Legislative Fiscal Bureau

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Income Tax Provisions Affected by Inflation
(General Fund Taxes -- Income and Franchise Taxes)

CURRENT LAW

Under the state individual income tax, the amount of income subject to taxation is based on Wisconsin adjusted gross income (AGI). To determine Wisconsin AGI, several modifications are made to federal AGI. Generally, these modifications decrease Wisconsin AGI when the amounts are taxable under federal law but are only partially taxable, or are not taxable, under state law. Modifications decreasing Wisconsin AGI can generally be classified into deductions (for expenses incurred) and exclusions (for classes or types of income). Both serve to reduce the amount of income subject to taxation (taxable income).

Taxable income is calculated by subtracting the state sliding scale standard deduction and personal exemptions from Wisconsin AGI. A personal exemption of $700 is provided for each taxpayer, their spouse (if a married-joint filer), and any qualifying dependents claimed on the taxpayer's return. An additional personal exemption of $250 is provided for each taxpayer (and spouse if a married-joint filer) who has reached age 65 by the close of the tax year to which the claim relates.

The state's marginal income tax rate and bracket schedule is then applied to taxable income to determine gross tax liability, against which eligible taxpayers may subtract any nonrefundable credits to arrive at net tax liability. Nonrefundable credits cannot be used in excess of gross tax liability.

BACKGROUND

The U.S. Department of Labor defines inflation as "the overall general upward price movement of goods and services in an economy." The consumer price index (CPI) measures average price changes within a particular 'market basket' of goods and services, which is based on purchasing data derived from the national Consumer Expenditure Survey. The CPI for all urban consumers, U.S. city average (CPI-U) is used to adjust several individual income tax provisions under current law.

Historically, the Federal Reserve has pursued a long-run inflation target of 2% annually, which it judges to be in line with its congressional mandate for maximum employment and price stability in the U.S. economy. The Board of Governors of the Federal Reserve contends that this level of inflation enables households and businesses to make sound decisions regarding saving, borrowing, and investment, which contributes to a well-functioning economy. By contrast, the August-over-August change in the CPI-U (used to inflation-adjust several current law state tax provisions) was 5.3% in 2021 (affecting tax year 2022) and 8.3% in 2022 (affecting tax year 2023). The inflation rate affecting tax year 2023 was the highest recorded annual increase in the CPI-U since 1981. Based on current national economic projections (May, 2023), the adjustment in 2023 (affecting tax year 2024) is expected to be 3.7%. To the extent inflation outpaces increases in wages and salaries, the real purchasing power of workers is diminished.

As noted previously, deductions and exclusions reduce taxable income. As a result, their actual value depends on the tax rate which would have otherwise applied to that income. For example, a $10,000 exclusion would yield a tax benefit of $500 for a taxpayer facing a marginal effective tax rate of 5%.

Unlike deductions, credits reduce taxes owed dollar-for-dollar, so the value of a $10,000 nonrefundable credit is $10,000 (provided the claimant has at least $10,000 of gross tax liability).

The maximum benefit amount, or the income at which a benefit is phased out, for several current law deductions, exclusions, and credits has remained static for many years, often since inception of the provision. As a result, the real value of these tax benefits for individuals has been reduced by inflation over time. This paper discusses possible adjustments to the following tax benefit provisions to offset the effects of inflation: (a) the deduction for organ donation expenses; (b) the exclusion for unemployment benefits; (c) the deduction for adoption expenses; (d) the deduction for private K-12 tuition expenses; (e) personal and elderly exemptions; (f) the married couple credit; and (g) the property tax/rent credit (PTRC). The retirement income exclusion has also been impacted by inflation, but is addressed separately in LFB Paper #364.

By contrast, several tax benefit provisions are adjusted for inflation under current law, such as: (a) the maximum sliding scale standard deduction amount and the income level at which the deduction phases out; (b) the taxable income amounts applicable to each marginal tax rate; (c) the maximum amount of contributions to 529 college savings accounts that may be deducted from gross income; and (d) the parameters of the earned income tax credit. For example, the sliding scale standard deduction and the state's rate and bracket structure are adjusted for a particular tax year based on the change in the CPI-U from August of the previous year over the CPI-U from August of a specified base year. The policy rationale for indexing tax provisions to inflation each year is to ensure that only real income growth is subject to tax, as opposed to taxing wages that have merely grown by the rate of inflation.

