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Limit Credit for Taxes Paid to Surrounding States (General Fund Taxes -- Income and Franchise Taxes)

CURRENT LAW

A nonrefundable credit for taxes paid to other states is available to taxpayers who are Wisconsin residents and who paid income and/or franchise tax on the same income both to Wisconsin and to another state, including the District of Columbia. The credit is equal to the amount of net tax paid to the other state on the same income that is subject to Wisconsin taxation, but the amount of the credit is limited to the amount of net tax that would be paid if the income were taxed under the Wisconsin individual income tax. However, this limitation does not apply to Wisconsin residents' income that is taxed in the four states which share a border with Wisconsin (Illinois, Iowa, Michigan, and Minnesota).

The credit does not apply to taxes paid by Wisconsin residents on personal service income (such as wages, salaries, and commissions) to Wisconsin and to another state with which Wisconsin has an income tax reciprocity agreement (Illinois, Indiana, Kentucky, and Michigan). Because the reciprocity agreement prohibits the other state from collecting tax on the Wisconsin resident's personal service income, there is no basis on which to claim the credit for this income. However, the credit can be claimed for taxes paid to Wisconsin and another reciprocity state on income other than personal service income, such as income from the sale of real property, rental income, or business income. Finally, the credit cannot be claimed on the same income for which a manufacturing and agriculture credit is claimed in the same tax year.

Tax-option (S) corporations and partnerships that elect to be taxed at the entity level may also claim the credit for taxes paid to another state from a partnership income or franchise tax return or from an individual income tax return if paid at the entity level on another state's composite return. The credit claimed at the entity level is generally computed to be the same credit amount as if each partner, member, or shareholder claimed the credit separately. Part-year residents are eligible for the credit on income earned while a Wisconsin resident.

BACKGROUND

2017 Act 59 limited the credit for taxes paid to other states by stipulating that the credit cannot exceed the net tax that would be paid if the income were taxed under Wisconsin's individual income tax. This limitation first applied for tax year 2017, but it does not apply for taxes paid to any of the four surrounding states, as mentioned above. At the time this limitation was enacted under Act 59, it was estimated that income tax collections would increase by $11.3 million in 2017-18 and $9.0 million in 2018-19.

DISCUSSION POINTS

1. Wisconsin taxes all income of its residents, regardless of where that income is earned. The same is true for part-year residents for the period of time during which they are a resident of Wisconsin. For nonresidents (and part-year residents during the period of time in which they are not a Wisconsin resident), Wisconsin only taxes income which is derived from Wisconsin sources (such as wages/salaries earned for services performed in Wisconsin, rental income from tangible property located in Wisconsin, etc.).

2. In general, sound tax policy attempts to ensure that the income of an individual is taxed only once. This is the main rationale for providing a credit for taxes paid to other states on the same income for which tax is paid to Wisconsin.

3. A credit for taxes paid to other states is a common feature of state individual income tax structures. Every two years, this office prepares an informational paper reviewing the individual income tax provisions of each state with such a tax. Based on that review, out of 44 states (including the District of Columbia) with an individual income tax in tax year 2019, 42 offered a credit for taxes paid to another state. Only New Hampshire and Tennessee did not provide such a credit. However, only interest and dividend income was subject to taxation in these two states in tax year 2019. Thus, each state with a relatively broad-based individual income tax provided a credit for taxes paid to other states in tax year 2019.

4. The other states tax credit is comparable to the treatment of business income of corporations using a single sales factor apportionment formula under the corporate income/franchise tax. When states tax the income of corporations generated by activities carried on across state lines, they are required under the due process and commerce clauses of the U.S. Constitution to tax only income that is fairly attributable to activities carried on within the state. In order to meet this constitutional obligation, Wisconsin employs a single sales factor apportionment (among other methods). Such apportionment is determined by dividing the total sales or receipts of the corporation in Wisconsin by the total sales or receipts of the corporation everywhere. Income apportioned to a state or territory that does not impose tax on that income is generally apportioned to, and taxed by, Wisconsin, similar to how income earned by an individual in a state without an income tax does not generate a credit for taxes paid to other states.

