



Legislative Fiscal Bureau

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TO: Representatives Katsma and Steffen
State Capitol

FROM: Dan Spika and John Gentry, Fiscal Analysts

SUBJECT: LRB 4136/1: Retirement Income Exclusion and Income Tax Rate Reduction

This memorandum summarizes the provisions of LRB 4136/1. Beginning in tax year 2023, the bill would: (a) reduce the rate applicable to the third individual income tax bracket; (b) exclude most retirement income for individuals aged 67 or older from tax; and (c) make technical changes to cross references under current law.

CURRENT LAW

The starting point for determining Wisconsin adjusted gross income (AGI) is federal AGI, which itself is derived from gross income. This includes income from all sources, unless a specific exclusion is provided. Income that is earned and contributed to a pre-tax retirement account is excluded from federal (and state) AGI.

For most qualified retirement accounts, state and federal income tax is paid once, either on the amount distributed (for pre-tax retirement accounts) or on the amount contributed (after-tax retirement accounts). For pre-tax retirement accounts (most pensions, 401(k)s, 403(b)s, and individual retirement accounts [IRAs]), contributions are made tax-free by employers and/or employees, the earnings grow tax free over the life of the investment, and tax is owed on the amounts distributed from the pre-tax account. Most qualified retirement accounts require the owner to reach a qualified retirement age (generally 59 and ½) before a distribution can be made from the account without penalty. In order to prevent an individual from growing their pre-tax investment in their retirement account forever, federal law generally requires owners to make required minimum distributions (RMDs) from their accounts, beginning at age 73 in 2023. For after-tax retirement accounts (such as a Roth IRA or Roth 401(k)), state and federal tax is paid on the individual's earnings that are used to make a qualified contribution to the account. Amounts contributed to an after-tax account grow tax-free over the life of the investment, and distributions are made tax-free once the owner reaches the qualified retirement age (generally 59 and ½). Because tax has already been paid on after-tax retirement accounts, federal law does not require RMDs from a Roth retirement account.

Under current law, the following retirement income categories are excluded from Wisconsin AGI: (a) Social Security benefits; (b) payments from the U.S. military employee retirement system and U.S. government retirement payments received by members of the U.S. Coast Guard, the Commissioned Corps of the National Oceanic and Atmospheric Administration, and the Commissioned Corps of the Public Health Service; (c) income from certain public retirement systems if the individual was a member of, or retired from, that system prior to 1964; and (d) up to \$5,000 of retirement income for taxpayers aged 65 or over with federal AGI of less than \$15,000 per filer or less than \$30,000 for married-joint filers. Together, these provisions are estimated to reduce individual income tax revenues by nearly \$950 million in tax year 2024 under current law (the exclusion for Social Security benefits accounts for an estimated \$900 million [95%] of this total).

Taxable income, the amount of income actually subject to tax, is calculated under current law by subtracting the state sliding scale standard deduction and personal exemptions from Wisconsin AGI. Table 1 displays the rate and bracket schedule applicable to taxable income in tax year 2023 under current law. Pursuant to 2023 Act 19, the 2023-25 biennial budget act, the bottom two rates were reduced from 4.65% and 3.54% to 4.40% and 3.50%, respectively, beginning in tax year 2023.

TABLE 1

Current Law Tax Rate and Bracket Schedule, Tax Year 2023

<u>Tax Rate</u>	<u>Income Tax Brackets by Filing Status</u>		
	<u>Single and Head-of-Household</u>	<u>Married-Joint</u>	<u>Married-Separate</u>
3.50%	\$0 to \$13,810	\$0 to \$18,420	\$0 to \$9,210
4.40%	13,810 to 27,630	18,420 to 36,840	9,210 to 18,420
5.30%	27,630 to 304,170	36,840 to 405,550	18,420 to 202,780
7.65%	304,170 and over	405,550 and over	202,780 and over

SUMMARY OF LRB 4136/1

Exclusion for Retirement Income. Beginning in tax year 2023, the bill would exclude the first \$100,000 of retirement income currently subject to state tax received by each individual who is at least 67 years of age before the close of the taxable year. For married-joint filers where each spouse has attained age 67, the maximum exclusion would equal \$150,000. For married-separate filers who have attained age 67, the exclusion claimed by each spouse could not exceed \$75,000. [For comparison, the estimated average state-taxable retirement income under current law for individuals with retirement income in tax year 2023 is \$37,530 for married-joint filers and \$22,140 for all other filers.] The bill would prohibit a taxpayer who claims this exclusion from claiming any state income tax credits provided under current law in the same tax year. The Appendix provides a list of all nonrefundable and refundable tax credits available under current law in tax year 2023.

