Legislative Fiscal Bureau

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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.

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