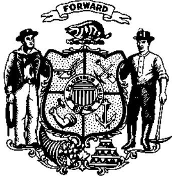

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February 16, 2010

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Assembly Bill 648 and Senate Bill 439: Individual Income Tax References to the Internal Revenue Code

Assembly Bill 648 and Senate Bill 439 are identical, and both would amend the state's individual income tax statutes to include reference to changes to the Internal Revenue Code (IRC) made by the Tax Increase Prevention and Reconciliation Act of 2005 and the Heroes Earnings Assistance and Relief Tax Act of 2008.

AB 648 was introduced on January 6, 2010, and referred to the Assembly Committee on Jobs, the Economy, and Small Business, which held a public hearing on the bill on January 12, 2010. By votes of 10 to 0 (with 3 absent), the Committee adopted Assembly Amendments 1 and 2 and recommended passage of the bill, as amended, on February 3, 2010.

Senate Bill 439 was introduced on December 23, 2009 and referred to the Senate Committee on Health, Health Insurance, Privacy, Property Tax Relief, and Revenue. On January 4, 2010, the bill was withdrawn from that Committee and re-referred to the Senate Committee on Veterans and Military Affairs, Biotechnology, and Financial Institutions. That Committee held a public hearing on the bill on January 20, 2010, and an executive session on the bill on February 3, 2010. By votes of 4 to 0, the Committee adopted Senate Amendments 1 and 2 and recommended passage of the bill, as amended. Also on February 4, 2010, SB 439 was referred to the Joint Committee on Finance.

Assembly Amendment 1 is identical to Senate Amendment 2, and Assembly Amendment 2 is identical to Senate Amendment 1.

Reports by the Joint Survey Committee on Tax Exemptions have been requested on both bills.

CURRENT LAW

State individual income tax and corporate and franchise tax provisions are generally referenced to definitions under federal law. Changes to federal law take effect for state purposes only after action by the Legislature. Last year, the Legislature reviewed changes to the Internal Revenue Code enacted in 2007 and 2008, as well as some law changes enacted in 2005 and 2006 that had not been adopted by previous Legislatures. In 2009 Wisconsin Act 28 (the 2009-11 biennial budget act), the Legislature amended the state's income tax statutes to generally refer to the IRC in effect as of December 31, 2008. However, Act 28 did not adopt a number of IRC provisions for state tax purposes.

The items not adopted include provisions in the Tax Increase Prevention Act of 2005 (TIPRA or Public Law 109-222) related to the conversion of traditional individual retirement accounts (IRAs) to Roth IRAs and in the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEARTA or Public Law 110-245) related to withdrawals from IRAs, contributions to Roth IRAs, withdrawals from health flexible spending accounts, and the exclusion from gross income of bonus payments for service in a combat zone. In addition, Act 28 did not include certain references to the Pension Protection Act (PPA or Public Law 109-280) that would permanently increase contribution limits for IRAs and certain retirement plans. These PPA provisions were considered during 2007-09 budget deliberations. At that time, the Governor did not recommend the PPA provisions for adoption, preferring that they be postponed for consideration during the 2009-11 legislative session.

SUMMARY OF BILLS

Federalization of Provisions in TIPRA (Conversion of Traditional IRAs to Roth IRAs). For traditional IRAs, contributions are generally deductible from income, but distributions of both contributions and investment earnings are subject to taxation as ordinary income. Roth IRAs differ from traditional IRAs in that contributions to Roth IRAs are fully taxable (are not deductible), and distributions of both contributions and investment earnings are exempt from taxation at the time of distribution.

Individuals with incomes above certain levels are not allowed to deduct their contributions to traditional IRAs, but individuals with income above the federal thresholds may make non-deductible contributions. Contributions to Roth IRAs are prohibited if a taxpayer's income exceeds an established threshold level. The threshold level for married-joint filers was set at $176,000 for 2009 and has increased to $177,000 for 2010. In addition, federal law permits taxpayers to convert traditional IRAs to Roth IRAs. Because distributions from traditional IRAs are subject to tax as ordinary income, the taxpayer must pay tax on amounts converted.

Prior to 2010, federal law prohibited conversions from traditional to Roth IRAs if the taxpayer's modified adjusted gross income was over $100,000. TIPRA permanently removed the $100,000 income limitation for the conversion of traditional IRAs to Roth IRAs for tax years beginning in 2010. This action effectively eliminates the income threshold on Roth IRAs since

taxpayers with incomes above the threshold will be able to make non-deductible contributions to a traditional IRA and immediately convert it to a Roth IRA. Also, TIPRA allows taxpayers making conversions in 2010 to report half of the distribution as taxable income in 2011 and the other half of the distribution as taxable income in 2012.

