area where the home is located. Individuals who live in a high-risk flood area and have a government-backed mortgage are required to purchase flood insurance. Those who live in a moderate-risk or low-risk flood area are eligible for cheaper flood insurance through a preferred risk policy.

Flood insurance rates also depend on the home's elevation relative to the base flood elevation (BFE). The BFE is the anticipated elevation of water during a flood that has a 1% probability of occurring in any year, also referred to as a 100-year flood. Generally, a higher risk of flood in a particular area, and lower elevation relative to the BFE, translates into more expensive flood insurance policies. For example, the owner of a home in a high-risk flood area might pay $2.25 per $100 of coverage per year if their home's elevation is equal to the BFE, but could pay greater than $14 per $100 of coverage if their home is significantly below the BFE. To fully insure a home valued at $200,000 against flood risk, this equates to annual premiums of $4,500 and $28,000, respectively. By contrast, the owner of a home of equivalent value that lies well above the BFE might pay only $480 annually to fully insure their home against flood risk. Several other factors influence the insurance rate, such as the type of dwelling (single or multi-family), the number of floors in the home, and whether the home contains a basement.

DISCUSSION POINTS

1. In its <u>Budget in Brief</u>, the administration cites the "growing problem" of flooding in Wisconsin, and the costliness of insuring a home against potential flood damage. According to FEMA's Declared Disasters database, there have been 18 major disaster declarations in Wisconsin related to flooding since May 1, 1969. Five of these disasters have occurred since October, 2016. Data from III show that there were nearly 13,000 NFIP policies active in Wisconsin in 2019, which represents about 0.3% of all active NFIP policies nationwide that year.

2. If the Committee desires to provide financial relief to taxpayers impacted by the adverse effects of flooding in Wisconsin, it could consider creating a nonrefundable individual income tax credit for flood insurance premiums paid, beginning in tax year 2021. A claimant could claim a credit equal to 10% of the amount of premiums the claimant paid during the tax year for flood insurance, up to a maximum credit of $60 per tax year, or $30 for married-separate filers (Alternative 1a). "Flood insurance" would mean a flood insurance policy that covers the principal dwelling of the claimant.

No flood insurance premiums tax credit would be allowed unless it were claimed within four years of the unextended due date of the income tax return to which the claim relates. Nonresidents

and part-year residents of Wisconsin would be prohibited from claiming the credit. No credit would be allowed for a tax year covering a period of less than 12 months, except for a tax year that was closed because of the death of the taxpayer. Current law provisions which apply to the individual income tax and relate to DOR's enforcement authority, and to assessments, refunds, appeals, collection, interest, and penalties, would also apply to this credit. Individual income tax collections would decline by an estimated $500,000 annually, beginning in 2021-22.

3. The credit under Alternative 1a is included in Assembly Bill 68/Senate Bill 111. At the time the bill was introduced, the credit was estimated to reduce individual income tax collections by $800,000 on an annual basis. This estimate has been revised down based on updated 2021 flood insurance premium data for Wisconsin.

4. A tax credit program for flood insurance could be viewed as a way to incentivize people to improve their financial stability. In the absence of insurance, people who experience flood damage would incur significant out-of-pocket restoration costs on their home. Because insurance would cover many of these costs, the individuals' financial situation would improve markedly relative to being uninsured. Moreover, for many homeowners, their home represents their largest source of wealth. If a flood destroys a home and the homeowner does not possess flood insurance, the family's financial situation would deteriorate significantly.

5. If a flood never occurs, the individual policyholder would still need to pay the requisite insurance premiums throughout the term of their policy to insure against the risk of flooding. A tax credit based on those premiums could also be characterized, therefore, as a way to compensate individuals for taking precautionary measures against flood risk.

6. Currently, Wisconsin offers disaster-related preferential tax treatment indirectly through the state's itemized deduction credit. Under current law, if a taxpayer's allowable federal itemized deductions exceed their state sliding scale standard deduction, the taxpayer may claim 5% of the excess amount as a nonrefundable credit. One such allowable deduction is for casualty losses resulting from a federally declared disaster. However, because taxpayers can only claim the credit if their allowable itemized deductions exceed their state standard deduction, credit claims generally flow toward those with higher incomes. In tax year 2019, greater than 83% of total itemized deduction credits were claimed by taxpayers with Wisconsin adjusted gross income (AGI) of $100,000 or more. Conversely, the nonrefundable flood insurance premiums credit under Alternatives 1a through 1c would be available to all state taxpayers with a net tax liability, and the refundable credit under Alternatives 2a through 2c would be available to all who file a state income tax return.

7. Alternatively, the Committee could decide to make the proposed flood insurance premiums credit more generous by increasing the dollar limitation under Alternative 1a from $60 to $100 (Alternative 1b), or by removing the dollar limitation altogether (Alternative 1c). Although particular dollar amounts ($60 and $100) and a reimbursement percentage of 10% are specified in Alternatives 1a through 1c, the Committee could select other values it may prefer.

8. Based on state-specific flood insurance premium data from NFIP, it is estimated that the average NFIP premium for residential dwellings in Wisconsin is around $1,000 in 2021. Due to its dollar limitation of $60, the 10% flood insurance premiums credit under Alternative 1a would only

recognize up to $600 of annual flood insurance premiums paid as eligible for computing the credit. If the Committee wanted to allow the average NFIP premium of $1,000 to be eligible for the credit, it could consider increasing the dollar limitation from $60 to $100 (Alternative 1b). This alternative is estimated to reduce individual income tax revenues relative to current law by $700,000 on an annual basis, beginning in 2021-22. By contrast, removing the dollar limitation altogether, as under Alternative 1c, would be estimated to reduce income tax revenues by $1.0 million annually, beginning in 2021-22.

9. An estimated 9,909 filers would receive a tax benefit under Alternatives 1a through 1c, representing about 0.3% of all individual income tax filers. Their estimated average tax benefit would be $50 under Alternative 1a, $71 under Alternative 1b, and $101 under Alternative 1c.

10. Another method to expand the credit would be to make it refundable, so that individuals who pay for flood insurance but do not have a net tax liability could still claim and use the credit (Alternatives 2a through 2c). Alternative 2a would provide a 10% credit up to $60, Alternative 2b would provide a 10% credit up to $100, and Alternative 2c would provide a 10% credit with no dollar limitation. If a refundable credit exceeds a claimant's tax liability, the balance is paid by check to the claimant. Refundable credits are funded through sum sufficient appropriations as GPR expenditures.

11. An estimated 12,234 filers would receive a tax benefit under Alternatives 2a through 2c, representing about 0.4% of all filers. Their estimated average tax benefit would be $49 under Alternative 2a, $68 under Alternative 2b, and $102 under Alternative 2c.

12. Opponents of tax incentives or other subsidies for flood insurance contend that such subsidies understate the true cost of insuring properties that lie in a floodplain. They argue that providing subsidized flood insurance policies incentivizes people to remain in flood-prone areas, which those individuals might not do in the absence of federally subsidized insurance. This can be especially relevant for residents of homes that were built prior to the effective date of an initial flood insurance rate map (FIRM) for that community. Residents of pre-FIRM homes are eligible for subsidized NFIP insurance at the rates which applied prior to the issuance of the FIRM. As described above, the owner of a $200,000 post-FIRM home that lies well below the BFE could pay as much as $28,000 annually to fully insure their home. By contrast, the owner of a $200,000 pre-FIRM home of equal flood risk could pay $2,720 to fully insure their home (less than 10% of the cost to insure a post-FIRM home).

13. Critics would argue that the above example demonstrates that tax incentives for flood insurance, especially those for subsidized insurance, can cause moral hazard. The concept of moral hazard holds that insured individuals are less likely to take preventative measures to protect against risk precisely because they are insured. In the case of flood insurance, individuals may be less likely to move out of a floodplain, or to make flood-resistant upgrades to their homes, because they know their insurance will cover flood-related losses they might incur. Though this aspect of moral hazard can occur across public and private flood insurance, when the cost of this insurance is subsidized (as through pre-FIRM rates), moral hazard is exacerbated.

14. Pre-FIRM policies comprise around 20% of existing NFIP policies, and pre-FIRM policyholders often pay premiums that only reflect 40% to 45% of the expected cost of insuring the

property against long-term losses. Even post-FIRM premiums are not sufficient to withstand catastrophic losses. Rather, NFIP relies on financing from the U.S. Treasury in years of extraordinary loss (and is currently indebted by $25 billion as a result). Because NFIP rates do not reflect the expected value of long-term losses, policyholders do not assume the full cost associated with flood risk, and are therefore even less likely to engage in mitigation strategies against flooding. It is estimated that over 95% of all flood insurance policies are offered through NFIP. It could be argued, therefore, that moral hazard relative to flood insurance is already prevalent, and that tax incentives for flood insurance would only deepen this problem.

15. In 2012, the federal government passed the Biggert-Waters Flood Insurance Reform Act, which was designed to address these moral hazard concerns in NFIP by removing subsidized insurance premiums. However, amid public outcry over rising premium costs, subsequent legislation was passed in 2014 that nullified many of these changes. It should also be noted, though, that FEMA is presently instituting a new pricing methodology program called Risk Rating 2.0, which will deliver insurance rates that are designed to better reflect the actuarial risk of living in a particular area. This updated premium pricing is scheduled to take effect for new flood insurance policies beginning October 1, 2021, and all remaining policies renewing on or after April 1, 2022.

16. Every two years, this office prepares an informational paper which reviews the individual income tax provisions in each state with such a tax. Based on that review, two states provided preferential state tax treatment specifically related to flooding in tax year 2019. Alabama provided a deduction of up to $3,000 for expenses incurred by its residents to upgrade or retrofit their home to resist wind or flood damage. South Carolina offered a nonrefundable credit of up to $1,250 if the amount of premiums paid to insure a taxpayer's legal residence, including premiums for flood insurance, exceeded 5% of the taxpayer's federal AGI. Unused credit amounts could be carried forward for the next five taxable years.

17. Six states offered state income tax preferences in tax year 2019 generally related to natural disasters (not specific to flooding). Alabama, Mississippi, and South Carolina offered income tax deductions for amounts deposited into a state catastrophe savings account. Georgia allowed a nonrefundable credit of up to $500 for disaster assistance payments received by FEMA or the state equivalent agency. Louisiana provided a deduction for any disaster-related grant, loan, or other benefit. Oklahoma offered a refundable credit for owners of residential real property whose primary residence was damaged or destroyed in a natural disaster. The credit equaled the difference between the ad-valorem property tax paid on the property in the tax year prior to the disaster and the amount of such tax paid in the first year after the property was repaired. The credit could be claimed in successive tax years equal to 80% of the amount claimed in the prior year.

18. In addition, four states provided state sales tax holidays for certain disaster preparedness items in 2020 (Alabama, Florida, Texas, and Virginia). During a specified time period, items such as generators, batteries, flashlights, and first-aid kits were exempt from sales tax in those states.

19. The aforementioned states that provide specific state tax benefits related to natural disasters are all located in the southern part of the United States, where natural disasters are often more severe. For example, III reports that, of the 10 costliest natural disasters in U.S. history, eight of these disasters (including the six costliest) primarily affected states in the southern region of the

United States. Costliness, as reported by III, is measured by casualties and/or monetary costs resulting from a natural disaster.

20. As noted above, the number of active NFIP policies in Wisconsin in 2019 represented approximately 0.3% of all NFIP policies in the U.S., despite the fact that nearly 1.8% of the nation's population lives in Wisconsin. If the purchase of NFIP flood insurance policies were strictly based on population, one would expect greater than 90,000 NFIP policies to be held by Wisconsin residents, rather than the actual number of policies (fewer than 13,000). The Committee could interpret this as an indication that the need for flood insurance in Wisconsin is lower than in other areas of the country, such as in the aforementioned southern states where natural disasters are often costlier.

