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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.

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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.