DISCUSSION POINTS

1. Each of the current law tax benefits discussed in this paper employ a maximum dollar amount that is static from year to year. As inflation occurs over time, the value of these tax benefits erodes. For example, consider a taxpayer eligible for a deduction of $5,000 in tax year 1990. If that deduction were set to grow at the rate of inflation, it would equal $12,120 in tax year 2023, or 242% of its nominal value from 1990. If, instead, the deduction remained at the flat value of $5,000 in the interim, it would provide tax relief of only 41% of its inflation-adjusted (real) value in tax year 2023. It could be argued that indexing relevant tax provisions to inflation enables taxpayers to better utilize the benefits as they were initially envisioned when enacted by the Legislature.

2. At public hearings on the state's biennial budget, several individuals testified about the need for income tax relief, and many cited a need to offset rising costs (such as for child care). As noted above, annual inflation in 2022 (affecting tax year 2023) was higher than at any point since 1981, which puts pressure on household finances and further erodes the value of tax provisions that are not indexed to inflation. This recent environment of high inflation provides an opportunity for the Legislature to provide tax relief by inflation-adjusting the aforementioned provisions.

3. *Organ Donation Expenses Deduction.* Since tax year 2004, a Wisconsin resident may deduct up to $10,000 from federal AGI when computing Wisconsin AGI if the taxpayer, the taxpayer's spouse, or the taxpayer's dependent, while living, donates one or more organs to another human being for organ transplantation. The deduction is allowed only for unreimbursed travel expenses, lodging expenses, and lost wages related to the organ donation. A deduction for such expenses may only be claimed once and must be claimed in the year in which the organ transplantation occurs. In tax year 2021, a total of 63 state taxpayers claimed deductions for organ donation expenses totaling $270,783, for an average deduction of $4,298.

As expenses for travel and lodging, as well as lost or foregone wages, generally rise with inflation over time, the expense limit under current law erodes the real value of the deduction for which an organ donor is eligible (thereby increasing real costs to the organ donor). If the $10,000 expense limit had been adjusted annually for inflation since 2004, its estimated value would be $16,210 in tax year 2023 and $16,830 in tax year 2024. Setting the deduction at these levels would reduce estimated individual income tax collections by a minimal amount.

If, instead, the current law deduction amount were indexed beginning in tax year 2023, the maximum deduction would increase to an estimated $10,830 in tax year 2023 and $11,200 in tax year 2024. In this scenario, estimated individual income tax collections would decrease by a minimal amount.

4. *Unemployment Compensation Exclusion.* Under the state exclusion for unemployment benefits, if the taxpayer's federal AGI is less than or equal to a base amount, then the entire benefit amount is excluded from income. Since tax year 1986, the base amount is $12,000 for single taxpayers, $18,000 for married couples filing joint returns, and zero for married couples filing separate returns when the couple lived together at some point during the year. The base amount for single taxpayers applies in the case of married taxpayers filing separate returns who lived separately for the entire year. If federal AGI exceeds the base amount, then the amount of unemployment compensation benefits includible in gross income is the lesser of: (a) one-half of the excess of the taxpayer's AGI,

including benefits, over the base amount; or (b) the amount of the unemployment compensation benefits. In tax year 2021, a total of 58,371 state taxpayers claimed $497.1 million of unemployment compensation exclusions, for an average exclusion of $8,517.

These tax benefits for unemployment compensation can be viewed as a way to offset the tax burden on lower-income individuals whose income has likely declined significantly as a result of becoming unemployed. As incomes generally rise with inflation over time, taxpayers receiving unemployment benefits will generally have higher federal AGI today, and so be made worse off in real terms, than their counterparts who claimed the exclusion in earlier years. Their higher federal AGI could render them ineligible for the full (or any) amount of the exclusion under current law. If the base AGI amounts had been adjusted annually for inflation since 1986, the estimated base amounts would be $33,420/$50,130 married-joint in tax year 2023, and $34,710/$52,060 married-joint in tax year 2024. Setting the base AGI amounts at these levels would reduce estimated individual income tax collections by $4.4 million in 2023-24 and $4.8 million in 2024-25.

If, instead, the base AGI amounts under current law were indexed for inflation beginning in tax year 2023, the estimated base amounts would be $12,990/$19,490 married-joint in tax year 2023, and $13,440/$20,160 married-joint in tax year 2024. In this scenario, estimated individual income tax revenues would decline by $100,000 in 2023-24 and 2024-25.

5. *Adoption Expenses Deduction.* State law allows a deduction for up to $5,000 in aggregate of adoption expenses for each child adopted, beginning in tax year 1996. The deduction may be taken during the tax year that a final order of adoption has been entered, for adoption expenses incurred in that tax year and the two prior tax years. Allowable expenses include adoption fees, court costs, and legal fees related to the adoption of a child for whom a final order of adoption is entered. A total of 249 state taxpayers claimed deductions of $1.0 million in tax year 2021, for an average deduction of $4,054.