21. Moreover, the Committee may want to avoid furthering the moral hazard that can result from subsidizing flood insurance. It could also be argued that the current state itemized deduction credit provides adequate tax assistance to individuals affected by a disaster situation, such as a flood. For these reasons, the Committee may wish to take no action on providing a flood insurance premiums credit (Alternative 3).

ALTERNATIVES

1a. Provide a nonrefundable flood insurance premiums tax credit, beginning in tax year 2021, equal to 10% of flood insurance premiums paid for a principal residence, up to $60 per tax year (or up to $30 for married-separate filers). Estimate reduced individual income tax collections of $500,000 annually, beginning in 2021-22.

ALT 1a	**Change to Base**
GPR-Tax	- $1,000,000

1b. Adopt Alternative 1a, but specify that the maximum credit is $100 per tax year (or $50 for married-separate filers). Estimate reduced individual income tax collections of $700,000 annually, beginning in 2021-22.

ALT 1b	**Change to Base**
GPR-Tax	- $1,400,000

1c. Provide a nonrefundable flood insurance premiums tax credit, beginning in tax year 2021, equal to 10% of flood insurance premiums paid for a principal residence. Estimate reduced individual income tax collections of $1,000,000 annually, beginning in 2021-22.

ALT 1c	**Change to Base**
GPR-Tax	- $2,000,000

2a. Provide a refundable flood insurance premiums tax credit, beginning in tax year 2021, equal to 10% of flood insurance premiums paid for a principal residence, up to $60 per tax year (or up to $30 for married-separate filers). Estimate increased GPR expenditures of $600,000 annually, beginning in 2021-22.

ALT 2a	**Change to Base**
GPR	$1,200,000

2b. Adopt Alternative 2a, but specify that the maximum credit is $100 per tax year (or $50 for married-separate filers). Estimate increased GPR expenditures of $850,000 annually, beginning in 2021-22.

ALT 2b	**Change to Base**
GPR	$1,700,000

2c. Provide a refundable flood insurance premiums tax credit, beginning in tax year 2021, equal to 10% of flood insurance premiums paid for a principal residence. Estimate increased GPR expenditures of $1,250,000 annually, beginning in 2021-22.

ALT 2c	**Change to Base**
GPR	$2,500,000

3. Take no action.

Prepared by: Dan Spika

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Supplemental State Work Opportunity Tax Credit (General Fund Taxes -- Income and Franchise Taxes)

[LFB 2021-23 Budget Summary: Page 206, #6]

BACKGROUND

The federal work opportunity tax credit (WOTC) can be claimed to offset federal income taxes and is equal to a specified percentage of wages paid to new employees who are members of certain target groups. The Department of Workforce Development (DWD) is responsible for the administration of the federal WOTC, including the certification process (described below), promoting the program to employers, and reporting program data on a quarterly basis to the U.S. Department of Labor (USDOL). DWD receives federal grant funding from USDOL in the amount of $335,089 in federal fiscal year (FFY) 2019 and $344,514 in FFY 2020 to support 3.0 Fed positions to administer the federal program. DWD does not receive state funds to administer the program.

Employers may claim the federal WOTC for up to 40% of the wages paid to eligible workers employed at least 400 hours and up to 25% for those employed for at least 120 hours, but less than 400. In general, the maximum qualified first-year wages are limited to $6,000, and no credit is allowed for the second year of employment. Thus, in general, the maximum credit is $2,400 for those employed 400 hours or more (40% of $6,000) and $1,500 for those employed at least 120 hours, but less than 400 (25% of $6,000).

The wage limit (and maximum credit) differs based on the type of targeted group member. For example, for disabled veterans, qualifying wages are limited to $12,000, and thus the maximum federal credit is: (a) $3,000 (25% of $12,000) for those employed for at least 120 hours but less than 400 hours; and (b) $4,800 (40% of $12,000) for those employed for 400 or more hours. For unemployed disabled veterans, qualified wages are limited to $24,000, and for unemployed veterans, wages are limited to $14,000. For long-term family assistance recipients,

the WOTC may be earned for the first two years of employment, except that wages are limited to $10,000, and employers may claim up to 40% for those employed at least 400 hours in the first year ($4,000 maximum credit) and 50% for those employed at least 400 hours in the second year ($5,000 maximum credit).

To claim the WOTC, the employer and applicant must first complete a federal pre-screening form and a verification form when the applicant is hired. The forms must be sent to DWD at least 28 days after the employee begins in order to obtain certification that an individual is a member of a targeted group. In FFY 2019, DWD provided WOTC certification for 1,850 employers eligible for up to $120,807,400 in total tax credits. In FFY 2020, DWD provided WOTC certification for 1,672 employers eligible for up to $96,272,400 in total federal tax credits. Employers may claim credits on their federal return after the employee has worked the requisite number of hours. Note that credits claimed for persons certified in one year may be applied against income tax liabilities in past or future years, and therefore credits need not be used in the year claimed.

Targeted group members, whose employment authorizes the employer to be eligible for the WOTC, are the following:

a. *TANF Recipients.* A member of a family receiving assistance under the temporary assistance for needy families (TANF) block grant program for any nine months of the last 18-month period ending on the hiring date.

b. *Qualified Veterans.* A veteran who is one of the following: (a) a member of a family that has received assistance under the supplemental nutrition assistance program (SNAP) for at least three of the previous 15 months prior to the hiring date; (b) entitled to compensation for a service-connected disability, and who has a hiring date of not more than one year after discharge or release from active duty, or has been unemployed for an aggregate period totaling at least six months during the one-year period ending on the hiring date; (c) has aggregate periods of unemployment during the one-year period ending on the hiring date which equal or exceed four weeks, but are less than six months; or (d) has aggregate periods of unemployment during the one-year period ending on the hiring date which equal or exceed six months.

c. *Ex-felons.* An individual convicted of a felony under federal or state law, released from prison within one year of the date of hire.

d. *Designated Community Residents.* A resident, aged 18 to 39 as of the hiring date, of a federal empowerment zone, enterprise community, renewal community, or rural renewal county. According to DWD, currently there are no such designated areas in Wisconsin. However, as indicated in the table below, 43 individuals lived in such areas outside the state and worked for Wisconsin-based companies.

e. *Vocational Rehabilitation Referrals.* An individual with a disability serious enough to be a barrier to employment and who was referred to the employer after completing, or while receiving, rehabilitation services under a state rehabilitation plan, or a program approved by the federal Department of Veteran's affairs. The rehabilitation services must have been received within two years of the hire date.

f. *Summer Youth Employees.* An individual who is 16 or 17 years old, who performs services for an employer between May 1 and September 15, and is a resident of a federally designated empowerment zone, enterprise community, or renewal community. The credit may be claimed for wages earned for up to 90 days between May 1 and September 15.

g. *SNAP Recipients.* An 18 to 39-year-old member of a family that has received SNAP assistance for the past six months, or for at least three of the past five months but is no longer eligible to receive them.

h. *SSI Recipients.* An individual who received supplemental security income (SSI) benefits for any month within 60 days from the hiring date.

i. *Long-term Family Assistance Recipients.* An individual who is a member of a family that: (a) received TANF payments for at least 18 consecutive months ending on the hiring date; (b) received such family assistance for a total of 18 months (consecutive or nonconsecutive) after August 5, 1997, if the individual is hired within two years after the 18-month total is reached. Alternatively, an individual would qualify if he or she became ineligible for assistance after August 5, 1997, due to federal or state law limitations, and the individual's hiring date was not more than two years after eligibility for assistance ends.

j. *Long-term Unemployed.* An individual who has been unemployed for a period not less than 27 consecutive weeks and received unemployment compensation during some of this period under state or federal law.

The following Table shows the targeted group members in Wisconsin certified in FFY 2020, based on data from USDOL, and the maximum amount of creditable wages available for each group. The largest targeted group certified is SNAP Recipients, who comprise more than half of participants. For comparison, according to USDOL, nationally, 68.3% of participants are SNAP recipients and 3.1% are TANF recipients. TANF-recipients in Wisconsin account for a higher proportion of certifications than they do nationally. However, DWD indicates that this may be a statistical anomaly as it counts TANF Recipients that are members of multiple targeted groups solely as TANF recipients.

WOTC Certifications in Wisconsin by Target Group in FFY 2020

	Target Population	Number	Percent	Maximum Creditable Wages
a.	TANF Recipients	6,937	17.5%	$6,000
b.	Qualified Veterans	2,324	5.8	$6,000 to $24,000
c.	Ex-felons	3,848	9.7	$6,000
d.	Designated Community Residents	43	0.1	$6,000
e.	Vocational Rehabilitation Referrals	1,458	3.7	$6,000
f.	Summer Youth Employees	0	0.0	$3,000
g.	SNAP Recipients	21,104	53.1	$6,000
h.	SSI Recipients	1,671	4.2	$6,000
i.	Long-term Family Assistance Recipients	1,772	4.5	$10,000 per year for up to two years
j.	Long-term Unemployed	571	1.4	$6,000
	Total	39,728	100.0%	

DISCUSSION POINTS

Policy Considerations

1. The premise of the federal WOTC is that providing employment opportunities for certain chronically unemployed groups that have been disadvantaged in the workforce will reduce poverty. This includes not only the short-term benefit of a targeted individual earning wages while participating in the program, but also improving their long-term employability by providing a work history, on-the-job training, and improving soft skills that assist in obtaining and maintaining employment, as well as increased earnings, by advancing in a career. Further, the intent is that targeted individuals will reduce their reliance on public assistance programs after they become employed.

2. Providing a tax credit as a subsidy for employment is intended to incentivize employers to hire targeted individuals. Because a subsidy (generally up to $1,500 or $2,400) is only available for hiring targeted individuals, and the credit amount increases for employees working more than 120 and more than 400 hours, the program is highly cost effective for employing individuals from those groups. For comparison, the Department of Children and Families (DCF) estimates that the average cost per participant in the Transform Milwaukee and Transitional Jobs programs (a state program that subsidizes employment of certain persons by way of payment to employers) is $10,000 per year.

3. Further, the tax credit is intended to leverage private funds to increase the reach of the program and the benefits provided to each participant. The subsidy becomes more cost effective the longer an employee's tenure extends beyond the maximum hour and wage thresholds incentivized.

4. Various studies have found that employment tax credits can be an effective market support for employing targeted individuals. For example, a study of WOTC subsidies for disabled veterans found that the WOTC generated a two percentage point increase in employment, and increased wage income by approximately 40%, compared to other groups (including veterans who were not eligible for the WOTC, other persons eligible for the WOTC, and other persons not eligible for the WOTC). The study found that the credit accounted for roughly 32,000 additional employed disabled veterans nationwide in both 2007 and 2008.

5. However, the effect on long-term employment has been mixed. A study of the federal WOTC and another previously available federal employment subsidy program in Wisconsin found that TANF recipients were 5.9% more likely to be employed in the second quarter of participation in WOTC than TANF recipients that did not participate, but that there was no significant difference in employment after one year. Further, participants earned 9% more than non-participants after their jobs began. That difference in wages for WOTC recipients represents 38% of the value of the tax credit. However, there was no measurable effect on job tenure.

6. On the other hand, the U.S. Government Accountability Office examined the WOTC program and found that employers generally do not terminate participating employees when their subsidies run out in order to obtain more credits by hiring different targeted individuals. The cost and difficulty of recruiting employees was found to not be worth the potential tax benefit.

Supplemental State WOTC

7. Assembly Bill 68/Senate Bill 111 (AB 68/SB 111) would create a supplemental state tax credit, with credit equal to roughly half of the federal WOTC, for employers in taxable years beginning after December 31, 2020. Credits could not be claimed on wages exceeding the wage limits, discussed above, that are set under the federal WOTC. Thus, in general, the maximum supplemental state WOTC would be $1,200 for those employed 400 hours or more (20% of $6,000) and $750 for those employed at least 120 hours, but less than 400 hours (12.5% of $6,000).