AB 648 and SB 439 would amend Wisconsin's individual income tax statutes to recognize the elimination of the $100,000 income limit in the Internal Revenue Code, beginning in tax year 2010. Taxpayers making conversions could recognize half of the amount as income in 2011 and the other half of the amount as income in 2012.

Federalization of Provisions in HEARTA. AB 648 and SB 439 would amend state individual income tax statutes to recognize four provisions enacted as part of HEARTA.

The first provision extends to national guardsmen or reservists who have been called to active duty for a period exceeding 179 days. They would be permitted to make penalty-free withdrawals from IRAs or elective deferrals, such as 401(k) plans. This provision was set to expire on December 31, 2007, but HEARTA made the provision permanent.

The second provision relates to Roth IRAs. Under current law, a $5,000 contribution limit with a $1,000 catch-up limit extends to Roth IRAs. Also, contributions are prohibited for taxpayers with incomes above certain levels, depending on filing status, and at somewhat lower income levels, the contribution limit starts being phased-out. For individuals receiving a military death gratuity, HEARTA waives the contribution and income limits, and the amount of the gratuity may be contributed without regard to the limits.

The third HEARTA provision relates to flexible spending accounts for health care expenses, where contributions to and withdrawals from accounts are excluded from income subject to taxation. Typically, amounts in accounts must be used by year's end, and any remaining amounts are forfeited. HEARTA allows distributions to reservists equal to all or part of that individual's balance if the reservist has been called to active duty for at least 180 days and provides that those distributions are not subject to penalty. The bills would extend this treatment to the state individual income tax with respect to distributions made after June 17, 2008.

The fourth HEARTA provision relates to bonus payments made by state or local governments to members of the military because that individual served in a combat zone. HEARTA excludes such payments from gross income for purposes of individual income taxation. The bills would extend the exclusion to the state individual income tax.

SUMMARY OF SENATE AMENDMENT 1 AND ASSEMBLY AMENDMENT 2

Senate Amendment 1 and Assembly Amendment 2 are identical and would amend Wisconsin's individual income tax statutes to recognize certain provisions included in the federal Pension Protection Act. Recent federal law changes to pension and IRA provisions were initially enacted on a temporary basis, as part of the Economic Growth and Tax Relief Reconciliation Act of

2001 (EGTRRA). They were scheduled to expire, effective in tax year 2011, but the Pension Protection Act extended them on a permanent basis. Wisconsin's individual income tax statutes have been updated to include references to EGTRRA, but state law does not include references to the PPA. As a result, the pension and IRA provisions in state law will revert to their pre-EGTRRA status in tax year 2011. The federal tax law changes in EGTRRA and the PPA affect contribution levels to IRAs, qualified retirement plans, and eligible deferred compensation plans.

Individual Retirement Accounts. Prior to EGTRRA, a taxpayer's maximum annual contribution to an IRA was set at the lesser of $2,000 or the taxpayer's taxable compensation for the year. EGTRRA increased the maximum contribution to $3,000 for tax years 2002 through 2004, $4,000 for tax years 2005 through 2007, and $5,000 for tax year 2008. Also, EGTRRA authorized individuals 50 years of age or older to make additional contributions, called "catch-up" contributions, of up to $1,000 per year. After 2008, contribution levels under both provisions are indexed for inflation and rounded to the nearest $500. Due to low inflation rates, no adjustment was made for tax year 2009 and no adjustment will be made for tax year 2010. For federal income tax purposes, the PPA extended the EGTRRA provisions on a permanent basis. SA 1 and AA 2 would update the state individual income tax statutes to recognize the PPA. Otherwise, the maximum IRA contribution level will revert to $2,000 and no "catch-up" contributions will be allowed beginning in tax year 2011.

Traditional 401(k) Plans. A 401(k) plan is one of several types of retirement plans that employers may offer their employees. It is characterized as a defined contribution plan, as opposed to a defined benefit plan, because the plan's level of retirement benefits is based entirely on contributions to the plan and the earnings on those contributions. Employees may elect to defer part of their compensation by making contributions to the plan on a pre-tax basis. Separate accounts are maintained for plan participants. Distributions from 401(k) plans are subject to taxation and generally may be made after the participant reaches the age of 59½. Prior to EGTRRA, the maximum contribution for 401(k) plans was set at $7,000 per year, adjusted for inflation. By 2001, the inflation adjustment had increased the maximum contribution level to $10,500. EGTRRA set the limit on elective deferrals at $11,000 for tax year 2002 and increased that limit by $1,000 annually until 2006, when the limit reached $15,000. For subsequent tax years, the limit is subject to an inflation adjustment, made in $500 increments. As a result of this adjustment, the limit on elective deferrals equals $16,500 for tax years 2009 and 2010. In addition, EGTRRA authorized "catch-up" contributions of $5,500 annually for plan participants who are 50 years of age, or older. SA 1 and AA 2 would update the state individual income tax statutes to recognize the PPA. Otherwise, the Department of Revenue (DOR) indicates that the maximum 401(k) contribution level will revert to the pre-EGTRRA level of $7,000, adjusted for inflation. For 2011, the inflation adjustment would result in a contribution level estimated at $13,000. No "catch-up" contributions will be allowed.

