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Joint Committee on Finance

Paper #361

Federalize Tax Treatment of Tax-Advantaged Savings Plans (General Fund Taxes -- Income and Franchise Taxes)

[LFB 2023-25 Budget Summary: Page 193, #4]

BACKGROUND

State individual income tax and corporate income/franchise tax provisions regarding the amount of income subject to taxation are generally referenced to definitions under federal law. The Department of Revenue (DOR) typically reviews the previous year's federal law changes each year and submits recommendations to the Legislature for updating 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 to several federal provisions, such as: (a) qualified retirement funds under federal law; (b) expensing of Section 179 depreciable assets; and (c) the computation of depletion for certain property placed into service.

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" or "529 college savings 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: college tuition and other fees; up to \$10,000 of principal and interest on the repayment of 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 2023, deductions may be claimed for up to \$3,860 (filing single or married-joint) or \$1,930 (for a divorced parent or married-separate filer) contributed per beneficiary. This deduction was created under 1999 Act 44 (and has been subsequently modified several times). In tax year 2021, a total of 74,485 filers (2.4% of all filers) claimed \$319.9 million of deductions for 529 college savings program contributions, yielding an average deduction of \$4,294.

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.

Wisconsin has adopted many federal provisions relating to Section 529 college savings programs. 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 adopted 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 adopted this federal provision, beginning in tax year 2018.

The federal Further Consolidated Appropriations Act of 2020 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 adopted this federal treatment under 2021 Act 1.

For distributions taken on or after January 1, 2024, a provision of the federal Consolidated Appropriations Act of 2023 (CAA23) enables 529 account beneficiaries to roll amounts remaining in a 529 account over to a Roth individual retirement account (IRA) without penalty upon distribution, up to a lifetime maximum of \$35,000. To receive this preferential treatment, the 529 account must have been open for at least 15 years, and the Roth IRA must be maintained for the benefit of the beneficiary. No amounts which were contributed within five years of the distribution date may be rolled over. Annual IRA contribution limits also apply to any amounts rolled over from a 529 account. For tax year 2023, the aggregate limit for contributions to any IRA is \$6,500, with an additional \$1,000 allowed for taxpayers aged 50 and over. Wisconsin has not adopted this provision (or any provision) of CAA23.

Under federal law, a qualified Achieving a Better Life Experience (ABLE) program may be established by any state for the purpose of meeting the qualified disability expenses of a designated beneficiary. As with 529 college savings programs, account contributions are deductible, earnings grow tax-free, and distributions are not taxable if used for qualified expenses. In general, federal law permits up to \$17,000 of contributions (total from all contributors) in tax year 2023 to be deposited into an ABLE account per designated beneficiary per calendar year. The maximum annual contribution limit is indexed to adjustments made to the annual exclusion amount under the federal gift tax.

Although Wisconsin does not have its own ABLE program, the state had adopted all federal law changes related to ABLE accounts prior to enactment of CAA23, and allows a state deduction for any eligible contribution deposited by an account owner, or any other person, for the year in which a contribution is made into any state's federally qualified ABLE account. In tax year 2021, a total of 298 state individual income tax filers (<0.1% of all filers) claimed \$3.3 million of ABLE account contributions, for an average deduction of \$11,161.

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 many of the relevant law changes to this point, the Committee could provide that, beginning in tax year 2022, changes to Section 529 of the IRC related to college savings plans are automatically adopted for state tax purposes [Alternative 1]. Such a proposal was included in AB 43/SB 70, and is estimated to reduce individual income tax collections relative to current law by \$0.8 million in 2023-24, \$2.0 million in 2024-25, \$2.4 million in 2025-26, \$2.8 million in 2026-27, and \$3.0 million in 2027-28.

2. The estimated fiscal effect shown for Alternative 1 assumes that the qualified tuition program provision under CAA23 allowing rollover contributions to Roth IRAs (also included for consideration in LFB Paper #360) is adopted for state tax purposes under this alternative. However, if the Committee chose to adopt this provision as part of the broader IRC update discussed under LFB Paper #360, Alternative 1 would have no fiscal effect.

3. 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 were required to add these distributions back to state taxable income when filing their tax year 2019 returns. If rolling conformity under Alternative 1 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 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.