8. Together with the federal credit, an eligible employer could generally claim a maximum of: (a) $3,600 for each targeted individual employed for 400 hours or more for $6,000 in wages or more (credits equal 60% of qualified wages paid); and (b) $2,250 for each targeted individual employed for at least 120 hours, but less than 400 hours, for $6,000 in wages or more (37.5% of qualified wages paid).

9. The state WOTC would have to be claimed at the same time as the federal credit, equal to up to one of the following amounts: (a) 20% of qualified first-year wages, as defined in the federal WOTC, paid during the taxable year to a targeted group member, as defined under the federal WOTC, who has performed at least 400 hours of services for the claimant in this state; (b) 12.5% of the qualified first-year wages paid during the taxable year to a targeted group member who has performed at least 120 hours, but less than 400 hours, of services for the claimant in this state; or (c) 25% of the qualified second-year wages paid during the taxable year to a long-term family assistance recipient (as defined under the federal WOTC) who has performed at least 400 hours of services for the claimant in this state. Claimants would not be able to claim the state WOTC for wages paid for services performed outside this state.

Partnerships, limited liability companies (LLCs), and tax-option (S) corporations would not be permitted to claim the credit, but the eligibility for, and the amount of, the credit would be based on their payment of the wages. A partnership, LLC, or S corporation would have to compute the amount of credit that each of its partners, members, or shareholders could claim and provide that information to each of them. The partners, members, and shareholders would be able to claim the credit in proportion to their ownership interests.

DOR would be authorized to administer the credit, and take any action, conduct any proceeding, and proceed as authorized under state income and franchise tax laws. State tax provisions related to timely claims, assessments, refunds, appeals, collection, interest, and penalties would apply to the credit. By contrast, DWD would not be authorized to administer the state WOTC (which would instead rely on the federal certification process). Further, DWD would not be provided with funding to promote the state program to employers.

Under current law, the federal WOTC will sunset after tax year 2025. The proposed supplemental credit under AB 68/SB 111 would follow federal law, such that the state WOTC would also sunset after 2025. In the event that the federal WOTC were to be extended, as it recently was under the federal Consolidated Appropriations Act of 2020, then the state WOTC would be similarly extended under the bill.

The proposed credit would incorporate the requirements and limitations of the federal WOTC for purposes of the state WOTC, including the following.

First, an individual could not be treated as a member of a targeted group unless: (a) on or before the day on which that individual begins work for the employer, that employer has received a certification from a designated local agency (such as a state employment security agency) that the individual is a member of a targeted group; or (b) on or before the day the individual is offered employment with the employer, a prescreening notice is completed by the employer with respect to such individual, and not later than 28 days after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under penalties of perjury, to the designated local agency as part of a written request for a certification. "Pre-screening notice" would mean a document which contains information provided by the individual on the basis of which the employer believes that the individual is a member of a targeted group. If an individual has been certified by a designated local agency as a member of a targeted group, and that certification is incorrect because it was based on false information provided by the individual, then the certification would be revoked. Wages paid by the employer after the date on which notice of revocation is received by the employer could not be treated as qualified wages. If a designated local agency denies a request for certification of membership in a targeted group, the agency would have to provide to the individual making such a request a written explanation of the reasons for such denial.

A veteran would be treated as having the required aggregate periods of unemployment for being a qualified veteran if the veteran is certified by such agency as being in receipt of unemployment compensation under state or federal law for a period of either: (a) not less than six months during the one-year period ending on the hiring date; or (b) not less than four weeks (but less than six months) during the one-year period ending on the hiring date.

Second, remuneration paid by an employer to an employee during any taxable year would be taken into account only if more than one-half of the remuneration paid is for services performed in a trade or business of the employer.

Third, certain individuals would not be eligible. No wages would be taken into account with respect to any individual if, prior to the hiring date, the individual had been employed by the employer at any time. Further, in the case of an individual who has performed at least 120 hours, but less than 400 hours, of service for the employer, the wage limit would be 25% rather than 40% (as discussed above). No wages would be taken into account with respect to any individual unless such individual has performed at least 120 hours of service for the employer. Further, no wages would be taken into account with respect to an individual who: (a) bears a relationship to the taxpayer, as defined under the Internal Revenue Code (IRC), including a child, brother, father, or mother, or, if the taxpayer is a corporation, to an individual who owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation, or, if the taxpayer is an entity other than a corporation, to any individual who owns, directly or indirectly, more than 50% of the capital and profits interests in the entity; (b) if the taxpayer is an estate or trust, is a grantor, beneficiary, or fiduciary of the estate or trust, or is an individual who bears a relationship to a grantor, beneficiary, or fiduciary of the estate or trust, as defined under the IRC; (c) is a dependent (as defined under the IRC) of the taxpayer; or, if the taxpayer is a corporation, is a dependent of an individual described above in "(a)"; or, if the

taxpayer is an estate or trust, is a dependent of a grantor, beneficiary, or fiduciary of the estate or trust.

In the case of a successor employer, the determination of the amount of the credit with respect to wages paid by the successor employer would be made in the same manner as if such wages were paid by the predecessor employer. No credit would be determined with respect to remuneration paid by an employer to an employee for services performed by such employee for another person unless the amount reasonably expected to be received by the employer for such services from such other person exceeds the remuneration paid by the employer to such employee for such services.

Fiscal Effect

10. Based on federal tax data on amounts used under the federal WOTC in tax year 2017 and growth rate estimates from the Joint Committee on Taxation for the extension of the sunset date of the WOTC, the administration estimated that the state WOTC under Alternative 1 would reduce state tax collections by $27,800,000 in 2021-22 and $24,100,000 in 2022-23.

11. For comparison, these estimates are substantially smaller than half of the maximum amounts certified by DWD for federal credits (which certified 1,672 employers as eligible for up to $96,272,400 in total federal credits in 2020). As noted, state credit amounts certified would be about half the amount of federal credits certified.

However, these certifications are the maximum amounts that could be earned and do not necessarily reflect the amounts actually earned, claimed, or used to offset income by claimants. Further, federal law permits the WOTC credits to be used in the previous tax year, or carried forward to be used in the following 20 tax years. Thus, the fiscal effect in any particular year may be less than the maximum amounts earned for nonrefundable credits.

12. The administration's estimates appear to be reasonable given recent estimates of nationwide use of the federal WOTC by the federal Office of Budget and Management in federal fiscal year 2018-19 and estimates prepared by the Joint Committee on Taxation.

Alternatives to State WOTC

13. As stated in the administration's Budget in Brief, the supplemental state WOTC is intended to increase the incentive for employers to hire targeted individuals and move these individuals into the labor force. As stated above, only 1,672 Wisconsin employers were certified to use the program in 2020. Increasing the credit amount be creating a supplemental state credit may increase participation by employers, and thereby increase in number of positions statewide that are available for targeted individuals certified to participate in the program.

14. Further, the amount of long-term unemployed persons has substantially increased during the COVID-19 pandemic. The Bureau of Labor Statistics estimated in its April, 2021, report that 2.7 million people have been unemployed for 52 weeks or longer (29% of the unemployed). The long-term unemployed generally have great financial difficulties and face difficulty in finding employment compared to similar persons seeking employment who are currently employed or who have more recently become unemployed. The state supplement could provide much needed assistance for

businesses to hire members of this group as the economy improves through 2021.

15. Also, as discussed in LFB Paper #200, participation in Wisconsin Works paid employment placements increased substantially in 2020 in response to the economic disruption caused by the COVID-19 pandemic. As shown above in the Table on page 3, 6,937 TANF recipients in Wisconsin were certified for the WOTC in FFY 2020. For comparison, there were a total of 12,213 participants in paid positions in W-2 in 2020. Thus, the majority of TANF recipients appear to be further assisted in finding employment in the private sector with businesses utilizing the WOTC program. Therefore, expanding the federal WOTC by providing a state supplement could assist more TANF recipients move into private employment as the inoculation campaign reduces COVID-19 caseloads and the economy improves.

16. Thus, the Committee could find that the federal WOTC is a cost effective way of providing employment for certain individuals who may otherwise have difficulty finding employment and, therefore, create a supplemental state WOTC to enhance the current program (Alternative 1).

17. Further, the Committee could choose to provide $100,000 GPR annually to DWD to promote the state supplemental WOTC (Alternative 2). According to DWD, it cannot expend federal funding provided to promote the federal program to also promote the state supplemental WOTC. Absent state funding to advertise the supplemental state credit, employers not currently participating in the program may not become aware of the supplemental credit.

18. On the other hand, because AB 68/SB 111 would create the state WOTC as a supplement substantially identical to the federal WOTC, the credit would only be successful in achieving its stated purpose to the extent it increases participation in the program by employers for which the current federal credit amounts were insufficient to incent them to participate. Otherwise, the state supplement rewards activities already occurring because current participants would receive the enhanced credit amounts without increasing the number of targeted individuals they hire or the length of time they retain them.

19. Thus, the Committee could alter the conditions for earning the state WOTC in order to extend the benefits provided by the current program, rather than enhance the current benefits, and incent employers to retain targeted individuals for longer periods of time (Alternative 3). Specifically, the Committee could require an employer to retain the targeted individual for at least 500 hours before qualified wages under the state WOTC were to accrue (compared to the 120 and 400 hour thresholds for the federal WOTC). Similar to the federal credit, this would require the targeted individual to be employed for another 100 hours prior to earning tax benefits, thereby incenting employers to retain the individual for a longer period. Further, the Committee could specify that no state WOTC would be allowed against the first $6,000 of wages paid (compared to the federal WOTC, which is available for all wages up to a maximum limit of $6,000).

20. In addition to providing an incentive to retain targeted individuals for longer periods of time, these changes would enhance the cost effectiveness of the federal program by ensuring that the enhanced credit amounts would not provide a windfall for those employers that would already use the federal program at the current credit amounts.

21. Because these changes would limit the amount of credit available to the extent employers fail to reach the thresholds for the supplement, the estimated cost of the state WOTC would decrease by an unknown amount.

22. Alternatively, for the following reasons, the Committee could decline to create a state WOTC (Alternative 5). First, as a nonrefundable tax credit, the program is only effective for employers with a state tax liability. Thus, nonprofits would have little, if any, incentive to participate in the state WOTC program. The federal WOTC is available to certain tax-exempt organizations for hiring qualified veterans (but not for other targeted individuals) for their share of payroll taxes (such as Social Security). However, this option would not be available for the state supplement, and thus would be of little use to new or currently participating nonprofits. Likewise, the incentive for businesses to participate would vary by tax year, depending on whether they are profitable or if they have little tax liability due to other tax credits and deductions (such as the manufacturing and agriculture tax credit). The issue is somewhat mitigated for businesses because the state proposed WOTC could be carried forward for up to 15 years for use in a future tax year when they may be profitable. However, due to the time value of money, the incentive is reduced the longer the credit is carried forward.

23. Second, the WOTC is not designed to create new jobs, but to incent hiring targeted individuals. As a result, the credit's effectiveness is limited in areas where there are insufficient numbers of preexisting, unfilled jobs for targeted individuals. This makes it difficult to scale the use of the program into the areas of the state where it would most be needed.

24. Thus, rather than create a new state tax credit, the Committee could decide to provide $27,800,000 GPR in 2021-22 and $24,100,000 GPR in 2022-23 to DCF to expand the Transform Milwaukee and Transitional Jobs programs to the targeted individuals outlined above (Alternative 4). As discussed in LFB Paper #201, the Transform Milwaukee and Transitional Jobs Programs offer subsidized work to low-income individuals for up to 1,040 hours (six months, full-time) and provide employers with a wage subsidy to offset their hiring costs. Providing state funding for this preexisting program would make use of current programs already available in the state designed to achieve a similar objective.

ALTERNATIVES

1. Create a nonrefundable income and franchise tax credit for taxable years beginning after December 31, 2020, as a supplement to the federal WOTC. It is estimated that the state WOTC would reduce state tax revenues by $27,800,000 in 2021-22 and by $24,100,000 in 2022-23. [See discussion point #9 for additional detail.]