5. Policymakers may be concerned about the lack of a limitation on the credit for taxes paid to the four surrounding states. Under current law, if a Wisconsin resident incurs a Minnesota net

tax liability of $2,000 that would equate to a Wisconsin net tax liability of $1,500 on the same income, this individual can still claim a credit against their Wisconsin income tax for the full $2,000 of net tax paid to Minnesota. If this same income were instead taxable by South Dakota, the individual could only claim a credit for $1,500 (equal to the amount of net tax they would otherwise incur in Wisconsin on that income). Critics might question why the current credit treats taxpayers with identical amounts of taxable income differently based solely on the state in which the income is taxable.

6. Moreover, they might contend that the current credit is inefficient because it subsidizes Wisconsin residents for generating additional income in surrounding states where higher net tax liabilities are incurred. Under the current credit, taxpayers might be encouraged to engage in a greater level of economic activity in a surrounding state than they otherwise would, because they know their full net tax liability in that state can be used to offset taxes owed to Wisconsin. Further, the current credit could allow the spouse of a married taxpayer filing jointly to offset Wisconsin tax liability with a credit generated from taxes paid on income earned in a surrounding state, creating a tax benefit that could not be realized by a similarly situated couple whose entire income is earned in Wisconsin. Efficient tax policy discourages this sort of distortion of the allocation of economic resources. Under the current credit structure, Wisconsin essentially pays resident taxpayers for the higher tax liabilities they incur in surrounding states. It could be argued, therefore, that the credit that currently exists for the surrounding states improperly exceeds its policy goal of preventing double taxation on the same income.

7. Proponents of the current credit structure may point out that Minnesota's other states credit includes preferential treatment for taxes paid to Wisconsin. Under Minnesota law, if a Minnesota resident's net tax owed to Wisconsin is greater than the net tax owed to Minnesota, the excess which is attributable to personal service income is eligible for a refundable credit. Wisconsin is the only state for which Minnesota provides such treatment.

8. Opponents could counter that similar preferential treatment is not provided in the other surrounding states. Iowa and Illinois do not offer tax-advantaged treatment for taxes paid to Wisconsin relative to taxes paid to any other state. Moreover, Michigan does not allow a credit for taxes paid to Wisconsin at all. The Michigan credit cannot exceed the amount of Michigan tax paid on the personal service income earned in another state, and since this income is already covered by the Wisconsin-Michigan income tax reciprocity agreement, no credit is permitted.

9. The Committee could decide to limit the credit for taxes paid to the four surrounding states by specifying that, beginning in tax year 2021, the credit cannot exceed the net tax that would be paid to Wisconsin on the same income (Alternative 1). This alternative is estimated to increase income and franchise tax collections relative to current law by $17.7 million on an annual basis, beginning in 2021-22. It is estimated that nearly 85% of this fiscal effect is attributable to taxes paid to Minnesota.

10. Those in favor of retaining the current credit structure for surrounding states might argue that limiting the credit as described under Alternative 1 is not desirable because it would represent a net tax increase on Wisconsin residents who earn income in other states. They might posit that the current credit structure maintains the essential feature of the former income tax reciprocity agreement between Minnesota and Wisconsin (which existed until tax year 2010), which was to ensure that the

out-of-state net tax paid by Wisconsin residents working in Minnesota did not exceed the net tax they would owe in Wisconsin. Allowing affected taxpayers to credit against their Wisconsin income tax the full amount of net income taxes paid to surrounding states, specifically Minnesota, ensures that this treatment is retained even in the absence of reciprocity.

11. It should also be noted that the COVID-19 pandemic could impact the fiscal effect under Alternative 1 in the near-term. Guidance from revenue agencies in surrounding states suggests that Wisconsin residents who normally work in a surrounding state -- but who are working remotely from Wisconsin during the pandemic -- may be required to apportion their income to the surrounding state based on the number of days worked inside that state relative to the total number of days worked. In other words, these individuals may pay a lower amount of tax to the surrounding states than they would have prior to the pandemic. To the extent this actually occurs during tax year 2021, the fiscal effect noted above would be lower in 2021-22.

ALTERNATIVES

1. Beginning in tax year 2021, specify that the current law credit for income and franchise taxes paid to Illinois, Iowa, Michigan, and Minnesota is limited to the amount of net tax payable to Wisconsin on the same income. Estimate increased income and franchise tax collections relative to current law of $17,700,000 in 2021-22 and 2022-23.

ALT 1	**Change to Base**
GPR-Tax	$35,400,000

2. Take no action.

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