4. 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. 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.

5. 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 long-term federal savings 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 prior to 2023. Therefore, an argument could be made that the state should ensure this conformity continues automatically, as would be provided under Alternative 1, similar to how the state automatically adopts changes to federal tax-advantaged retirement funds.

6. Under federal law (IRC Section 529A), a qualified ABLE program may be established by any state for the purpose of meeting the qualified disability expenses of a designated beneficiary, generally an individual whose blindness or disability occurred before age 26. A provision included in CAA23 provides that, beginning in tax year 2026, the eligible age of occurrence of the blindness or disability is increased to 46.

7. It could be argued that ABLE accounts are comparable savings vehicles to the college savings plans described in this paper. Both types of accounts are established to assist beneficiaries in paying for qualified expenses. In both ABLE and 529 accounts, earnings accumulate on a tax-free basis, and distributions are excluded from taxable income provided they are used for qualified expenses. In addition, federal law permits amounts in a 529 account to be rolled over to an ABLE account without penalty, provided the ABLE account beneficiary is the 529 account beneficiary or a qualified family member of the 529 account beneficiary.

8. College savings plans and ABLE accounts can arguably be viewed as complementary. Both programs provide tax-advantaged, long-term savings accounts that many parents (or other persons) establish to assist a child (or other beneficiary) to obtain a higher education, or to enhance their long-term quality of life if blind or disabled. With the exception of the recently enacted CAA23, Wisconsin has adopted federal tax treatment of ABLE accounts to date. The Committee could decide to provide that future changes to ABLE accounts are automatically adopted for state tax purposes, beginning in tax year 2023 [Alternative 2]. This would not have an estimated fiscal impact in the 2023-25 biennium, since the CAA23 provision extending the eligible age for account beneficiaries to 46 does not apply until tax year 2026. If adopted under Alternative 2, the provision would reduce estimated individual income tax collections by \$0.3 million in 2026-27, \$0.7 million in 2027-28, \$1.0 million in 2028-29, \$1.4 million in 2029-30, \$1.9 million in 2030-31, and \$2.5 million in 2031-32. However, this provision is also described in LFB Paper #360. If adopted as part of the broader IRC update described therein, Alternative 2 would have no fiscal impact. Alternatives 1 and 2 could be adopted together.

9. Critics of rolling conformity could argue that it binds states to federal law changes over which it has no control, some of which could carry a significant fiscal impact. For example, if the federal government were to pass legislation enabling 529 accounts to be used for a substantially greater variety of expenses that results in a significant increase in program participation, this would automatically decrease state tax revenues by a considerable amount. However, proponents of rolling conformity may counter that, 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.

10. Another 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, 2023, for a tax year 2023 law change), DOR would have to spend time and agency resources to republish tax year 2023 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 lead DOR to incur additional costs to reprogram prior year tax forms and process amended returns.

11. It should be noted, however, that whenever a state program is based on a federal program, this administrative challenge can still occur in the absence of rolling conformity. For example, if a similar federal law change that the Legislature does not immediately adopt is enacted late in a calendar year affecting Section 529 or ABLE accounts, DOR would still be required to update and reissue the applicable forms and guidance to specify that the particular federal law does not apply for Wisconsin purposes. If such a federal law change were applied retroactively, DOR would also incur the additional administrative cost of processing amended returns.

12. The Legislature has recently chosen to adopt all of the relevant tax law changes, including retroactive changes, affecting qualified tuition plans and ABLE accounts, except for recent federal law changes enacted under CAA23. 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.

ALTERNATIVES

1. Beginning in tax year 2022, specify that changes to Section 529 of the IRC related to college savings plans are automatically adopted for state tax purposes. Estimate reduced individual income tax collections of \$0.8 million in 2023-24 and \$2.0 million in 2024-25. [This alternative could be adopted in conjunction with Alternative 2.]

ALT 1	Change to Base
GPR-Tax	- \$2,800,000

2. Beginning in tax year 2023, specify that changes to Section 529A of the IRC related to ABLE accounts are automatically adopted for state tax purposes. [This alternative could be adopted in conjunction with Alternative 1.]

3. Take no action.

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