ALT 1	Change to Base
GPR-Tax	-$51,900,000

2. Create a biennial appropriation and provide $100,000 annually for DWD to promote and

administrate the state and federal WOTC. This alternative may be adopted in addition to either Alternative 1 or 3.

ALT 2	**Change to Base**
GPR	$200,000

3. Adopt Alternative 1, but with the modification to require an employer to retain the targeted individual for at least 500 hours before the state WOTC accrues for qualified wages. Further, the Committee could specify that no state WOTC would be allowed against the first $6,000 of wages paid (compared to the federal WOTC, which is available for all wages up to a maximum limit of $6,000).

ALT 3	**Change to Base**
GPR-Tax	- $51,900,000

4. Create an annual appropriation under DCF and provide $27,800,000 GPR in 2021-22 and $24,100,000 GPR in 2022-23 to expand the Transform Milwaukee and Transitional Jobs programs to provide subsidized employment to the targeted individuals eligible for the federal WOTC program.

ALT 4	**Change to Base**
GPR	$51,900,000

5. Take no action.

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June, 2021 | Joint Committee on Finance | Paper #314

State Housing Tax Credit
(General Fund Taxes -- Income and Franchise Taxes)

[LFB 2021-23 Budget Summary: Page 211, #10]

CURRENT LAW

The federal low-income housing tax credit (LIHTC) provides tax credits to developers of properties serving low-income residents. For 30 years, properties must reserve 20% of units for households with incomes below 50% of county median income, or 40% of units for households with an average income below 60% of county median. Residents pay 30% of their income as rent, including utilities. In exchange, developers receive federal tax credits claimable each year for 10 years.

The federal LIHTC is offered at two levels, a more valuable credit (9% credit) limited to total allocation of $16.4 million each year in Wisconsin under a competitive process, and a less valuable credit (4% credit) provided on an unlimited basis to any development meeting eligibility criteria. Credit values are determined based on the present value of construction costs for a given development, with the 4% credit providing federal tax credits over the 10-year credit period generally equal to at least 30% of the present value of construction costs associated with a project, and the 9% credit providing at least 70% of construction costs. These amounts vary based on market conditions. As of June, 2021, the federal Internal Revenue Service reports the 4% and 9% credits equal approximately 38% and 86% of the present value of a development, respectively.

Developments supported by the 4% credit also receive additional subsidy in the form of financing supported by federal tax-exempt bonds, which have more favorable interest rates. Each year, states are allocated an amount of federal tax-exempt bonding authority ("volume cap"), adjusted annually to reflect cost-of-living increases. For 2021, this amount is $110 per capita, or $325 million, whichever is greater. The Wisconsin Housing and Economic Development Authority (WHEDA) provides a portion of this authority to finance 4% LIHTC projects.

The state housing tax credit was created under 2017 Wisconsin Act 176, and is a nonrefundable tax credit claimable against individual income, corporate income/franchise, and insurance premiums taxes. The state credit is administered by WHEDA, which awards state credits as a match to the federal 4% LIHTC. Act 176 limited WHEDA to certifying credit claims of no more than $42 million annually, equal to awarding $7 million in credits annually that are claimed each year for six years. State credit recipients must maintain compliance with the same low-income requirements as federal properties, and finance their development with federal tax-exempt bonding.

Table 1 shows allocations of the federal 4% credit and state credit since 2018, the first year state credits were awarded. In instances where WHEDA does not fully allocate a prior year's credit, it is allowed to allocate credits under that authority in subsequent years, such as under the 2020 award cycle. Once fully phased in, the current limit will result in an annual reduction in state tax revenue of $42 million.

TABLE 1

State Housing Tax Credit and Federal 4% Low-Income Housing Tax Credit Allocations

Year	Projects	Federal 4% LIHTC	State HTC	Low-Income Units
2018	9	$6,632,587	$6,620,994	1,065
2019	11	7,008,948	6,243,491	796
2020	11	7,958,843	7,947,444	1,009
2021	16	13,286,027	7,112,492	1,334
Total	47	$34,886,405	$27,924,421	4,204

Specific requirements for applications and scoring of housing tax credits are laid out in the Authority's qualified allocation plan (QAP). Under the plan, properties receiving state or federal housing tax credits must receive a determination that identifies a need for housing in a given market, as well as the need for tax credit support to be financially feasible. Further, applicants must undergo a scoring process that determines eligibility, with a minimum score necessary to receive the credit. Scoring gives preference to developments that, among other factors: (a) serve a variety of income levels; (b) are located in lower-income areas; (c) are energy-efficient and sustainable; (d) have units suitable for larger families; (e) provide supportive services; (f) are accessible to disabled persons; (g) rehabilitate or stabilize a neighborhood; (h) are located in rural areas without recent credit awards; and (i) are ready to proceed with construction. The QAP also specifies allocation of credits amongst different categories of need, with applicants competing in their respective category for a portion of total available credits. For the state credit, 2021 awards are split into categories of: (a) projects in rural areas (25% of available credits); (b) projects in small urban municipalities (20%); (c) projects that provide supportive services for persons at risk of homelessness to at least 25% of residents (10%); and (d) a general allocation (45%).

DISCUSSION POINTS

1. As seen in Table 2, Wisconsin has awarded an average of approximately $15.4 million each year in federal 9% credits to developments in Wisconsin since 2016. The process for receiving 9% credits is competitive, and approximately 41% of eligible requests were funded from 2016 to 2021. Projects that do not win a competitive 9% credit may consider applying for the noncompetitive 4% credit, which is available to any project meeting eligibility criteria, including being financed with federal tax-exempt bonds and the same low-income requirements under the 9% credit. However, given the lower value of the 4% credit, projects may not be financially feasible when financed with solely the 4% credit. As noted previously, as of June, 2021, the federal 9% credit provides tax credits equal to roughly 86% of total construction costs, and the federal 4% credit provides tax credits equal to roughly 38% of construction costs.

TABLE 2

Federal 9% Low-Income Housing Tax Credit Requests and Awards

Year	Requested Amount	Eligible Requests	Federal 9% Award	Unmet Requests
2016	$19,425,247	$19,147,095	$15,873,653	17%
2017	25,483,353	19,181,017	10,751,265	44
2018	28,140,769	25,320,304	14,833,291	41
2019	39,218,280	34,629,797	19,856,399	43
2020	35,926,992	30,502,746	16,478,419	46
2021	29,623,810	28,794,924	14,730,616	49
Total	$177,818,451	$157,575,883	$92,523,643	41%

2. To address unmet demand for the 9% credit, the state housing tax credit was created as a supplement to the 4% credit. In general, WHEDA allocates the state credit in an amount equal to the federal 4% credit awarded to a project, up to the state limit of $1.4 million in credits per project, and limited by the total allowable allocation of state credits under the program. However, during the 2021 allocation, WHEDA awarded state credits at a lower ratio relative to federal credits due to limited available state credits. Combined with a federal 4% credit, an equal match of state credits results in tax credits equal to approximately 61% of project costs. While not as high of a proportion of construction costs as a competitive 9% credit, the combined state credit and federal 4% credit with financing supported by tax-exempt bonds represents a significant subsidy for prospective projects that may make many projects financially feasible in lieu of credits under the federal 9% program.

3. Assembly Bill 68/Senate Bill 111 would extend the period that the state housing tax credit may be claimed from six to 10 years, and increase from $42 million to $100 million the total amount WHEDA may certify to be claimed annually. The bill would also allow the Authority to waive the current requirement that a development receiving state housing tax credits be financed with federal tax-exempt bonds if the Authority determines allowable bonding authority under the federal volume cap will be insufficient to finance developments in any given year. As written, the bill does

not have an initial applicability provision, meaning credits awarded prior to the enactment of the bill could be claimed for 10 years, rather than six. The administration reports it intends for the provision to apply only to new projects, and alternatives would incorporate an initial applicability to projects awarded credits after January 1, 2022.

4. The proposed increase of the state credit would consist of two components: (a) an increase in the number of years an awarded credit may be claimed from six to 10; and (b) an increase in the number of credits that may be awarded each year from $7 million to $10 million. The proposal under AB 68/SB 111 would be expected to reduce state income and franchise tax revenue by an additional $58 million annually by 2033-34 once fully phased in.

5. An increased length of credit claims has the effect of increasing the value of the credit for a recipient receiving an award. That is, under current law, if allocated as a match to the federal 4% credit, the state credit provides a subsidy of approximately 23% of the present value of construction costs of a project. If the state credit were extended from six to 10 years, the state credit would provide a subsidy of approximately 38%. If the state credit were provided as an equal match to the federal credit under the proposed increased credit length, the federal 4% and state credit combined would be expected to provide a total subsidy equal to about 76% of the present value of construction costs, not including any additional savings from tax exempt bond-supported financing.

6. Increasing the value of the state credit would increase the number of projects that would be financially feasible if allocated credits, which would increase demand for credits, and resulting construction of affordable housing. Thus, an increased credit value would be intended to increase participation in the state program. However, as seen in Table 3, demand for state credits has grown significantly since the program's inception, and only 46% of eligible requests were met in 2021. Thus, increasing the value of the state credit could be considered unnecessary given the high demand for state credits under their current valuation.

TABLE 3

State Housing Tax Credit Applications and Awards

Year	Requested Amount	Eligible Requests	State Award
2018	$10,421,246	$7,385,579	$6,620,994
2019	14,504,588	6,247,317	6,243,491
2020	12,099,423	8,970,848	7,947,444
2021	16,163,468	15,509,343	7,112,492
Total	$53,188,725	$38,113,087	$27,924,421

Note: Some applications may withdraw or be determined ineligible, resulting in incomplete allocations in some years.

7. Under current law, WHEDA may not award state credits for projects unless it is

determined that such subsidy is necessary for the financial feasibility of a project. Thus, WHEDA could offset the increased allocation period by decreasing the amount of credits provided per project. Notably, as demand was high for credits during the 2021 allocation, WHEDA provided smaller allocations of state credits to more projects, and did not provide an equal match to federal credits for most projects. Thus, regardless of the length and resulting value of a state credit, WHEDA would retain significant discretion in allocating credits to projects to maximize their effectiveness and provide subsidies only as is necessary for financial feasibility. Further, the federal LIHTC is provided over 10 years, and increasing the length of the state credit from six to 10 years would align it with the credit period under federal law.

8. An increased annual credit allocation would increase the number of projects able to be supported by tax credits each year. As noted previously and seen in Table 3, demand has exceeded availability of credits in recent years. Since the state housing tax credit's inception, credits have been provided to 73% of requests, which may suggest demand is sufficient to justify additional state housing tax credits. However, if $10 million in state housing tax credits had been available each year, requests would not have been sufficient to allocate available credits. Thus, the Committee could consider providing a lower additional allocation of state housing tax credits.

9. An analysis by the National Low-Income Housing Coalition, using U.S. Census Bureau data, concluded that Wisconsin's housing shortage disproportionally impacts its lowest-income households. Wisconsin has an estimated 188,100 households earning less than 30% of median income, but 69,000 residences that are considered affordable for those families. For the lowest-income households, an estimated 86% spend more than 30% of household income on rent. Provision of additional funding for state housing tax credits would increase the availability of affordable housing that costs no more than 30% of household income.

10. As the state housing tax credit is typically allocated to match federal 4% credits, provision of additional housing tax credits could be considered a more cost-effective approach to encouraging the development of low-income housing in Wisconsin than other state-operated programs not able to receive unlimited federal matching funds. When a project is not financially feasible if provided only federal 4% credits, a state credit may fill a gap in funding necessary to realize development and capture federal funding that otherwise would not have been used to support housing in Wisconsin. For example, before the creation of the state housing tax credit, WHEDA allocated an average of $1.4 million in federal 4% credits each year from 2005 to 2017 to support construction of an average of 421 low-income units each year. From 2018 to 2021, after the state housing tax credit was created, WHEDA allocated an average of $8.7 million in federal 4% housing tax credits each year to support an average of 1,051 low-income units each year.