Nonresidents would be prohibited from claiming the exclusion. Part-year residents could claim the exclusion only for the portion of their retirement income which is sourced to Wisconsin. For part-year residents, this amount is calculated by multiplying the total exclusion amount they could otherwise claim by a fraction where the numerator is the individual's wages, salary, tips, unearned income, and net earnings from a trade or business that are taxable by this state and the

denominator is the individual's total wages, salary, tips, unearned income, and net earnings from a trade or business from all sources.

Retirement income, for purposes of the exclusion, would be defined as payments or distributions received each year by an individual from a qualified retirement plan under the Internal Revenue Code under 26 USC 408 [such as distributions from a pension, 401(k), or 403(b)] or from an IRA established under specified provisions of federal law, which are generally subject to RMDs. The proposed exclusion would not apply to any retirement income which is already exempt under any of the aforementioned provisions of current state law (to prevent an exclusion from being claimed twice on the same income). Distributions from qualified after-tax retirement plans for which tax had already been paid (such as a Roth IRA, Roth 401(k), or Roth 403(b) plan) would not receive an additional tax benefit under the bill.

Income Tax Rate Reduction. Further, beginning in tax year 2023, the bill would reduce the marginal tax rate applicable to the third bracket from 5.30% to 4.40%. As a result, the third bracket would be consolidated into the second bracket. The rate and bracket structure that would apply in tax year 2023 under the bill is displayed in Table 2.

TABLE 2

Tax Rate and Bracket Schedule under LRB 4136/1, Tax Year 2023

<u>Tax Rate</u>	<u>Income Tax Brackets by Filing Status</u>		
	<u>Single and Head-of-Household</u>	<u>Married-Joint</u>	<u>Married-Separate</u>
3.50%	\$0 to \$13,810	\$0 to \$18,420	\$0 to \$9,210
4.40%	13,810 to 304,170	18,420 to 405,550	9,210 to 202,780
7.65%	304,170 and over	405,550 and over	202,780 and over

Technical Cross Reference Changes. Finally, the bill would eliminate certain cross references between the current law retirement income exclusion for up to \$5,000 of payments under qualified retirement plans and the current law exclusions for retirement payments received under military retirement systems, uniformed services retirement benefits, and disability payments. The Department of Revenue (DOR) indicates that it is unnecessary to have two sets of cross references, and thus the cross references removed under the bill would have no effect to current law.

FISCAL EFFECT

The bill is estimated to reduce individual income tax collections by \$1,549.5 million in 2023-24 and \$1,403.1 million in 2024-25. This estimate, and the attached distributional tables, are based on a simulation by DOR.

Table 3 displays the fiscal estimate of the bill for each year of the 2023-25 biennium. As shown, the estimates include an interactive effect, which may occur when multiple tax law changes impact an individual's tax liability. The estimates for 2023-24 also include one-time revenue impacts, which result from differences in timing between the state fiscal year and the tax year.

TABLE 3

**Estimated Fiscal Impact of LRB 4136/1 by Provision, 2023-25 Biennium
(Millions)**

<u>Provision</u>	<u>2023-24</u>	<u>2024-25</u>	<u>2023-25 Biennium</u>
Reduce 5.30% Rate to 4.40%	-\$1,048.3	-\$1,030.2	-\$2,078.5
Retirement Exclusion	-572.7	-425.5	-998.3
Interactive Effect	<u>71.5</u>	<u>52.6</u>	<u>124.1</u>
Total	-\$1,549.5	-\$1,403.1	-\$2,952.7

It should be noted that, based on current population estimates published by the Department of Administration, the proportion of the Wisconsin population that is of retirement age is projected to increase from 17.7% in 2020 to 23.7% in 2040. The total number of retirement-aged Wisconsin residents over this same time period is expected to increase by 57%, from 0.98 million residents (as reported by the U.S. Census Bureau) to 1.54 million. To the extent this projected demographic trend occurs, the cost of the proposed retirement exclusion would increase in the future.

The attachment displays the estimated distributional impact of the retirement income exclusion and the rate reduction for tax year 2023. As shown in the attachment, it is estimated that 1.73 million filers would receive tax decreases totaling \$1,332.3 million, for an average decrease of \$772 in tax year 2023. It is estimated that the bill would reduce the share of taxpayers with a net income tax liability in tax year 2023 by 5.1 percentage points, from 71.9% under current law to 66.8% under the bill.

DOR indicates that it will draft tax forms and begin programming (along with third-party software developers) for tax year 2023 in September, 2023, and that it will print tax forms and instructions in October, 2023. Depending on the date of enactment, the proposed tax changes under LRB 4136/1 could require DOR to incur costs to re-print forms and delay the date for individuals to file their tax returns for the 2023 tax year.

We hope this information is helpful, please contact us with any questions.