Based on research from the Administration for Children & Families within the U.S. Department of Health and Human Services, the total cost of adopting a child can far exceed the $5,000 expense limit allowed under current state law. Adoption expenses incurred by prospective adoptive parents can include: (a) the facilitation of a home study; (b) social work services provided to match a child with the adoptive family; and (c) counseling, medical, and legal services for birth parents. If the $5,000 expense limit had been adjusted annually for inflation since 1996, its estimated value would be $9,800 in tax year 2023 and $10,180 in tax year 2024. Setting the deduction at these levels would reduce estimated individual income tax collections by $50,000 in 2023-24 and 2024-25.

If, instead, the current law expense limit were indexed beginning in tax year 2023, it would be estimated at $5,410 in tax year 2023 and $5,600 in tax year 2024. In this scenario, estimated individual income tax collections would decrease by a minimal amount.

6. *Private School Tuition Deduction Limits.* Beginning in tax year 2014, taxpayers may deduct amounts paid for tuition to a private school for state tax purposes. The deduction is limited to expenses of up to $4,000 per year per pupil enrolled in kindergarten through grade eight and $10,000 per year per pupil enrolled in grades nine through twelve. The pupil must be a dependent of the claimant for federal income tax purposes and be enrolled in kindergarten or grades one through twelve

of a private school, as defined in state law, that meets all the criteria for a private school. The deduction cannot be claimed if the tuition expenses are paid using a distribution from a 529 account. In tax year 2021, a total of 31,821 state taxpayers claimed $168.4 million of deductions, for an average deduction of $5,292.

Unless specific policies are enacted to the contrary, school tuition costs generally rise over time. If the $4,000/$10,000 expense limits had been adjusted annually for inflation since 2014, the estimated values would be $5,070/$12,660 in tax year 2023 and $5,260/$13,150 in tax year 2024. Increasing the expense limits to these levels would reduce estimated individual income tax revenues by $1.0 million in 2023-24 and $1.1 million in 2024-25.

By contrast, indexing the current law expense limits beginning in tax year 2023 would yield estimated values of $4,330/$10,830 in tax year 2023 and $4,480/$11,200 in tax year 2024. This alternative would reduce estimated individual income tax collections by $0.3 million in 2023-24 and $0.4 million in 2024-25.

7. *Personal Exemptions.* Personal exemptions of $700 are provided for each taxpayer, their spouse (if a married-joint filer), and each qualifying dependent of the taxpayer. An additional $250 exemption is provided for each taxpayer (and spouse if filing married-joint) who has reached age 65 by the close of the tax year to which the claim relates. These personal exemption amounts have been in effect since tax year 2001. In tax year 2021, including dependent exemptions and the $250 additional exemptions for taxpayers aged 65 and over, a total of $4.31 billion of personal exemptions were claimed.

Personal exemptions are provided to account for the impact of family size on household finances. If the amounts had been adjusted annually for inflation since 2001, their estimated values would be $1,220/$440 in tax year 2023 and $1,270/$450 in tax year 2024. If the exemptions were set at these values, individual income tax collections would decline by an estimated $130.2 million in 2023-24 and $134.2 million in 2024-25.

If, instead, the exemption amounts were indexed for inflation beginning in tax year 2023, their values would be estimated at $760/$270 in tax year 2023 and $780/$280 in tax year 2024. If the exemptions were set to these values, individual income tax collections would decline by an estimated $14.3 million in 2023-24 and $19.3 million in 2024-25.

It should be noted that both the preceding fiscal estimates do not assume that the individual income tax withholding tables (which reflect the income tax rates, brackets, sliding scale standard deduction, and personal exemptions applicable to current law as of January 1, 2022) would be updated to accommodate the increase in the personal exemption. If the Department of Revenue were to exercise its current law authority to update the withholding tables to reflect this change, the estimates under both alternatives would be somewhat higher.

8. *Married Couple Credit.* Two-earner families filing married-joint are eligible for a married couple credit equal to 3.0% of the earned income of the secondary wage earner, up to a maximum credit of $480 (implying maximum earned income for the secondary wage-earning spouse of $16,000). The credit maximum has been in effect since tax year 2001. In tax year 2021, a total of

636,190 state taxpayers claimed $262.9 million of married couple credits, for an average credit of $413.