11. It may be that high demand for housing tax credits is representative of significant capacity for development of low-income housing projects and that additional credits are unnecessary. That is, it is possible some portion of projects could be modified to become financially feasible without receiving state housing tax credits, and credits may be provided to developers for behavior they would have otherwise conducted regardless of state credits. Thus, additional credit allocations could be ineffective at incentivizing new development.

12. While the Authority generally provides state credits as a match to the federal 4% credit,

there is no requirement under current law that limits awards to the amount of 4% credit awarded. In several instances during the 2021 allocation, WHEDA provided state credits greater than the federal 4% credit allocated to a project. If the Committee wished to increase the total available state housing tax credits in order to leverage available federal 4% credit funding, it could consider limiting WHEDA awards of state housing tax credits to no more than the federal 4% amount awarded to any given project. Creating such a requirement would limit credit awards to a certain proportion of total project cost, in effect creating a match requirement for developers to contribute a certain proportion to project financing. Such a requirement would limit provision of state credits to projects that are more cost-effective and thus extend the relative impact of state credits offered for development of low-income housing.

13. As part of its expansion of the state housing tax credit, AB 68/SB 111 would authorize WHEDA to waive the requirement that a development receiving state housing tax credits be financed with federal tax-exempt bonds if the Authority determines that available tax-exempt bonding authority is insufficient to finance developments in a given year. Under current law, state housing tax credit developments must receive financing with tax-exempt bonding, as is required for developments receiving federal 4% credits. As tax-exempt bonding allows for lower-cost lending to developments, use of tax-exempt bonding limits the amount of state housing tax credit necessary to make a project financially feasible. Thus, the requirement for use of tax-exempt bonding limits the impact to state tax revenues of developing state housing tax credit properties.

14. Given the significant proposed increase in allocations of state housing tax credits, it is possible that federal tax-exempt bonding may be insufficient to offer financing to proposed projects. In the event such tax-exempt bonds were not available, WHEDA would still be able to offer state housing tax credits. As the provision applies only if such tax-exempt bonding were not available, priority would still be given to projects subsidized with tax-exempt bonding. However, regardless of this provision, federal 4% credits would remain available only to projects financed with tax-exempt bonding, as required under federal law.

15. Given the shortage of affordable housing for low-income residents in Wisconsin, high demand for state and federal low-income housing tax credits, and the opportunity to leverage additional available federal 4% credits for development of low-income housing in Wisconsin, the Committee could consider increasing the cap on allocation of state housing tax credits in Wisconsin. Consideration could be given to the proposal under AB 68/SB 111 to raise the annual cap to $100 million, equal to $10 million per year over a longer credit period of 10 years [Alternative 1]. It is estimated that the increase under Alternative 1 would not reduce state tax revenues during the 2021-23 biennium, but would begin reducing state tax revenues by an additional $750,000 in 2023-24 and $3,750,000 in 2024-25, phasing in to a total additional decrease of $58 million by 2033-34.

16. Given demand for state credits in recent years, the Committee could consider a smaller increase to the credit cap. If the Committee wished to increase the amount of credits available, but not their value, it could increase the annual cap to $60 million, equal to $10 million per year over the six year credit period under current law [Alternative 2]. It is estimated that the increase under Alternative 2 would not reduce state tax revenues during the 2021-23 biennium, but would begin reducing state tax revenues by an additional $750,000 in 2023-24 and $3,750,000 in 2024-25, phasing in to a total

additional decrease of $18 million by 2029-30.

17. If the Committee wished to ensure increased credit allocations were provided to leverage federal 4% credits provided to projects, it could specify that the allocation of state housing tax credits to a given project not exceed the federal 4% credit awarded to that project [Alternative 3], as has generally been the practice for state housing tax credit projects in recent years.

18. If the Committee elected to increase state housing tax credit allocations, it could also consider providing WHEDA the authority to waive the requirement that a state housing tax credit-supported development be financed with tax-exempt bonding if it determines available tax-exempt bonding were insufficient in any given year [Alternative 4]. If the Committee were concerned about additional tax credits supporting behavior that is already occurring, it could also take no action, and state housing tax credits would be capped at $42 million, equal to $7 million per year claimable over six years [Alternative 5].

ALTERNATIVES

1. Increase the total amount of state housing tax credits that WHEDA may certify to be claimed to $100 million and allow credits to be claimed each year for 10 years. Specify that the increased cap apply first to projects awarded credits after January 1, 2022. (It is estimated that the increase would not reduce state tax revenues during the 2021-23 biennium, but would begin reducing state tax revenues by an additional $750,000 in 2023-24 and $3,750,000 in 2024-25, phasing in to a total additional decrease of $58 million by 2033-34.)

2. Increase the total amount of state housing tax credits that WHEDA may certify to be claimed to $60 million, equal to $10 million per year over the six-year credit period under current law. Specify that the increased cap apply first to projects awarded credits after January 1, 2022. (It is estimated that the increase would not reduce state tax revenues during the 2021-23 biennium, but would begin reducing state tax revenues by an additional $750,000 in 2023-24 and $3,750,000 in 2024-25, phasing in to a total additional decrease of $18 million by 2029-30.)

3. Limit the allocation of state housing tax credits to a given project to no more than the amount of federal 4% low-income housing tax credits awarded to that property.

4. Allow WHEDA to waive the requirement that a state housing tax credit-supported development be financed with tax-exempt bonding if it determines available tax-exempt bonding were insufficient in any given year.

5. Take no action.

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June, 2021 Joint Committee on Finance Paper #315

Limit Credit for Taxes Paid to Surrounding States
(General Fund Taxes -- Income and Franchise Taxes)

CURRENT LAW

A nonrefundable credit for taxes paid to other states is available to taxpayers who are Wisconsin residents and who paid income and/or franchise tax on the same income both to Wisconsin and to another state, including the District of Columbia. The credit is equal to the amount of net tax paid to the other state on the same income that is subject to Wisconsin taxation, but the amount of the credit is limited to the amount of net tax that would be paid if the income were taxed under the Wisconsin individual income tax. However, this limitation does not apply to Wisconsin residents' income that is taxed in the four states which share a border with Wisconsin (Illinois, Iowa, Michigan, and Minnesota).

The credit does not apply to taxes paid by Wisconsin residents on personal service income (such as wages, salaries, and commissions) to Wisconsin and to another state with which Wisconsin has an income tax reciprocity agreement (Illinois, Indiana, Kentucky, and Michigan). Because the reciprocity agreement prohibits the other state from collecting tax on the Wisconsin resident's personal service income, there is no basis on which to claim the credit for this income. However, the credit can be claimed for taxes paid to Wisconsin and another reciprocity state on income other than personal service income, such as income from the sale of real property, rental income, or business income. Finally, the credit cannot be claimed on the same income for which a manufacturing and agriculture credit is claimed in the same tax year.

Tax-option (S) corporations and partnerships that elect to be taxed at the entity level may also claim the credit for taxes paid to another state from a partnership income or franchise tax return or from an individual income tax return if paid at the entity level on another state's composite return. The credit claimed at the entity level is generally computed to be the same credit amount as if each partner, member, or shareholder claimed the credit separately. Part-year residents are eligible for the credit on income earned while a Wisconsin resident.

BACKGROUND

2017 Act 59 limited the credit for taxes paid to other states by stipulating that the credit cannot exceed the net tax that would be paid if the income were taxed under Wisconsin's individual income tax. This limitation first applied for tax year 2017, but it does not apply for taxes paid to any of the four surrounding states, as mentioned above. At the time this limitation was enacted under Act 59, it was estimated that income tax collections would increase by $11.3 million in 2017-18 and $9.0 million in 2018-19.

DISCUSSION POINTS

1. Wisconsin taxes all income of its residents, regardless of where that income is earned. The same is true for part-year residents for the period of time during which they are a resident of Wisconsin. For nonresidents (and part-year residents during the period of time in which they are not a Wisconsin resident), Wisconsin only taxes income which is derived from Wisconsin sources (such as wages/salaries earned for services performed in Wisconsin, rental income from tangible property located in Wisconsin, etc.).

2. In general, sound tax policy attempts to ensure that the income of an individual is taxed only once. This is the main rationale for providing a credit for taxes paid to other states on the same income for which tax is paid to Wisconsin.

3. A credit for taxes paid to other states is a common feature of state individual income tax structures. Every two years, this office prepares an informational paper reviewing the individual income tax provisions of each state with such a tax. Based on that review, out of 44 states (including the District of Columbia) with an individual income tax in tax year 2019, 42 offered a credit for taxes paid to another state. Only New Hampshire and Tennessee did not provide such a credit. However, only interest and dividend income was subject to taxation in these two states in tax year 2019. Thus, each state with a relatively broad-based individual income tax provided a credit for taxes paid to other states in tax year 2019.

4. The other states tax credit is comparable to the treatment of business income of corporations using a single sales factor apportionment formula under the corporate income/franchise tax. When states tax the income of corporations generated by activities carried on across state lines, they are required under the due process and commerce clauses of the U.S. Constitution to tax only income that is fairly attributable to activities carried on within the state. In order to meet this constitutional obligation, Wisconsin employs a single sales factor apportionment (among other methods). Such apportionment is determined by dividing the total sales or receipts of the corporation in Wisconsin by the total sales or receipts of the corporation everywhere. Income apportioned to a state or territory that does not impose tax on that income is generally apportioned to, and taxed by, Wisconsin, similar to how income earned by an individual in a state without an income tax does not generate a credit for taxes paid to other states.

5. Policymakers may be concerned about the lack of a limitation on the credit for taxes paid to the four surrounding states. Under current law, if a Wisconsin resident incurs a Minnesota net

tax liability of $2,000 that would equate to a Wisconsin net tax liability of $1,500 on the same income, this individual can still claim a credit against their Wisconsin income tax for the full $2,000 of net tax paid to Minnesota. If this same income were instead taxable by South Dakota, the individual could only claim a credit for $1,500 (equal to the amount of net tax they would otherwise incur in Wisconsin on that income). Critics might question why the current credit treats taxpayers with identical amounts of taxable income differently based solely on the state in which the income is taxable.

6. Moreover, they might contend that the current credit is inefficient because it subsidizes Wisconsin residents for generating additional income in surrounding states where higher net tax liabilities are incurred. Under the current credit, taxpayers might be encouraged to engage in a greater level of economic activity in a surrounding state than they otherwise would, because they know their full net tax liability in that state can be used to offset taxes owed to Wisconsin. Further, the current credit could allow the spouse of a married taxpayer filing jointly to offset Wisconsin tax liability with a credit generated from taxes paid on income earned in a surrounding state, creating a tax benefit that could not be realized by a similarly situated couple whose entire income is earned in Wisconsin. Efficient tax policy discourages this sort of distortion of the allocation of economic resources. Under the current credit structure, Wisconsin essentially pays resident taxpayers for the higher tax liabilities they incur in surrounding states. It could be argued, therefore, that the credit that currently exists for the surrounding states improperly exceeds its policy goal of preventing double taxation on the same income.

7. Proponents of the current credit structure may point out that Minnesota's other states credit includes preferential treatment for taxes paid to Wisconsin. Under Minnesota law, if a Minnesota resident's net tax owed to Wisconsin is greater than the net tax owed to Minnesota, the excess which is attributable to personal service income is eligible for a refundable credit. Wisconsin is the only state for which Minnesota provides such treatment.

8. Opponents could counter that similar preferential treatment is not provided in the other surrounding states. Iowa and Illinois do not offer tax-advantaged treatment for taxes paid to Wisconsin relative to taxes paid to any other state. Moreover, Michigan does not allow a credit for taxes paid to Wisconsin at all. The Michigan credit cannot exceed the amount of Michigan tax paid on the personal service income earned in another state, and since this income is already covered by the Wisconsin-Michigan income tax reciprocity agreement, no credit is permitted.