457 Plan Deferrals. Section 457 of the Internal Revenue Code authorizes state and local governments and tax-exempt organizations to establish deferred compensation plans whereby their employees may elect to defer part of their compensation to the plan on a pre-tax basis. Distributions from plans are subject to tax. Prior to EGTRRA, annual contributions to Section 457 plans were

limited to no more than $7,500, plus an annual adjustment for inflation. In addition, participants could increase their contribution to $15,000 in each of the three years immediately preceding retirement. EGTRRA set the maximum contribution level for Section 457 plans at the same amounts that are allowed for elective deferrals to traditional 401(k) plans. Consequently, the limit for tax years 2009 and 2010 equals $16,500. In addition, EGTRRA created a "catch-up" provision that allows individuals 50 years of age or older to contribute an additional amount. As of 2010, the catch-up amount has increased to $5,500. Also, participants who are 50 years of age or older and in the three years immediately preceding retirement are allowed to contribute the greater of the catch-up amount or an amount equal to the limit otherwise applicable (that is a total deferral of $16,500 x 2, or $33,000 in 2009 and 2010). SA 1 and AA 2 would update state income tax provisions to include changes made by the PPA. Otherwise, Section 457 plan deferral limits will revert to their pre-EGTRRA levels in Wisconsin, or $7,500, adjusted for inflation. For tax year 2011, the inflation adjustment would result in a contribution limit estimated at $10,500. The "catch-up" limit for participants within three years of retirement would be $15,000, with no special provision for taxpayers 50 years of age or older.

SIMPLE Plans. Savings incentive match plans for employees, or SIMPLE plans, allow small businesses to establish retirement plans for their employees. Self-employed individuals may also participate in SIMPLE plans. Under the plan, an employee and employer sign an agreement whereby the employer reduces the employee's wages by a certain percentage each pay period. The employer contributes the salary reduction to a SIMPLE IRA on behalf of the employee, unless the SIMPLE plan has been established as part of a 401(k) plan. Employers are required to make matching contributions to SIMPLE plans, and businesses establishing plans must allow employees meeting certain qualifications to participate. Contributions to plans are made on a pre-tax basis, but distributions from plans are subject to tax. Prior to EGTRRA, the maximum elective deferral to a SIMPLE plan was set at $6,000 per year, although the maximum had increased to $6,500 in tax year 2001 due to an inflation adjustment. EGTRRA established the maximum deferral at $7,000 for tax year 2002 and increased the maximum in $1,000 increments through tax year 2005. An inflation adjustment for subsequent years raised the maximum to $11,500 for tax years 2009 and 2010. Also, EGTRRA allows "catch-up" contributions for employees who are 50 years of age or older. The limit on such contributions is set at $2,500 annually for tax years 2009 and 2010 and is subject to inflation-based adjustments in succeeding years. SA 1 and AA 2 would update state income tax provisions to include changes made by the PPA. Otherwise, the deferral limit for SIMPLE plans will revert to the pre-EGTRRA level of $6,000, adjusted for inflation. The inflation adjustment would result in a contribution level estimated at $8,000 for tax year 2011. "Catch-up" contributions for eligible employees will not be allowed.

Roth 401(k) and Roth 403(b) Plans. A 401(k) plan, as described above, is a defined contribution retirement plan where employees may elect to defer part of their compensation. A 403(b) plan is an employer-sponsored retirement plan offered by tax-exempt charitable organizations and educational institutions of state and local governments where employees make elective deferrals in exchange for an annuity. The limits on deferrals that apply to 401(k) plans also apply to 403(b) plans. Deferrals to 401(k) and 403(b) plans are made on a pre-tax basis, and distributions from plans are subject to tax. EGTRRA allows 401(k) and 403(b) retirement plans to

offer employees a Roth option whereby part or all of the deferral made to the regular 401(k) or 403(b) plan would instead be made on an after-tax basis to a Roth account. Subsequent distributions from the Roth account would not be subject to tax. As enacted, the EGTRRA provisions governing 401(k) and 403(b) Roth contributions apply to tax years 2006 through 2010. The PPA made those changes permanent. SA 1 and AA 2 would update the income tax statutes to include references to the PPA. As a result, Wisconsin participants in 401(k) and 403(b) retirement plans would continue to be able to designate all or part of their elective deferrals to Roth accounts in tax year 2011.

SUMMARY OF SENATE AMENDMENT 2 AND ASSEMBLY AMENDMENT 1

Senate Amendment 2 and Assembly Amendment 1 are identical technical amendments that would correctly reference the HEARTA-related provisions described above.

