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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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