9. The Committee could decide to limit the credit for taxes paid to the four surrounding states by specifying that, beginning in tax year 2021, the credit cannot exceed the net tax that would be paid to Wisconsin on the same income (Alternative 1). This alternative is estimated to increase income and franchise tax collections relative to current law by $17.7 million on an annual basis, beginning in 2021-22. It is estimated that nearly 85% of this fiscal effect is attributable to taxes paid to Minnesota.

10. Those in favor of retaining the current credit structure for surrounding states might argue that limiting the credit as described under Alternative 1 is not desirable because it would represent a net tax increase on Wisconsin residents who earn income in other states. They might posit that the current credit structure maintains the essential feature of the former income tax reciprocity agreement between Minnesota and Wisconsin (which existed until tax year 2010), which was to ensure that the

out-of-state net tax paid by Wisconsin residents working in Minnesota did not exceed the net tax they would owe in Wisconsin. Allowing affected taxpayers to credit against their Wisconsin income tax the full amount of net income taxes paid to surrounding states, specifically Minnesota, ensures that this treatment is retained even in the absence of reciprocity.

11. It should also be noted that the COVID-19 pandemic could impact the fiscal effect under Alternative 1 in the near-term. Guidance from revenue agencies in surrounding states suggests that Wisconsin residents who normally work in a surrounding state -- but who are working remotely from Wisconsin during the pandemic -- may be required to apportion their income to the surrounding state based on the number of days worked inside that state relative to the total number of days worked. In other words, these individuals may pay a lower amount of tax to the surrounding states than they would have prior to the pandemic. To the extent this actually occurs during tax year 2021, the fiscal effect noted above would be lower in 2021-22.

ALTERNATIVES

1. Beginning in tax year 2021, specify that the current law credit for income and franchise taxes paid to Illinois, Iowa, Michigan, and Minnesota is limited to the amount of net tax payable to Wisconsin on the same income. Estimate increased income and franchise tax collections relative to current law of $17,700,000 in 2021-22 and 2022-23.

ALT 1	Change to Base
GPR-Tax	$35,400,000

2. Take no action.

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June, 2021 Joint Committee on Finance Paper #316

Repeal Obsolete Tax Credits and Appropriations (General Fund Taxes -- Income and Franchise Taxes)

CURRENT LAW

A tax credit is an amount that is subtracted from the gross income tax liability of the taxpayer in a given year. Business tax credits are generally available to businesses to reduce state income and franchise tax liability, and some credits are available to insurers to reduce insurance premiums and gross investment tax liability. In general, a tax credit differs from a deduction in that the credit is subtracted from the tax itself, resulting in a dollar-for-dollar reduction in the gross tax liability. In contrast, a deduction is subtracted from income, resulting in a reduction in the amount of income subject to tax.

Some tax credits are refundable. When a refundable tax credit exceeds gross tax liability, the taxpayer receives a payment for the difference between the credit amount and the tax liability. For the nonrefundable credits, unused amounts for certain credits (most business credits) can be carried forward and claimed in future years. In some cases, unused credits can be sold or otherwise transferred to other taxpayers. Nonrefundable credits available to individuals typically cannot be carried forward for use in future years.

The tax credits described below were previously available to be used under the individual income tax, corporate income/franchise tax, and/or insurance premiums tax. These credits have been sunset under prior acts of the Legislature and can no longer be claimed to offset tax. However, the credits remain enumerated in the statutes. In general, a taxpayer can amend a tax return from a prior year to timely claim a credit within four years of the unextended due date for that taxable year.

Refundable Tax Credits. Under the individual income tax and the corporate income/franchise tax, the refundable farmland tax relief credit was sunset after tax year 2009.

Claims for farmland tax relief credits were paid from: (a) a sum sufficient GPR appropriation prior to the 2000 budget; (b) a sum sufficient SEG appropriation using lottery fund revenues prior to tax year 2009, but not during 1999-00; and (c) an all monies received PR appropriation from tribal gaming revenues. The last date a taxpayer could amend their return to timely claim the credit was April 15, 2015. Base funding of $0 is provided for each of these appropriations.

The earned income tax credit (EITC) has not been sunset and is available under current law. However, the statutes enumerate prior iterations of the credit that were available to individuals through tax years 1993, 1994, 1995, and 2010. The last date an individual could amend their return to timely file any of the previously authorized EITC claims was March 15, 2016.

Nonrefundable Tax Credits for Individuals. The statutes provide a nonrefundable personal exemptions credit for natural persons under the individual tax for tax years 1986 through 1999. The personal exemptions credit was sunset and replaced with personal exemptions beginning in tax year 2000. No personal exemption credit could be claimed after tax year 1999. The last date an individual could amend their return to timely claim the credit was March 15, 2005.

State law also provided a nonrefundable community development finance authority credit under the individual income tax, which was sunset after tax year 2013. Unused credits for individuals could not be carried forward and claimed after that year. The last date an individual could amend their return to timely claim the credit was March 15, 2019.

Nonrefundable Tax Credits for Businesses. Under the corporate income/franchise tax, the nonrefundable relocated business credit was sunset after tax year 2013, except that a claimant who was first eligible to claim a credit in tax year 2013 could claim the credit in tax year 2014. Unused relocated business credits could not be carried forward for use in future tax years. The last date a taxpayer could amend their return to timely claim the credit was April 15, 2020.

The airport development zones credit was available to eligible businesses that were certified by the former Department of Commerce (Commerce) as eligible to receive the credit prior to March 6, 2009. The airport development zones credit was consolidated under the economic development tax credit under 2009 Act 2. However, Commerce did not certify any businesses as eligible to receive the airport development zones credit prior to March 6, 2009.

Insurance companies subject to the insurance premiums tax were eligible to claim the credit for certified capital investment companies (CAPCOs) certified by Commerce for ten years, beginning with the year of the certified capital investment. All credit certifications were completed by Commerce in 1999. Credits claimed but not used to offset the premiums tax could be sold to another insurer or could be carried forward indefinitely for use in future tax years. However, the credit has not been used to offset the premiums tax since tax year 2012.

DISCUSSION POINTS

1. Tax credits are generally sunset, rather than repealed, to allow eligible claimants to claim the credit when timely filing a return or an amended return. For refundable credits, the appropriations

must be retained after the sunset date to pay credits claimed on amended returns. A return can be amended within four years after the unextended due date to which the claim relates. For example, the majority of individuals, and most corporate filers, have a tax year that coincides with a calendar year. If a claimant claimed the refundable farmland tax relief credit in tax year 2009 (the last year to claim the credit), the unextended due date for that return would be the 15th day of the fourth month following the close of the tax year (April 15, 2010) for an individual and the 15th day of the fifth month following the close of the tax year for a corporate filer (May 15, 2010). These taxpayers may file an amended return to claim the credit for up to four years beyond the unextended due date of the tax year. As a result, an eligible claimant whose tax year coincides with a calendar year could file an amended return to claim the farmland tax relief credit until April 15, 2014 for an individual filer (May 15, 2014 for a corporate filer).

2. However, many corporations, and some individuals, have a tax year that does not align with a calendar year. For example, a corporate filer that claimed the relocated business credit in tax year 2014 (the last year to claim the credit) that had a tax year beginning on December 1, 2014, could timely file their return by April 15, 2016, and could file an amended return to claim the credit through April 15, 2020.

3. With the exception of the credit for CAPCOs, each of the credits identified above no longer allow amended returns to claim the credit and could be repealed without any impact on taxpayers that file an income tax or franchise tax return [Alternative 1].

4. The credit for CAPCOs authorizes the indefinite carryforward of unused credits under the insurance premiums tax. As noted, the credit has not been claimed since tax year 2012. According to records maintained by the Office of the Commissioner of Insurance (OCI), three companies have unused credits totaling $142,000. However, these companies have not claimed a credit against the premiums tax since processing year 2008-09. The Committee could consider whether the statutes should be maintained indefinitely, or whether the credit should be repealed effective January 1, 2023 [Alternative 2]. The delayed repeal date would allow an additional year and a half for these companies to either: (a) claim the credit against premiums taxes when filing a return for tax year 2021; (b) file an amended return to claim and use the credit against taxes paid in a previous year; or (c) sell the credit to another insurance company that could use the credit to offset its premiums taxes.

5. According to the Legislative Reference Bureau, if the Committee chose to repeal the tax credit statutes and appropriations identified above, the number of printed pages of the statutes would be reduced by approximately 14 pages.

ALTERNATIVES

1. Repeal the GPR, SEG, and PR appropriations and associated statutory language related to the farmland tax relief credit. Repeal the nonrefundable tax credit statutes associated with the airport development zones credit, personal exemptions for natural persons credit, and relocated business credit. Repeal the nonrefundable community development finance credit statutes under the individual income tax. Repeal the EITC statutes that were sunset after tax years 1993, 1994, 1995, and 2010.

2. Adopt Alternative 1. In addition, repeal the nonrefundable tax credit statutes associated with the credit for certified capital investment companies on January 1, 2023.

3. Take no action.

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June, 2021 Joint Committee on Finance Paper #317

First-Time Homebuyer Savings Accounts (General Fund Taxes -- Income and Franchise Taxes)

[LFB 2021-23 Budget Summary: Page 212, #13]

CURRENT LAW

There are several steps involved in calculating a taxpayer's total state tax liability. In brief, these steps are to: (a) determine Wisconsin adjusted gross income (AGI); (b) subtract the state's sliding scale standard deduction and personal exemptions from Wisconsin AGI to arrive at taxable income; (c) apply the state's tax rate and bracket structure to taxable income to figure gross tax liability; (d) subtract any applicable nonrefundable credits to compute net tax liability; and (e) employ any applicable refundable credits to determine total tax liability. To determine Wisconsin AGI under (a), several modifications are made to federal AGI. These modifications can take the form of additions to, or subtractions from, federal AGI, and reflect differences between the state and federal tax codes.

BACKGROUND

The Wisconsin Realtors Association (WRA) contends that Wisconsin faces a problem of declining housing affordability. According to a 2019 report on workforce housing from WRA, housing affordability for "entry-level" homes has declined in 57 of the 72 counties in Wisconsin from 2007 to 2017 (the WRA index for "entry-level" housing compares a county's median price of homeownership using a low-down-payment mortgage to that county's median household income to determine the level of affordability). Moreover, Federal Housing Finance Agency (FHFA) data compiled by WRA demonstrate that the average home price in Wisconsin is greater than its previous peak in 2007 (the period immediately preceding the national housing crisis).

Median home price data for Wisconsin from WRA demonstrate that housing costs have risen by a compound annual average growth rate of 4.4% between 2010 and 2020. Between 2015 and

2020, that rate is 7.3%. Comparable data from the Federal Reserve Bank of St. Louis show that the compound annual average rate of growth in median home prices nationwide was 4.2% between 2010 and 2020 and 2.8% between 2015 and 2020, indicating that the rising cost of housing in Wisconsin has exceeded national growth in housing costs over the last decade.

WRA notes that housing costs are currently outpacing income growth in the state. WRA highlights several reasons for this trend, including: (a) population growth eclipsing the rate of housing construction; (b) steadily rising construction costs due to price increases for materials and labor shortages; and (c) stringent zoning regulations that curtail the supply of housing. Housing costs rising more quickly than income is one reason for the reported decline in homeownership, particularly among first-time homebuyers. Table 1 displays overall rates of homeownership in Wisconsin, and in the U.S., since 1990, using economic data from the Federal Reserve Bank of St. Louis.

TABLE 1

Homeownership Rate, U.S. and Wisconsin: 1990 to 2020

Year	U.S.	Wisconsin
1990	64.0%	68.3%
1995	64.8	67.5
2000	67.4	71.8
2005	68.9	71.1
2010	66.9	71.0
2015	63.7	66.6
2020	66.6	67.9

Table 1 demonstrates that the Wisconsin homeownership rate has outpaced that of the U.S., but the rate for Wisconsin has generally declined since 2000. The homeownership rate in Wisconsin in 2020 was roughly equivalent to the rate in 1995. It could be argued that this is an indication that homeownership rates have returned to historically normal levels. A 2016 report in the Housing Market Perspectives series of the Federal Reserve Bank of St. Louis notes that, "prior to the late 1990s, the homeownership rate had fluctuated for three decades in a narrow band, between 63% and 66%. This still might be the range to expect in the future."