DS/JG/lb
Attachment

ATTACHMENT

LRB 4136/1: Exclude First \$100,000 of Retirement Income if Aged 67 or Older (\$150,000 Married-Joint and \$75,000 Married-Separate per Spouse) and Reduce 5.30% Rate to 4.40%, Tax Year 2023

Wisconsin Adjusted Gross Income	Taxpayers with a Tax Decrease						Count of All Returns	% of all Returns in AGI Class
	Count	% of Count	Amount of Tax Decrease	% of Decrease	Average Decrease			
Under \$5,000	19,765	1.1%	\$253,222	<0.1%	\$13	471,850	4.2%	
5,000 to 10,000	10,718	0.6	393,002	<0.1	37	209,515	5.1	
10,000 to 15,000	8,170	0.5	466,950	<0.1	57	170,885	4.8	
15,000 to 20,000	9,290	0.5	831,631	0.1	90	150,071	6.2	
20,000 to 25,000	17,042	1.0	1,991,700	0.1	117	149,470	11.4	
25,000 to 30,000	20,030	1.2	4,179,952	0.3	209	154,593	13.0	
30,000 to 40,000	71,673	4.2	16,271,067	1.2	227	303,991	23.6	
40,000 to 50,000	229,328	13.3	39,216,608	2.9	171	274,021	83.7	
50,000 to 60,000	193,828	11.2	58,758,851	4.4	303	224,455	86.4	
60,000 to 70,000	171,716	9.9	67,611,966	5.1	394	174,677	98.3	
70,000 to 80,000	138,796	8.0	72,143,046	5.4	520	141,021	98.4	
80,000 to 90,000	112,596	6.5	70,806,292	5.3	629	114,227	98.6	
90,000 to 100,000	96,248	5.6	70,040,214	5.3	728	97,605	98.6	
100,000 to 125,000	192,127	11.1	169,285,457	12.7	881	194,584	98.7	
125,000 to 150,000	133,595	7.7	150,336,689	11.3	1,125	135,489	98.6	
150,000 to 200,000	143,030	8.3	205,767,031	15.4	1,439	145,579	98.2	
200,000 to 250,000	60,792	3.5	114,676,793	8.6	1,886	62,061	98.0	
250,000 to 300,000	29,851	1.7	69,426,048	5.2	2,326	30,591	97.6	
300,000 to 500,000	43,201	2.5	133,576,872	10.0	3,092	44,207	97.7	
500,000 to 1,000,000	17,806	1.0	61,898,283	4.6	3,476	18,294	97.3	
1,000,000 and over	<u>7,307</u>	<u>0.4</u>	<u>24,378,549</u>	<u>1.8</u>	<u>3,337</u>	<u>7,620</u>	<u>95.9</u>	
Total	1,726,908	100%	\$1,332,310,223	100.0%	\$772	3,274,806	52.7%	

--In tax year 2023, it is estimated that 1,726,908 filers (52.7% of all filers) would receive tax decreases totaling \$1,332.3 million, for an average decrease of \$772. Filers without a decrease would generally be those who: (a) do not have any taxable income above the bottom two brackets; or (b) are not at least aged 67 with state-taxable retirement income.

--Taxpayers with Wisconsin AGI under \$100,000 would represent 63.7% of all filers with a tax decrease, and would receive 30.2% of the decrease. Their estimated average decrease would be \$367 in tax year 2023.

--Taxpayers with Wisconsin AGI of \$100,000 or more would represent 36.3% of all filers with a tax decrease, and would receive 69.8% of the decrease. Their estimated average decrease would be \$1,481 in tax year 2023.

--In general, the average decrease rises with Wisconsin AGI over the AGI groups shown above.

Based on a simulation of tax year 2023 by the Department of Revenue.

APPENDIX

The following tax credits are available to be claimed by individuals in tax year 2023 under current law, but could not be claimed if an individual were to claim the proposed exclusion for retirement income under LRB 4136/1.

Nonrefundable Individual Income Tax Credits

- Married Couple Credit
- Itemized Deduction Credit
- Property Tax/Rent Credit
- Working Families Credit
- Taxes Paid to Other States Credit
- Child and Dependent Care Expenses Credit
- State Historic Rehabilitation Credit
- Angel Investment Credit
- Unused Credits Carried Forward from Prior Years

Refundable Individual Income Tax Credits

- Earned Income Tax Credit
- Homestead Credit
- Veterans and Surviving Spouses Property Tax Credit
- Repayment (Claim of Right) Credit

Nonrefundable Business Tax Credits

- Community Rehabilitation Program Credit
- Early Stage Seed Investment Credit
- Employee College Savings Account Contribution Credit
- Insurance Security Fund Assessment Credit
- Low-Income Housing Credit
- Manufacturing and Agriculture Credit
- Nonrefundable Research Credit
- Supplement to the Federal Historic Rehabilitation Credit
- Unused Credits Carried Forward from Prior Years

Refundable Business Tax Credits

- Business Development Credit
- Electronics and Information Technology Manufacturing Zone (Foxconn) Credit
- Enterprise Zone Credit
- Farmland Preservation Credits
- Refundable Research Credit