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ISSUE REVIEW

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Impact of Federal Income Tax Changes on Iowa General Fund Revenue

ISSUE

Iowa law allows taxpayers to deduct federal income taxes paid from income prior to calculating state income tax liability. Due to the federal tax deduction, changes to federal income taxes enacted by Congress directly and automatically impact Iowa's revenue stream. While this issue is present every year, the impact on the budget process has been more pronounced over the past three years as federal tax reductions enacted during the early 2000s were set to expire, were extended, and are now set to expire again. This ***Issue Review*** examines federal deductibility and the related issue of federal conformity.

CODE AUTHORITY

Iowa Code section 422.9(2) (federal deductibility)

Iowa Code section 422.3(5) (Internal Revenue Code (IRC) coupling)

BACKGROUND

Federal Deductibility

Iowa law allows taxpayers to deduct federal income tax paid from their Iowa income prior to calculating their State income tax liability for the year.[1] This is commonly referred to as federal deductibility. Due to federal deductibility, Iowa's individual income tax revenue stream is directly and automatically affected any time Congress enacts legislation that increases or decreases federal individual income taxes. When federal legislation raises income taxes, Iowa's State income tax yield is lowered. Conversely, when Congress lowers federal individual income taxes Iowa's State income tax revenue increases.[2]

Iowa has allowed the deduction of net federal income taxes paid (federal income taxes paid, minus federal income tax refunds received) from Iowa income since the inception of the Iowa income tax (HF 1 – Net Income and Retail Sales Tax Act of 1934). As initially enacted, the federal tax deduction was limited. Iowa allowed all deductions from income, including the federal tax deduction, to total no more than 15.0% of reported income.

In HF 225 (Income Tax Act of 1955), federal income taxes became an unlimited deduction from Iowa-taxed income tax.

[1] Itemize filers and standard filers both benefit from the federal tax deduction.
[2] Iowa also allows C-corporations to deduct 50.0% of federal corporate income taxes paid so the issue of federal deductibility also applies to the corporate tax. However, the federal corporate tax change impacts are usually quite small compared to the impact of individual income tax changes.

According to the Federation of Tax Administrators, Iowa is one of three states[3] that allow full deductibility of federal income taxes, while an additional three states[4] allow a limited deduction.

Short of the enactment of legislation repealing or suspending federal deductibility, federal income tax changes that increase or decrease federal taxes automatically impact Iowa General Fund revenue. On two separate occasions during the 2000s, Congress adopted legislation that significantly reduced federal income taxes. In those instances, federal deductibility raised the State income tax owed by Iowa taxpayers that benefited from the tax deduction at the federal level. The Department of Revenue provides annual estimates for the Iowa Revenue Estimating Conference (REC) to use to help adjust revenue projections for any changes enacted in the previous year that impact federal taxes owed and deducted by Iowa taxpayers.

Iowa's top individual income tax rate is one of the highest top State rates, but Iowa income tax rates compare more favorably if the effect of federal deductibility is included. The impact of federal deductibility on the effective Iowa income tax top marginal rate depends on several factors, including:

- The taxpayer's top marginal federal income tax rate for that income source.
- The taxpayer's top marginal Iowa income tax rate for that income source.
- Whether the taxpayer itemizes deductions at the federal level.

Iowa's highest individual income tax rate is 8.98%. However, to determine the effective tax rate, the 8.98% must be adjusted for automatic deductibility of federal taxes paid on that same income. For taxpayers with ordinary income taxed by the federal government at the current top rate of 35.0%, the top effective tax rate for Iowa, adjusted for federal taxes paid, is 5.84% for federal standard filers and slightly higher for federal filers that itemize deductions.[5]

Without Congressional action, the current federal tax system will be significantly modified beginning in January 2013. Should the current temporary tax rates expire and the previous tax rates return, Iowa's top effective tax rate will change due to the change in the federal taxes owed on that taxed income. For taxpayers with ordinary income taxed by the federal government at the former top rate of 39.6%, the top effective tax rate for Iowa, adjusted for federal taxes paid, will be 5.42% for federal standard filers and slightly higher than that for federal filers that itemize deductions.