DISCUSSION POINTS

1. Rising home prices in Wisconsin translate to a larger down payment needed for first-time homebuyers to finance the purchase of a home. Moreover, increasing costs to rent make it more difficult to save money up front for a subsequent home purchase. U.S. Census Bureau data reported by WRA show that median rent costs grew by 21.7% from 2007 to 2017, while median household incomes grew more slowly (17.3%) during this same period. In its Renter Affordability Index (RAI) for 2017, WRA demonstrates that the median renting household cannot afford the median-priced rental unit in 14 of the 72 counties throughout Wisconsin. The RAI measures whether a family earning

the median household income in a particular county can afford the median-priced rental unit by spending no more than 30% of their income on rent. These growing costs to rent and to own a home can combine to exacerbate the issues of declining housing affordability and rates of homeownership.

2. The National Association of Realtors (NAR) finds that the share of first-time homebuyers as a percentage of all homebuyers is historically near 40%. However, in its most recent profile of homebuyers and sellers, NAR notes that the current first-time homebuyer share is 31%. Table 2 displays homeownership rates by age category for the nation as a whole between 1985 and 2020, using data from the U.S. Census Bureau. Individuals who are 35 years of age or younger could be considered the closest proxy for first-time homebuyers. Indeed, NAR reports that the typical first-time homebuyer is 32 years of age.

3. Over the entire period depicted in Table 2, the homeownership rate has declined for each age group except for those aged 65 or older. Since 2005, however, rates of homeownership have declined for all age groups, with individuals aged 35 to 44 experiencing the largest percentage point decrease during that span (6.5). Over this same period, individuals under the age of 35 registered a 3.8 percentage point decline in homeownership. Both declines are considerably larger than for the U.S. as a whole during the same time (2.3). Conversely, individuals younger than age 35 and aged 35 to 44 experienced the largest percentage point growth in homeownership rates since 2015 among all age groups.

TABLE 2

Homeownership Rates by Age of Homeowner, United States: 1985 to 2020

Year	Under 35	35 to 44	45 to 54	55 to 64	65 and over	U.S. Total
1985	39.9%	68.1%	75.9%	79.5%	74.8%	63.9%
1990	38.5	66.3	75.2	79.3	76.3	64.0
1995	38.6	65.2	75.2	79.5	78.1	64.8
2000	40.8	67.9	76.5	80.3	80.4	67.4
2005	43.0	69.3	76.6	81.2	80.6	68.9
2010	39.1	65.0	73.5	79.0	80.5	66.9
2015	35.0	58.5	70.0	75.4	78.9	63.7
2020	39.2	62.8	71.1	76.5	80.0	66.6
	Percentage Point Change in Homeownership Rate					
2005 to 2020	-3.8%	-6.5%	-5.5%	-4.7%	-0.6%	-2.3%
2010 to 2020	0.1	-2.2	-2.4	-2.5	-0.5	-0.3
2015 to 2020	4.2	4.3	1.1	1.1	1.1	2.9

4. The aforementioned decline in homeownership since 2005 is largely attributable to the bursting of the housing bubble, which precipitated the 2008-09 national economic downturn referred to as the "Great Recession." In the wake of the Great Recession, several legislative and regulatory

safeguards were implemented to strengthen the housing market. However, many of these changes may have disproportionately impacted first-time homebuyers. For example, lending agencies now generally impose stricter credit standards on prospective buyers than before the financial crisis. First-time homebuyers may have more difficulty establishing a strong credit rating than those who have previously owned a home (and have been able to build credit by making consistent mortgage payments). In addition, debt-to-income ratios for borrowers are now more restrictive than before the housing market crash, which can make it more challenging for new homebuyers to enter the housing market. This trend is exacerbated by student debt loads, which have been steadily rising in recent years.

5. According to NAR, the typical first-time homebuyer holds nearly $30,000 in student debt. Data from the St. Louis Federal Reserve demonstrate that the aggregate amount of outstanding student loans in the U.S. has grown from $800 billion in 2010 to nearly $1.7 trillion in 2020. It could be argued that rising student loan debt is one reason why the share of first-time homebuyers is below the historical trend. A 2019 survey conducted by Freddie Mac (the Federal Home Loan Mortgage Corporation) found that 22% of current renters chose to delay buying a home in order to service their student debt obligations. These increased debt loads can impose a significant financial burden on prospective first-time homebuyers, so a program that offers tax savings for the eventual purchase of a home could be viewed as a way to ameliorate these financial challenges.

6. Further, the Great Recession engendered a relative scarcity of modestly priced homes, which are generally more attainable for first-time homebuyers. In the wake of the financial crisis, large volumes of moderately-priced homes slated for foreclosure were auctioned off, and many were ultimately sold to companies that converted the homes into rental properties. As a result, the available stock of entry-level homes, which would otherwise be attractive to first-time homebuyers, contracted. Freddie Mac similarly maintains that the overall shortage of single-family homes in the U.S. is especially pronounced for entry-level homes, which makes it increasingly expensive for first-time homebuyers to enter the market. This lower level of affordable housing stock could bolster the rationale for providing financial assistance to first-time homebuyers.

7. The Joint Center for Housing Studies at Harvard (JCHS) reports that annual growth in nominal home prices has been positive for each of the last eight years, and that nominal home prices are now 20% higher than their previous apex in 2007. JCHS cautions that these steadily rising home prices make it increasingly difficult for first-time buyers to afford the down payment and closing costs associated with the purchase of a home. Because it provides a tax advantage for these costs, the proposed first-time homebuyer savings account program could help ease the financial barriers to homeownership that these buyers often confront.

8. Another way to demonstrate the recent decline in housing affordability is by comparing growth in per capital personal income to growth in the house price index compiled by FHFA. This comparison is displayed in Table 3, which uses personal income data from the U.S. Department of Commerce, Bureau of Economic Analysis (BEA), in addition to FHFA data. The FHFA house price index measures average price changes in repeat sales or refinancings on the same properties, based on properties whose mortgages have been purchased or secured by Fannie Mae (Federal National Mortgage Association) or Freddie Mac. Both the BEA and FHFA maintain data specific to

Wisconsin. As shown in Table 3, average per-capita income growth has outpaced average growth in the house price index in each period except for the most recent five years. Between 2015 and 2020, the average growth of the Wisconsin house price index is noticeably larger than the average growth in per-capita personal incomes over the same period, suggesting that housing in Wisconsin has become less affordable during this time.

TABLE 3

Average Rate of Change in Wisconsin Per-Capita Personal Income and Wisconsin House Price Index for Select Periods Ending in 2020

Period Beginning	Per-Capita Personal Income	House Price Index
1995 (25-yr. average)	3.6%	3.0%
2000 (20-yr. average)	3.2	2.6
2005 (15-yr. average)	3.2	1.4
2010 (10-yr. average)	3.6	2.4
2015 (5-yr. average)	3.4	4.8

9. To combat these issues related to the affordability of homeownership, the Committee could decide to create a program administered by the Department of Revenue (DOR), beginning in tax year 2022, allowing an individual to become an account holder by creating an account at a financial institution, either individually or jointly with his or her spouse, to pay or reimburse the eligible costs of a first-time homebuyer (Alternative 1). Eligible costs would mean the down payment and allowable closing costs, defined as disbursements listed in a settlement statement for the purchase of a single-family residence in Wisconsin by an account owner or beneficiary. The program would be limited to individuals who reside in Wisconsin and have not owned or purchased, either individually or jointly, a single-family residence during the 36-month period prior to the month of purchase of a single family residence that is located in Wisconsin. The program would first take effect for tax year 2022, so that DOR would have adequate lead time to develop policies and procedures necessary to administer the program.

Such a program could be structured so as to authorize account holders to subtract from federal AGI the amount of any deposits by the account holder into their accounts, as well as any interest, dividend, or other gain accruing in the account, if the interest, dividend, or other gain is redeposited into the account. The Committee could choose to limit the subtraction for each account holder to $5,000 of deposits per year, or $10,000 of deposits per year if the account holder is a married-joint filer, for each account that the account holder creates and to which the account holder makes a deposit (the amount of interest, dividends, or other gains accruing to and subsequently redeposited in the account that may be excluded from taxable income would not be limited). An account holder could not claim the subtraction for more than a total of $50,000 of deposits into any account for each beneficiary. Such a proposal is included in Assembly Bill 68/Senate Bill 111 (AB 68/SB 111), and was originally estimated by the administration to reduce individual income tax collections by $4.1 million in 2022-23, $7.0 million in 2023-24, and $7.5 million in 2024-25.

Account holders would be required to dissolve an account not later than 120 months (10 years) after its creation, and financial institutions would be required to distribute any proceeds in dissolved accounts to the account holder. If the account holder dies while funds remain in the account, proceeds would be required to be distributed to the account holder's estate. Account holders would need to increase their AGI to include any distribution of proceeds from a dissolved account, and account holders' estates would be required to increase the AGI of the estate to include any distribution to an account holder's estate after the death of an account holder. In addition, account holders would have to increase their AGI to reflect any amount withdrawn from an account for any reason other than payment or reimbursement of eligible costs, unless the withdrawal is the result of a transfer to an account at a different financial institution, or unless the disbursement is pursuant to a filing for bankruptcy protection. A penalty of 10% would apply to any amounts which are added to AGI under the preceding provisions.

For federal tax purposes, no deduction for contributions is, or would be, allowed, and the interest earnings accruing to accounts would be subject to federal income tax. Since the accounts would be taxable on the "front end," no federal tax would be imposed at the time of withdrawal. Nor would withdrawals trigger a state tax liability, provided the proceeds are used for eligible costs. The account holder would be required to designate a single account beneficiary who is a first-time homebuyer and who may be the account holder. The account holder would be permitted to change the beneficiary at any time. Individuals would be allowed to jointly own accounts with their spouses. An individual may be the account holder of more than one account, but the account holder could not have more than one account that designates the same beneficiary. However, an individual could be the beneficiary of more than one account.

Account contributions would be limited to cash and marketable securities, and persons other than account holders would be allowed to contribute to accounts. However, only the account holder would be able to take the subtraction described above for first-time homebuyer account contributions. Account holders would be required to submit the following information related to the account to DOR each year, on forms prepared by the Department, with the account holder's income tax return: (a) a list of account transactions during the tax year, including the account's beginning and ending balances; (b) the 1099 form issued by the financial institution relating to the account; and (c) a list of eligible costs, and other costs, for which account funds were withdrawn during the tax year. Account holders would be authorized to withdraw and transfer funds to a different financial institution without incurring a withdrawal penalty or affecting the account holder's Wisconsin AGI, provided the transfer occurs immediately and the funds are deposited in a first-time homebuyer savings account at that institution.

10. Every two years, this office publishes an informational paper that reviews the individual income tax provisions in each state with such a tax. Based on that review, 11 states provided some form of preferential tax treatment for first-time homebuyers in tax year 2019.

11. The fiscal estimate included in AB 68/SB 111 assumed that the rate of participation in a first-time homebuyer savings program could be as high as 30%. However, based on correspondence with several states who have implemented similar first-time homebuyer tax benefit programs in their state tax codes, it appears that actual rates of program participation are considerably lower. Therefore,

it is estimated that Alternative 1 would reduce individual income tax revenues by $0.2 million in 2021-22 and $1.5 million in 2022-23.

12. Under the proposed first-time homebuyer savings account program, there would be no required minimum duration for funds to remain in the account in order to receive the associated tax benefits. Therefore, if an individual opened an account just prior to purchasing a home, deposited the annual maximum contribution into the account ($5,000 or $10,000 depending on their filing status), and then immediately withdrew these funds to purchase a home, they would still be eligible for the full tax deduction on the amount temporarily contributed to the account prior to purchasing a home. This process does not apply to other tax-advantaged savings accounts. For example, 529 college savings accounts generally require that funds remain in the account for at least 365 days in order to receive tax benefits. The Committee could choose to modify Alternative 1 to require that contributions into a first-time homebuyer account must remain in the account for at least one year in order to qualify for the related tax preferences (Alternative 2). This alternative is estimated to reduce individual income tax revenues by $0.7 million on an annual basis relative to current law, beginning in 2022-23.