FISCAL EFFECT

Effect of TIPRA Provisions Related to IRA Conversions. If Wisconsin does not adopt the TIPRA provisions, taxpayers with incomes over $100,000 who make conversions would incur penalties. DOR's Wisconsin Tax Bulletin for October, 2009, describes these penalties:

> If the person is under age 59½, the person would be subject to an early distribution penalty. The penalty is equal to 3.33% of the amount converted. The person would also be subject to a 2% penalty for an excess contribution to the Roth IRA. This penalty would be applied each year until the excess contribution is withdrawn. Persons age 59½ or over would only be subject to the excess contribution penalty.

At the time of its adoption, the waiver of the $100,000 income limit was estimated to have a positive effect on federal income tax collections in federal fiscal years 2011, 2012, and 2013 and a negative impact on revenues in later years. The positive effect is due to the taxes on amounts previously deducted from taxable income when the traditional IRAs were created. The negative effect is due to future withdrawals from Roth IRAs, which are exempt from taxation.

Changes in federal tax policy may induce certain behavioral responses from taxpayers. Wisconsin's 3.33% tax on early distributions and 2% tax on excess contributions will likely cause some taxpayers to refrain from converting their IRAs, although some taxpayers who are unaware of the penalties will make conversions. Therefore, Wisconsin's adoption of the federal conversion treatment would have two offsetting effects. Among taxpayers who will make conversions without regard to Wisconsin's tax treatment, a revenue loss of $2.1 million is estimated for 2010-11 (penalties of $1.2 million on early distributions and $0.9 million on excess contributions). Among taxpayers who will not undertake conversions unless Wisconsin adopts the federal conversion treatment, a revenue increase of $3.1 million is estimated. The combined effect of adopting the federal treatment is therefore estimated as an additional $1.0 million in state tax collections in 2010-11. The combined effect on state revenues is estimated at +$1.5 million for 2011-12 and -$1.7 million for 2012-13. In future years, this provision would continue to have a negative effect on state

revenues because distributions would be made from Roth IRAs on a tax-free basis, rather than from traditional IRAs on a taxable basis.

Effect of HEARTA Provisions Related to National Guardsmen, Reservists, and Members of the Military. Adoption of the four provisions in HEARTA is estimated too have a minimal effect on state revenues.

Effect of PPA Provisions Related to Contribution Levels for IRAs and Certain Retirement Plans and Programs (Senate Amendment 1 and Assembly Amendment 2). For state individual income tax purposes, current law provisions provide for lower levels of contributions to IRAs and elective deferrals to qualified retirement plans in tax year 2011, than in tax year 2010. Even though higher contribution and deferral levels will be permitted at the federal level, DOR will impose excess contribution penalties on Wisconsin taxpayers who make contributions or deferrals at the maximum levels allowed under federal law. Because the higher contribution and deferral amounts will not be allowed under state law, estimated state income tax collections for the 2009-11 biennium and beyond assume that Wisconsin taxpayers will not make contributions and deferrals at the higher levels. Consequently, if Wisconsin amends its individual income tax statutes to incorporate the PPA provisions (SA 1 and AA 2), state tax collections would decrease due to the loss of taxes on deferred compensation used for contributions or elective deferrals.

Because the state's treatment of contributions to IRAs and elective deferrals to qualified retirement plans will revert to its pre-EGTRRA status in tax year 2011, amending the state individual income tax statutes to recognize changes made by the PPA would affect state tax collections in 2010-11. Based on the fiscal analysis of the PPA by the staff of the federal Joint Committee on Taxation, adopting the PPA provisions would reduce Wisconsin individual income tax collections by an estimated $13.0 million in 2010-11 (-$3.9 million due to IRA contributions and -$9.1 million due to elective deferrals). Reductions of $33.3 million (-$12.0 million due to IRA contributions and -$21.3 million due to elective deferrals) and $40.4 million (-$16.5 million due to IRA contributions and -$23.9 million due to elective deferrals) are estimated for 2011-12 and 2012-13, respectively.

Combined Fiscal Effect. Adoption of the preceding provisions would have a combined fiscal effect of reducing state tax collections by $12.0 million in 2010-11. Relative to the 2011-13 biennium, reductions of $31.8 million in 2011-12 and $42.1 million in 2012-13 are estimated.

On January 27, 2010, this office issued a memorandum regarding the status of the state's general fund. At that time, the gross balance of the general fund, as of June 30, 2011, was estimated at $55.7 million, or $9.3 million below the $65.0 million balance required under s. 20.003(4) of the state statutes. As a result, AB 648 and SB 439 should be amended to include a notwithstanding clause relative to s. 20.003(4).

Prepared by: Rick Olin