Internal Revenue Code (IRC) Coupling

In addition to the deductibility impact, there is also an impact from federal tax changes should Iowa choose to "couple" with any change that impacts IRC definitions such as the calculation of federal adjusted gross income. Coupling involves updating the Iowa Code to reflect a newer version of the federal IRC. When the Iowa Code is updated to reflect federal changes, the computation of Iowa taxable income also changes. Coupling with the updated federal IRC is not automatic and is at the discretion of the General Assembly.

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[3] The three states that allow full deduction of federal income taxes paid are Iowa, Alabama, and Louisiana.

[4] Missouri and Montana allow up to $5,000 (single) or $10,000 (married) of federal income taxes to be deducted. Oregon allows filers to deduct up to $5,950.

[5] Iowa's top nominal tax rate is also the top effective tax rate for any income that is not subject to federal income tax but is subject to Iowa income tax. Municipal bond interest is a common example of income that is exempt from federal tax but subject to State tax. That type of income does not benefit from federal deductibility.

For individual income tax, Iowa does not automatically adopt (or couple with) federal changes to the Internal Revenue Code. Each year, the Legislature decides whether to couple (conform) Iowa's individual income tax laws to changes made by Congress. The changes relate to how "net income" is calculated. With very few exceptions, Iowa generally couples with federal IRC changes. The fiscal impact related to IRC coupling can vary greatly from year to year, depending on the types of changes Congress enacted over the previous year. The Department of Revenue provides annual estimates for the General Assembly to use during the fiscal note process for the annual IRC update legislation.

CURRENT SITUATION

The Bush-era federal tax reductions are set to expire at the end of calendar year 2012.[6] Congress may consider extending some or all of the expiring provisions for one or more tax years, or Congress may consider making some or all of the tax reductions permanent. Those decisions are likely to come near or after the expiration date. Since the size of the expiring federal tax change is so large, the impact on Iowa's budget and planning is also large. The result is significant and immediate uncertainty for the Iowa budget development process.

Significant federal individual income tax provisions set to expire at the end of 2012 include:

- Alternative Minimum Tax (AMT) – The AMT applies a separate tax calculation to high income taxpayers. If the tax calculated through the AMT process is higher than the tax calculated through the conventional process, the taxpayer owes the AMT amount. The AMT was originally conceived as a method to ensure that high-income taxpayers paid income tax. However, the AMT income thresholds do not receive automatic inflation adjustment, so through time the AMT would apply to a much larger percentage of taxpayers. Congress has annually "patched" the AMT to keep this from happening. The patch process fixes the issue for one or two tax years. No patch has been enacted for tax year 2012. Without Congressional action, the AMT will be in full force retroactive to January 1, 2012.
- Reduced income tax rates – Prior to the Bush-era tax changes, the top income tax rate was 39.6% and the other rates were also higher. The current rates, topping at 35.0%, expire at the end of December.
- Capital gains rates and qualified dividends rates – The current top tax rate for long-term capital gains will revert back to 20.0% from the current 15.0%. Qualified dividends are currently taxed at the top long-term capital gains rate of 15.0% if the dividends are from investments that have been held for a sufficient period of time. Qualified dividends are scheduled to revert to the previous tax status and taxed as ordinary income.
- Expiration of biodiesel and alternative fuels tax credits
- Child tax credit – The federal child tax credit was raised from $500 to $1,000 and the credit will return to $500 without Congressional action.
- Married tax reductions – Congress significantly reduced the "marriage penalty"[7] and the law is scheduled to revert to its previous status.

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[6] The Bush-era federal tax reductions were initially scheduled to expire at the end of calendar year 2010, but the deadline was extended two years by Congress in mid-December 2010.
[7] The marriage penalty refers to a situation where two married individuals pay more in income tax than two single individuals with the same income, deductions, and credits.