13. WRA reports that the median price of homes sold in Wisconsin in 2020 was $220,000. An account with a $50,000 balance (the maximum allowed under the proposed first-time homebuyer account) could provide a 20% down payment on a home with a $250,000 selling price, which is reasonably comparable to the median price of Wisconsin homes. A 20% down payment is a goal for many buyers because a down payment at that level eliminates the requirement for private mortgage insurance (PMI), which protects the lender against foreclosure on loans with less than a 20% down payment. The associated premiums typically increase a homeowner's mortgage payment by $30 to $70 per month for every $100,000 borrowed, but the actual PMI rate depends on the borrower's credit rating. If a buyer is willing to incur that cost, conventional mortgages are available in the private sector with down payments of less than 20%.

14. It has been argued that homeownership is an important vehicle for building wealth. One reason for this is that mortgage payments (and the initial down payment) constitute a form of investment, wherein the value of the home is incorporated into the homeowner's wealth once the mortgage is fully paid. In addition, the house price index from FHFA demonstrates that home prices have grown at an average annual growth rate of 3.9% since 1991 (6.5% since 2012), which generally outpaces the average rate of inflation during that span. Because home prices have generally appreciated faster than inflation, homeownership can add to the real wealth of the homeowner over time (appreciating home values also make it more financially difficult for new buyers to enter the market). As the home appreciates in value, the homeowner's mortgage payment remains fixed. Thus, as a share of income, inflation-adjusted housing payments for homeowners generally decrease over time, enabling homeowners to retain a greater share of their earnings. However, the wealth-building aspect of homeownership is mitigated by regularly incurred expenses, such as maintenance costs (for which it is often recommended to save at least 1-2% of the home's total purchase price each year), homeowners' insurance, mortgage interest, PMI, and property taxes.

15. Homeownership as wealth creation is likely of particular importance for individuals with relatively moderate incomes. A study completed by the University of North Carolina at Chapel Hill found that, among low-income and middle-income households, consistent ownership of a home

translated into higher levels of reported median wealth than for groups who did not report consistent homeownership. A study commissioned by the U.S. Department of Housing and Urban Development noted similarly that "owned housing is an important means of wealth accumulation," particularly for lower-income and minority households. Furthermore, JCHS concluded that "homeownership continues to represent an important opportunity for individuals and families of limited means to accumulate wealth."

16. In the Budget in Brief prepared by the Department of Administration (DOA), the first-time homebuyer savings account was presented as a way to provide "additional relief to lower and middle-income Wisconsin taxpayers, who have struggled the most with the effects of the COVID-19 pandemic." DOA also characterized the first-time homebuyer accounts as a way to address the "urgent need for more affordable housing in the state." If a policy goal is to encourage homeownership among low- and moderate-income households, it could be debated whether creating a first-time homebuyer savings account, like that proposed above, is the most effective incentive.

17. WRA reports that, among all Midwestern states, Wisconsin has the highest percentage of renters who are "extremely cost-burdened", meaning these renters spend greater than 50% of their income on housing costs. For example, 65.3% of renters in Wisconsin whose income is between 0% and 30% of the area median income (AMI) spend over 50% of their income on rent, the highest share among all surrounding states for that income category. According to WRA, over 158,000 renting households earning less than 50% of AMI in Wisconsin spend over half their income on housing. As a result, these households have less income to set aside for a future home purchase, both as a share of their income and in overall dollars. A program that incentivizes such savings would be less valuable, and potentially less effective, for these households relative to households of greater economic means.

18. First-time homebuyer savings account programs may be most useful for households with a greater ability to save over a longer time horizon. One could interpret from this that these programs potentially pose an equity problem. If those receiving tax benefits for saving under a first-time homebuyer program are already more able to save, such a program may not achieve the goal of making homeownership more attainable for those otherwise unable to afford it. Moreover, if those with relatively higher incomes avail themselves of the program with greater frequency precisely because they are more able to save in advance for a down-payment, it is questionable whether this represents an effective means of spurring homeownership, or whether it represents a state subsidy of a purchase which would have occurred anyway. Therefore, it could be debated whether a first-time homebuyer program is the most effective means to achieve the goal of making homeownership more accessible to a greater number of individuals.

19. The Committee could, instead, provide a more immediate tax benefit available to all first-time homebuyers by creating an individual income tax deduction for the down payment and allowable closing costs associated with a first-time home purchase (Alternative 3). The criteria defining an eligible individual and eligible costs would be the same as under Alternative 1. The deduction could only be claimed for the year in which the eligible home purchase was made. As noted above, the proposed first-time homebuyer savings account program under AB 68/SB 111 was initially estimated to reduce individual income tax collections by $7.0 million in 2023-24 and $7.5 million in 2024-25. While the Committee could select any maximum deduction amount it prefers, if the

Committee wanted to ensure that the deduction under Alternative 3 provided an aggregate tax benefit similar to the amount originally estimated under AB 68/SB 111, it could set the maximum deduction at $2,500 ($5,000 for married-joint filers). If such a deduction were provided beginning in tax year 2021, individual income tax revenues would decline by an estimated $7.3 million on an annual basis, beginning in 2021-22.

20. Various tax incentives have already been implemented with the goal of encouraging homeownership. At the federal level for example, taxpayers can claim an itemized deduction for interest paid on a home mortgage. State taxpayers can then claim these amounts on their state tax return as part of the state's itemized deduction credit. In addition, taxpayers are able to itemize and deduct for federal tax purposes up to $10,000 of state and local taxes, which include property taxes, whereas renters cannot deduct rent constituting state and local property taxes.

21. Other programs currently exist that are designed specifically to assist lower- and moderate-income individuals in attaining homeownership. Under the Federal Housing Authority (FHA) mortgage program, an eligible buyer can make a down payment as low as 3.5% of the purchase price, and borrow the remainder using a loan that is guaranteed by the FHA. Eligible buyers are subject to minimum credit requirements in order to qualify, but these requirements are generally less stringent than those for conventional loans. Borrowers pay a mortgage insurance premium, which is similar to PMI.

22. The Wisconsin Housing and Economic Development Authority (WHEDA) offers preferential rate mortgages for low- to moderate-income first-time homebuyers. Eligible homeowners meeting certain income limits (roughly $80,000 to $103,000 for a household of two, depending on county median income) and credit requirements may receive a low-cost mortgage. Additionally, WHEDA offers down payment assistance (DPA) loans, which may be utilized in conjunction with its first mortgage offerings. DPA programs support closing costs and provide additional financing of up to 6% of the purchase price. Combined with a WHEDA mortgage, DPA programs allow a borrower to finance their down payment, resulting in up to 100% financing for eligible homebuyers (no down payment). In general, DPA is offered over 10 years at the same interest rate as the initial mortgage, although 30-year DPA loans at 0% interest are offered to the lowest-income borrowers. WHEDA DPA programs are funded from a combination of federal funds and an encumbrance of $14.9 million from the Authority's general fund.

23. If the Committee wished to provide financial support to lower-income first-time homebuyers, it could consider increased funding for existing WHEDA DPA programs. Alternatives 4a and 4b would provide $1.5 million GPR annually to subsidize interest rates or other housing costs for first-time homebuyers receiving a DPA loan from the Authority. Subsidized interest rates on DPA loans would similarly reduce the financial barrier to entry for first-time homebuyers, but would allow homebuyers to realize the economic benefits of homeownership more quickly. Alternative 4a or 4b could be adopted together with Alternative 1, 2, or 3. Although GPR funding of $1.5 million is displayed in this example, a different amount could be appropriated to assist first-time homebuyers. For example, as mentioned previously, the first-time homebuyer savings account program proposed under AB 68/SB 111 was initially estimated to reduce individual income tax revenues by $7.0 million in 2023-24, and $7.5 million in 2024-25.

24. If the Committee wished to provide DPA funding to WHEDA, it could create an annual appropriation and provide $1.5 million GPR each year to the Authority to subsidize interest rates or other housing costs for first-time homebuyers receiving a DPA loan from WHEDA (Alternative 4a). It could also consider creating an annual appropriation under WHEDA, reserving $1.5 million GPR each year in the Committee's supplemental appropriation, and directing WHEDA to submit a proposal to the Committee for use of that funding (Alternative 4b).

25. Alternatively, the Committee could decide that low levels of participation in first-time homebuyer programs in other states are an indication that these programs may not be the most effective means to spur homeownership. The Committee might also conclude that sufficient tax incentives, and state and federal first-time homebuyer programs, already exist to encourage homeownership. As noted, following the Great Recession, many moderately-priced homes in foreclosure were sold to companies that converted the homes to rental properties, reducing the supply of affordable homes available to first-time homebuyers. The Committee may determine that the standing committee process is better suited to consider potential regulatory changes that address the scarcity of affordable, entry-level housing available to first-time homebuyers. In this case, the Committee could decide to take no action on creating a first-time homebuyer savings account program (Alternative 5).

ALTERNATIVES

1. Beginning in tax year 2022, create a program administered by DOR allowing an individual to become an account holder by creating an account at a financial institution, either individually or jointly with his or her spouse, to pay or reimburse the eligible costs of a first-time homebuyer. Create an individual income tax deduction for up to $5,000 ($10,000 for married-joint filers) of contributions to such an account each year, up to a lifetime maximum of $50,000 per beneficiary. Specify that only the account holder could claim this deduction, and that an individual may not be the account holder of multiple accounts which designate the same beneficiary. Estimate a reduction in individual income tax revenues relative to current law of $200,000 in 2021-22 and $1,500,000 in 2022-23 and annually thereafter. [A more detailed description of the program is provided in discussion point #9.]

ALT 1	**Change to Base**
GPR-Tax	- $1,700,000

2. Create the first-time homebuyer program described under Alternative 1, but require that contributions into a first-time homebuyer account are to remain in the account for at least one year (365 days) in order to qualify for the associated tax deduction. Estimate reduced individual income tax revenues relative to current law of $700,000 on an annual basis, beginning in 2022-23.

ALT 2	**Change to Base**
GPR-Tax	- $700,000

3. Beginning in tax year 2021, create an individual income tax deduction for first-time homebuyers of up to $2,500 ($5,000 for married-joint filers) for the associated down payment and allowable closing costs, defined as disbursements listed in a settlement statement for the purchase of a single-family residence in Wisconsin. Limit the deduction to individuals who reside in Wisconsin and have not previously owned or purchased, either individually or jointly, a single-family residence. Stipulate that the deduction may be claimed only for the year in which the home purchase is made. Estimate reduced individual income tax collections of $7,300,000 on an annual basis, beginning in 2021-22.

ALT 3	**Change to Base**
GPR-Tax	- $14,600,000

4a. Create an annual appropriation under WHEDA and provide $1,500,000 GPR each year to subsidize interest rates and other housing costs for first-time homebuyers receiving a DPA loan from the Authority.

ALT 4a	**Change to Base**
GPR	$3,000,000

4b. Create an annual appropriation under WHEDA and reserve $1,500,000 GPR each year in the Committee's supplemental appropriation. Direct WHEDA to submit a proposal for the Committee to approve, or modify and approve, use of that funding.

ALT 4b	**Change to Base**
GPR	$3,000,000

5. Take no action.

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June, 2021 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]

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.

ALT 1	Change to Base
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.

ALT 2	Change to Base
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.

ALT 3	Change to Base
GPR-Tax	-$40,200,000

4. Take no action.

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General Fund Taxes -- Income and Franchise Taxes

LFB Summary Items for Which No Issue Paper Has Been Prepared

Item #	Title
16	Creation of Individual Income Tax Exclusion for AmeriCorps Awards