Legislative Fiscal Bureau

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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.

DOR 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 updated on January 1, 2022, so the current tables reflect the tax rates, brackets, and sliding scale standard deduction applicable to tax year 2022.

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, 2022, but did not remit that aid until July, 2022, GAAP mandates that the $40 million be accounted for in state fiscal year 2021-22, even though the payment was not made until fiscal year 2022-23. By contrast, the modified cash accrual method would account for the $40 million expenditure in 2022-23.

DISCUSSION POINTS

1. The Committee could direct the DOR Secretary to issue guidance, no later than October 1, 2023, for the individual income tax withholding tables to reflect the income tax rates, brackets, and sliding scale standard deduction in effect for tax year 2024. The withholding table change would take effect on January 1, 2024, and is estimated to reduce individual income tax revenues on a one-time basis by $112.9 million in 2023-24 [Alternative 1].

2. In its Annual Comprehensive Fiscal Report (ACFR) for 2021-22, the Department of Administration reports that the year-end general fund balance under GAAP was $4,645.5 million. However, the second largest negative contribution to the GAAP general fund balance in 2021-22 came from the individual income tax (-$833.7 million). The individual income tax has consistently been a significant negative contributor to the state's balance under GAAP.

3. 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 balance is worsened by this difference. For comparison, prior to the most recent withholding table update, the negative adjustment under GAAP due to the individual income tax was reported to be $1,735.5 million in the 2020-21 ACFR (more than $900 million higher than the negative adjustment in 2021-22). Some caution that carrying large GAAP-based liabilities overstates the soundness of the state's financial position (which is typically measured using the modified cash accrual method) in that it does not consider the pending liability associated with individual income tax refunds that must be paid in the subsequent fiscal year.

4. The parameters of the state standard deduction, and the taxable income amounts applicable to each bracket, are adjusted each year based on the consumer price index for all urban consumers, U.S. city average (CPI-U) for the previous August relative to the CPI-U in August of a specified base year. This adjustment yielded an increase of 8.3% for tax year 2023 (the highest such growth since 1981). Based on current national economic projections (May, 2023), the adjustment for tax year 2024 is expected to be 3.7%. However, no such indexing has occurred in the withholding tables since 2022, so 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 $27,630 of taxable income in tax year 2023, 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 ($2,110) would be subject to income tax withholding under the third income tax bracket. LFB Papers #363 and #364 discuss other individual income tax provisions that have been affected by inflation.

5. Adjusting the withholding tables would allow taxpayers to better realize, throughout the year, the effect of updating withholding for inflation. 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, 2024.

7. The main drawback of adjusting the withholding tables is the 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 $112.9 million on a one-time basis in 2023-24. However, this withholding revenue reduction would be offset in 2024-25 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 2023-24 resulting from a withholding table change effective January 1, 2024, is not offset by lower refunds in that same fiscal year, but rather is offset in the next fiscal year (2024-25).

8. For the same policy reasons as under Alternative 1, the Committee could desire to also update the withholding tables on January 1, 2025 [Alternative 2]. Current CPI-U projections suggest that the tax year 2025 inflation adjustment will be 2.4%. Therefore, the additional estimated one-time revenue reduction of Alternative 2 is $24.5 million in 2024-25, and the total one-time revenue impact in the 2023-25 biennium is $137.4 million.

9. At the federal level, the Internal Revenue Service updates the individual income tax

withholding tables each year to reflect inflationary adjustments and other relevant law changes. In years of relatively high inflation (such as occurred during tax year 2022), frequent updates help ensure taxes withheld more closely reflect taxes actually owed, rather than higher inflation which is not ultimately taxed.

10. If the Committee desired to similarly update the state withholding tables each year, it could require DOR to annually update the individual income tax withholding tables to reflect the income tax rates, brackets, and sliding scale standard deduction in effect for each tax year no later than the preceding October 1 [Alternative 3]. The withholding table change would take effect on January 1 of each tax year, beginning with tax year 2024. Assuming annual changes to CPI-U continue to decline towards the Federal Reserve's stated goal for inflation of 2.0% annually, future year-over-year revenue reductions associated with withholding table adjustments for tax year 2026 and later would be somewhat less (in tax year 2025 dollars) than the $24.5 million adjustment estimated for 2024-25.

ALTERNATIVES

1. Direct the DOR Secretary to issue guidance no later than October 1, 2023, updating the individual income tax withholding tables to reflect the tax rates, brackets, and sliding scale standard deduction in effect for tax year 2024. Specify that these withholding table changes first take effect on January 1, 2024. Estimate a one-time reduction in individual income tax revenues of $112,900,000 in 2023-24.

ALT 1	Change to Base
GPR-Tax	- $112,900,000

2. In addition to Alternative 1, direct the DOR Secretary to issue guidance no later than October 1, 2024, updating the individual income tax withholding tables to reflect the tax rates, brackets, and sliding scale standard deduction in effect for tax year 2025. Specify that these withholding table changes first take effect on January 1, 2025. Estimate an additional one-time reduction in individual income tax revenues of $24,500,000 in 2024-25.

ALT 2	Change to Base
GPR-Tax	- $137,400,000

3. Direct the DOR Secretary to annually issue guidance no later than October 1, updating the individual income tax withholding tables to reflect the tax rates, brackets, and sliding scale standard deduction in effect for the following tax year, first applicable to tax year 2024. Specify that these annual withholding table changes first take effect on January 1 of each tax year. Estimate a

reduction in individual income tax revenues of $112,900,000 in 2023-24 and $24,500,000 in 2024-25.

ALT 3	Change to Base
GPR-Tax	- $137,400,000

4. Take no action.

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