The married couple credit is provided to mitigate the impact of the marriage penalty under the state individual income tax, whereby married taxpayers who are both employed and earn similar incomes incur a greater tax liability filing jointly than if both spouses filed as single individuals (absent the credit). The credit also provides a tax incentive for both spouses to seek employment, thereby increasing the supply of labor. As wages and salaries rise over time with inflation, the real value of the credit is diminished. If the credit maximum had been adjusted annually for inflation since 2001, the estimated value would be $840 in tax year 2023 (implying maximum earned income for the secondary wage-earning spouse of $28,000) and $870 in tax year 2024 (maximum earned income of $29,000). Under these credit values, total individual income tax collections would decline by an estimated $154.9 million in 2023-24 and $158.0 million in 2024-25.

If, instead, the credit values were indexed to inflation beginning in tax year 2023, the maximum credit value would be estimated at $520 in tax year 2023 (maximum earned income of $17,333) and $540 in tax year 2024 (maximum earned income of $18,000). Under these credit values, total individual income tax collections would decline by an estimated $20.2 million in 2023-24 and $28.3 million in 2024-25.

9. *Property Tax/Rent Credit.* The PTRC is equal to 12% of property taxes, or rent constituting property taxes, paid on a principal residence, up to a maximum of $2,500 in property taxes. Rent constituting property taxes is defined as 25% of actual rent if payment for heat is not included in rent or 20% of actual rent if payment for heat is included in rent. Since tax year 2000, the maximum credit is $300. In tax year 2021, a total of 2.05 million state taxpayers claimed $511.9 million of PTRC, for an average credit of $250.

In general, property taxes within a local taxing jurisdiction cannot increase except by the value of net new construction or by referendum. Rather than using inflation as the basis of adjusting the PTRC, this paper utilizes the current law estimates for changes to net property taxes paid on the median-value home in Wisconsin since 2000. If the maximum property tax amount eligible for the credit had been adjusted annually for growth in the estimated net property tax bill on the median-value home since 1999(00), the estimated value would be $3,170 in tax year 2023 (implying a maximum credit of $380) and $3,200 in tax year 2024 (a maximum credit of $384). Setting the maximum allowable property taxes at these levels would decrease estimated individual income tax collections by $83.8 million in 2023-24 and $86.1 million in 2024-25.

If, instead, the maximum allowable property taxes under the PTRC were increased by the five-year compound annual average growth rate in the net property tax bill on the median-value home (1.0%), beginning in tax year 2023, the property tax maximum would be estimated at $2,530 in tax year 2023 and $2,560 in tax year 2024. In this scenario, estimated individual income tax revenues would decline by $4.5 million in 2023-24 and $8.1 million in 2024-25.

10. *Index all Provisions since Previous Modification Year.* For tax year 2023, Alternative 1 would provide that, with the exception of the PTRC, all the preceding provisions are indexed based on inflation that has occurred since each provision was last adjusted, or was enacted, whichever is

applicable. Alternative 1 would provide that each provision is then adjusted for inflation each year thereafter, beginning in tax year 2024. For tax year 2023, the maximum allowable property taxes under the PTRC would be increased by 27%, based on growth in the estimated net property tax bill on the median-value home in Wisconsin since 1999(00). As displayed in Table 1, relative to current law, total individual income tax revenues would decline under Alternative 1 by an estimated $373.3 million in 2023-24 and $383.3 million in 2024-25.

Table 1 also includes the estimated interactive effects of adopting Alternative 1. These interactive effects can occur when multiple deductions and credits are adopted simultaneously, because the former reduces taxable income, and the latter reduces the resulting gross tax. In other words, there is less gross tax for a credit to offset when another provision that reduces taxable income is adopted simultaneously. The result is that the total estimated tax decrease is slightly less than would be suggested from merely adding the fiscal estimate for each individual provision separately.

TABLE 1

Estimated Effect of Alternative 1: Index Provisions since Previous Modification Year in Tax Year 2023, and Index Thereafter (Millions)

Provision	2023-24	2024-25	Biennial Total
Organ Donation Expenses	Minimal	Minimal	Minimal
Unemployment Compensation	-$4.40	-$4.80	-$9.20
Adoption Expenses	-0.05	-0.05	-0.10
Private School Tuition	-1.00	-1.10	-2.10
Personal Exemptions	-130.20	-134.20	-264.40
Married Couple Credit	-154.90	-158.00	-312.90
Property Tax/Rent Credit	-83.80	-86.10	-169.90
Interactive Effects	1.05	0.95	2.00
Total	-$373.30	-$383.30	-$756.60

11. *Index all Provisions Beginning in Tax Year 2023.* Alternative 2 would provide that, with the exception of the PTRC, all the preceding provisions are indexed for inflation annually, beginning in tax year 2023. Alternative 2 would provide that each provision is then adjusted for inflation each year thereafter, beginning in tax year 2024. The maximum allowable property taxes under the PTRC would be grown by 1.0% annually. As displayed in Table 2, relative to current law, total individual income tax revenues would decline by an estimated $39.4 million in 2023-24 and $56.2 million in 2024-25.