The Iowa REC provides General Fund revenue estimates for the current and one future fiscal year. The REC provides estimates three times during the course of a year. Uncertainties related to potential federal action on income tax issues have been an issue for the October and December REC estimates since the early 2000s, because Congressional work to “patch” the AMT has rarely taken place prior to the December estimate. The REC has dealt with the AMT uncertainty by assuming that Congress will enact a patch for the current tax year. So far, that assumption has always proven correct.

This year, as it was in 2010 when the Bush-era tax credits were first scheduled to expire, the federal uncertainty is much greater. There appears to be a myriad of potential Congressional outcomes, ranging from no extensions at all and no AMT patch, to an extension of all expiring provisions along with an AMT patch. The December 2012 REC based the FY 2013 and FY 2014 estimates on federal law as it stood on the date of the meeting, but with an assumed AMT patch. If Congress enacts something different, or if Congress does not enact an AMT patch, the REC estimates will need to be revised to correctly reflect Congressional action or inaction.

ALTERNATIVES

The following list of alternatives does not relate specifically to the impending expiration of federal tax provisions. The listed alternatives are tax policy options applicable to any time period.

Eliminate federal deductibility

Eliminating federal deductibility, if not combined with other Iowa income tax changes, will significantly increase income tax revenue. Previous proposals to eliminate federal tax deductibility have been combined with lower tax rates. The fiscal impact of any proposal to eliminate federal deductibility would depend on if, or to what extent, Iowa’s tax rates are also altered.

Limiting deductibility

As an alternative to the complete elimination of federal deductibility, Iowa could restrict the deduction to no more than a set amount, or no more than a set percent of income. Such action would concentrate the taxpayer benefit of the deduction in the lower income brackets. The revenue impact of limiting federal deductibility would be less than the impact of eliminating it, all else being equal.

No coupling

The Iowa General Assembly is asked each Session to approve an update to the Iowa Code that would incorporate federal tax changes enacted during the previous year. The General Assembly has generally adopted the IRC update. But as has been the case on several occasions or for specific provisions, the Legislature has declined to couple. The General Assembly always has the option of not coupling with federal tax changes. Utilizing annual coupling requires the General Assembly to affirmatively approve the coupling process each year.

Permanent coupling

As opposed to enacting IRC updates to the Iowa Code each year, the General Assembly could enact legislation to permanently couple with IRC changes, thus eliminating the need to adopt IRC coupling legislation each year. The General Assembly would then have to pass legislation only if the decision is made not to couple with a federal tax change. Utilizing this option would require the General Assembly to specifically act to deny coupling with federal changes.

BUDGET IMPACT

The Iowa budget impact due to changes to the federal tax code has been an issue as long as Iowa has had a state individual income tax. Federal deductibility has an automatic impact, and conformity has an impact should the General Assembly chose to adopt the federal revisions.

The following table provides estimates of the revenue impact of federal uncertainties associated with expiring federal tax provisions that impact Iowa tax revenue. Note that the estimates include some provisions that do not impact individual income tax directly.[8] Also note that the numbers reflect the current best estimate of the Department of Revenue and are subject to revision.

The first column provides the adjustment to the December 2012 REC estimates should no federal action take place, including no AMT patch. An amount of $3.7 million would be subtracted from the FY 2013 estimate and $76.4 million subtracted from FY 2014. The negative numbers here reflect the decreased Iowa revenue that results from higher federal taxes related to the expanded reach of the AMT.

The second column reflects the adjustment necessary should Congress simply extend all expiring provisions and patch the AMT for at least two years. An amount of $85.1 million would be added to the FY 2013 estimate and $156.5 million added to FY 2014. The positive numbers here reflect the increased Iowa revenue that results from the lower federal tax structure being extended farther into the future.

Potential Iowa Revenue Estimate Adjustments
(Dollars in Millions)

	No Federal Action, Including No AMT Patch	All Expiring Provisions Extended, Including AMT Patch
FY 2013	$ -3.7	$ 85.1
FY 2014	$ -76.4	$ 156.5

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[8] Besides individual income tax adjustments, the revenue estimate adjustments related to the expiring federal tax provisions include a small amount of change to corporate income tax and a positive adjustment due to the impending return of the federal estate tax.