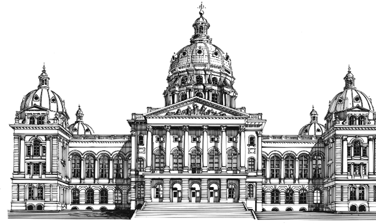
Iowa Legislative Fiscal Bureau



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ISSUE REVIEW

State Deduction For Federal Income Tax

ISSUE

Iowa currently allows taxpayers to deduct 100% of federal taxes from their Iowa individual taxable income. Recent federal law changes have brought into question the complications that this deduction creates, as well as the tax incidence effects the policy has on Iowa taxpayers.

AFFECTED AGENCIES

Department of Revenue and Finance (DRF)

CODE AUTHORITY

Chapter 422.9 and 422.35, Code of Iowa

BACKGROUND

According to a recent survey completed by the National Conference of State Legislatures (NCSL), 8 states allow individuals to deduct from taxable income the amount that is paid in federal income taxes. In addition to Iowa, Alabama and Louisiana allow a 100% deduction without qualification. The other 5 states (Oklahoma, North Dakota, Utah, Oregon, and Missouri[1]) have a variety of policies that include capping the deduction, limiting the percentage that can be deducted, and requiring those who use the deduction to use a higher tax rate schedule.

States that allow the deduction face 2 concerns when the federal government changes the federal tax code (IRC). In 1993, for example, the federal government increased the top marginal tax rate on individuals, which increased income tax liability on those families with taxable income in excess of $140,000. States that allow the deduction of federal income tax experienced revenue shortfalls because higher federal taxes have the effect of reducing State taxable income. Secondly, the tax burden shifted such that lower income individuals paid a greater proportional share of state income taxes than before the federal changes.

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[1]Missouri, which previously allowed a 100% deduction, capped the deduction at $5,000 and $10,000 for single filers and married filers respectively beginning January 1, 1994. The Missouri Department of Revenue estimates that approximately $205.0 million in new revenue will be raised, which represents an increase in personal income taxes of approximately 10.0%.

All things being equal, the policy of federal deductibility in Iowa is regressive because the federal income tax is progressive. Since higher income individuals pay a larger percentage in federal tax, they receive a proportionally larger deduction from their state income tax.

CURRENT SITUATION

Each tax year, taxpayers filing Iowa tax returns deduct more than $5.6 billion[2] in federal taxes from their State income taxes, which equates to approximately $350.0 million in lost revenue. This figure is subject to change when the federal government changes tax policy. The figures are also sensitive to the performance of the economy. When personal income increases, so does federal tax. As a result, when the State economy grows, much like when federal rates are increased, high income taxpayers are given a smaller proportional share of the Iowa tax burden. Similarly, in recessions, those with federal income tax savings will absorb a larger proportional share of the State tax burden.

Currently, Iowa's top marginal tax rate is 9.98%. Actual tax burden, however, is a combination of both the tax rate and deductions. Factoring federal deductibility at the new federal tax level of 36.0%, the top marginal tax rate is effectively 6.39%. When the new federal surtax is considered, the effective marginal tax rate on Iowa's highest income taxpayers drops to 6.03%.

ALTERNATIVES

Many options exist with regard to federal deductibility. Most options that curtail the deduction will reduce the sensitivity of State revenues to federal tax rate changes. The following are 3 alternatives to the present system: 1) Cap deduction for federal income tax; 2) Allow full deduction as an option, but contingent on different rate structure; 3) Eliminate the deduction.

Putting a Cap on the Deduction for Federal Income Tax

The first alternative is to cap federal deductibility at a dollar amount or percentage. A percentage change in the allowable deduction would result in a similar change in State revenues. Reducing the deduction by 50.0%, for example, would recoup approximately 50.0% of the impact from the deduction. A "dollar cap" behaves differently, because low income filers will be less affected than high income filers. The marginal tax rates could be adjusted to reverse the progressivity that a cap would induce. Table 1 illustrates the impact of capping federal deductions at various amounts.

[2] This figure represents a DRF estimate for tax year 1992.

Table 1

Cap Level		Increase in State Revenues
Single	Married	
$ 5,000	$ 8,000	$ 160.0
10,000	16,000	105.1
30,000	48,000	60.6
50,000	80,000	47.2
100,000	160,000	33.2

Deduction Allowance with Separate Rate Criteria

A second option would allow the deduction without qualification, but institute a different rate structure. Under this scenario, if a taxpayer chose to deduct federal taxes, the individual's taxable income would be subject to a higher rate schedule. While this alternative softens the regressive nature of the deduction, it adds complexity to the tax system. Additionally, although the impact of federal tax changes could conceivably be reduced under this plan, the State would still experience federally-induced revenue swings.

Eliminating the Deduction and Maintaining Current Effective Tax Rates

The third alternative is to eliminate the deduction completely. This option might entail changing the rate structure to provide revenue neutrality. Due to the magnitude of federal deductibility, however, it is not possible to maintain current effective tax rates for each income class without having declining marginal tax rates for upper income brackets. Table 2 shows marginal tax rate changes that come close to revenue neutrality across income classes.