TABLE 2

Estimated Effect of Alternative 2: Index all Provisions Annually, Beginning in Tax Year 2023 (Millions)

Provision	2023-24	2024-25	Biennial Total
Organ Donation Expenses	Minimal	Minimal	Minimal
Unemployment Compensation	-$0.10	-$0.10	-$0.20
Adoption Expenses	Minimal	Minimal	Minimal
Private School Tuition	-0.30	-0.40	-0.70
Personal Exemptions	-14.30	-19.30	-33.60
Married Couple Credit	-20.20	-28.30	-48.50
Property Tax/Rent Credit	-4.50	-8.10	-12.60
Interactive Effects	<0.01	<0.01	<0.01
Total	-$39.40	-$56.20	-$95.60

12. If the Committee prefers to inflation-adjust some, but not all, of the aforementioned provisions since they were last indexed and/or beginning in tax year 2023, it could adopt some combination of the provisions described in this paper. Tables 1 and 2 display the estimated fiscal effect associated with each provision. However, depending on which provisions are adopted, a small interactive effect could occur that slightly lowers the total estimated tax decrease (similar to the interactive effects displayed in Tables 1 and 2).

13. Alternatively, the Committee could decide to pursue other avenues of tax relief that do not tie state expenditures to potential spikes in inflation, as was observed in 2022. Members of the public testified during biennial budget hearings in support of a proposed flat individual income tax. As such, the Committee may prefer to deliver income tax relief through some other mechanism. In this case, the Committee may decide to take no action on indexing the provisions discussed herein [Alternative 3].

ALTERNATIVES

1. *Adjust all Provisions since Previous Modification Year.* For the following current law tax benefit provisions, provide that the following changes apply to tax year 2023: (a) the organ donation expenses deduction is increased to $16,210; (b) the base federal AGI amounts at which the unemployment exclusion begins to phase out are increased to $33,420 ($50,130 married-joint); (c) the adoption expenses deduction is increased to $9,800; (d) the private school tuition deduction is increased to $5,070 (kindergarten through grade eight) and $12,660 (grades nine through 12); (e) the personal exemption and elderly exemption amounts are increased, respectively, to $1,220 and $440; (f) the maximum married couple credit is increased to $840; and (g) the maximum allowable property taxes under the PTRC are increased to $3,170. Beginning in tax year 2024, specify that each provision is adjusted for inflation annually based on the change in the CPI-U for August of the previous year over the CPI-U for August, 2022, provided the adjustment is not a negative number, except provide

that the maximum allowable property taxes under the PTRC are to increase by 1.0% annually. Relative to current law, estimate reduced individual income tax revenues of $373,300,000 in 2023-24 and $383,300,000 in 2024-25.

ALT 1	**Change to Base**
GPR-Tax	- $756,600,000

2. *Adjust all Provisions Beginning in Tax Year 2023.* For the following current law tax benefit provisions, provide that the following changes apply to tax year 2023: (a) the organ donation expenses deduction is increased to $10,830; (b) the base federal AGI amounts at which the unemployment exclusion begins to phase out are increased to $12,990 ($19,490 married-joint); (c) the adoption expenses deduction is increased to $5,410; (d) the private school tuition deduction is increased to $4,330 (kindergarten through grade eight) and $10,830 (grades nine through 12); (e) the personal exemption and elderly exemption amounts are increased, respectively, to $760 and $270; (f) the maximum married couple credit is increased to $520; and (g) the maximum allowable property taxes under the PTRC are increased to $2,530. Beginning in tax year 2024, specify that each provision is adjusted for inflation annually based on the change in the CPI-U for August of the previous year over the CPI-U for August, 2022, provided the adjustment is not a negative number, except provide that the maximum allowable property taxes under the PTRC are to increase by 1.0% annually. Relative to current law, estimate reduced individual income tax revenues of $39,400,000 in 2023-24 and $56,200,000 in 2024-25.

ALT 2	**Change to Base**
GPR-Tax	- $95,600,000

3. Take no action.

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