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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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