Table 2

Taxable Income		Current Marginal Rates	Alternative Marginal
Over	Not Over		
$ 0	$ 1,060	0.40%	0.40%
1,060	2,120	0.80	0.80
2,120	4,240	2.70	2.00
4,240	9,540	5.00	4.50
9,540	15,900	6.80	6.20
15,900	21,200	7.20	6.80
21,200	31,800	7.55	7.00
31,800	47,700	8.80	7.10
47,700	140,000	9.98	7.20
140,000		9.98	7.50

These brackets and rates apply to all Iowa taxpayers, regardless of filing status. The effects on taxpayers, however, is not the same for each filing status. Table 3 compares the change in

effective tax rates for individual income taxpayers by Family Expanded Income (FEI)[3]. The effective rate change reflects the 2 rate schedules listed in Table 2 for each filing classification.

Assuming the listed marginal rates, the most significant benefit would go to families who file either Head of Household or Married Jointly, and have FEI between $20,000 and $30,000. Individuals who file a single return would pay the largest share of increases. Lower income single filers would receive a modest reduction in State tax. Single filers with incomes between $75,000 and $100,000, however, would pay an additional 0.48% of their income in State taxes.

Table 3

FEI	Change in Effective Tax Rate					Average Change in Tax (Dollars Per Family)				
Not Over	Single	Married Separate Combined	Married Joint	Head of Household	All	Single	Married Separate Combined	Married Joint	Head of Household	All
10,000	-0.01 %	-0.09 %	-0.02 %	0.00 %	0.00 %	$ 0	$ -56	$ -17	$ 0	$ -5
20,000	0.08	-0.14	-0.11	-0.19	-0.04	9	-15	-12	-27	-4
30,000	0.24	-0.16	-0.44	-0.44	-0.11	52	-35	-89	-102	-23
50,000	0.39	-0.25	-0.07	-0.16	-0.07	139	-94	-24	-22	-23
75,000	0.47	-0.15	0.1	0.17	-0.03	253	-88	50	104	-16
100,000	0.48	0.15	0.03	0.2	0.18	368	116	18	143	139
200,000	0.36	0.19	0.04	0.21	0.18	390	215	36	222	199
and over	0.33	0.44	-0.38	-0.05	-0.02	1,000	1,716	-4,962	0	96
Average	0.31 %	-0.03 %	-0.22 %	-0.1 %	0 %	$ 55	$ -10	$ -80	$ -24	$ 1

Overall, Iowa families earning less than $75,000 would pay slightly less in State taxes, while those earning more than $75,000 would realize a small increase in the effective tax rate. The increase is partially offset, however, by the federal government's policy of allowing those who itemize to deduct state income taxes from their federal return. The net result would be that the State would receive approximately the same amount of revenue from income taxes, but Iowa taxpayers would pay approximately $13.2 million less in federal taxes.

Typically, families who save on their federal taxes are upper income itemizers, and those who save on their State taxes are lower income Iowans who generally take the standard deduction. The following chart illustrates the overall change in tax burden for Iowa taxpayers, taking into account both federal and State taxes. The numbers above the columns indicate the change in taxes for a taxpayer with the mean income for the given income class.

Additionally, due to the nature of resident income distribution, nonresident Iowa taxpayers will pick up a disproportionate share of the tax increase (for those that have an increase). Nonresident families make up an estimated 18.7% of Iowa taxpaying families. Whereas resident families will see a mean reduction in their State tax bill of approximately $8.34, nonresident taxpayers will see a mean increase in their State tax bill of approximately $5.40.

[3] FEI uses the household as the unit of analysis, and includes Adjusted Gross Income (AGI) plus adjustments, excluded pensions, exempt interest, unemployment, and Social Security, but does not include business or passive losses.

BUDGET IMPACT

Thus far, the fiscal effects of the elimination of the deduction of federal income taxes have been discussed in terms of tax years rather than fiscal years. There are transitional effects of eliminating the deduction that would affect the budget in the first fiscal year, which is assumed to be FY 1995.

This analysis assumes that the deduction would be eliminated for tax years beginning January 1, 1995. Wage earners who pay federal taxes primarily through withholding typically pay close to 100% of their tax liability in the tax year for which it is owed. Thus, these individuals would be able to deduct virtually all of their federal tax liability for tax year 1994. Taxpayers who make estimated payments, however, do not pay all of their tax liability in the tax year for which it is owed. Absent special provisions, the estimated payment that is due on January 15, 1995, would not be deductible from the 1996 tax return.

Similarly, those taxpayers who have to make a final federal tax payment by April 15, 1995, will not be able to deduct that payment. Like those who make estimated payments, these individuals would lose the deduction before the lower rates go into effect. Likewise, the State will lose revenue due to refunds that are sent out in 1995 for taxes paid in tax year 1994. Under current law, taxpayers must pay State tax on the previous year's refunds. Again, additional provisions can be made to adjust for these effects.

The DRF estimates the net impact of these transitional effects would be an increase in revenues to the General Fund of approximately $18.0 million. If the legislation includes language to allow for the deduction of estimated and final payments, and require the inclusion of 1995 refunds in taxable income, the effect would become negligible.

The marginal tax rates can be adjusted such that the expected budget impact would be nearly zero. If this is accomplished, and transition provisions are included, the State would have no reduction in revenues, and taxpayers as a group would pay slightly less federal tax. At the same time, the elimination of federal deductibility would give the State a more stable tax structure that would not be adversely affected by changes in the federal IRC.

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