LEGISLATIVE SERVICES AGENCY
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Fiscal Note

Fiscal Services Division

HF 478 – Dual Income Tax & Taxpayer Trust Fund Credit (LSB 1421HV.1)
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Fiscal Note Version – As passed the House

Description

Division I of **House File 478** as passed the House, creates a dual-system Iowa individual income tax. When filing tax returns for tax years 2013 and beyond, taxpayers will be allowed to choose between the current tax system with nine tax rates, itemized deductions, the federal income tax deduction, and various refundable and nonrefundable credits, and a new system that taxes income at a flat rate of 4.5% and allows very limited deductions. Taxpayers will be allowed to choose one system one tax year and the other system the next tax year. The bill adjusts the local option income surtax rates for those taxpayers choosing the new tax system.

Division II of this Bill makes changes to the Taxpayer Trust Fund. Under current law, the Taxpayer Trust Fund receives the first $60.0 million each year of the Economic Emergency Fund excess after the Cash Reserve Fund and Economic Emergency Fund balances are at the statutory maximums. The bill removes the $60.0 million limit and instead transfers all of the annual excess revenue to the Taxpayer Trust Fund.

Division III of this Bill establishes a new individual income tax credit effective beginning in tax year 2013. The bill creates a new Taxpayer Trust Fund Tax Credit Fund and transfers the balances in the Taxpayer Trust Fund to the Taxpayer Trust Fund Tax Credit Fund beginning in FY 2014. The maximum tax credit per taxpayer each tax year is calculated by dividing the amount transferred to the Taxpayer Trust Fund Tax Credit Fund by the number of eligible individuals from the previous tax year. This Bill defines "eligible individual" as a person that makes and files an individual income tax return pursuant to Iowa Code section **422.13**. The result of this math equation becomes the amount of the tax credit that may be claimed on a tax return. The tax credit is not refundable, meaning that the value of the tax credit to each taxpayer is limited to no more than the individual's Iowa income tax liability for that tax year.

The new tax credit reduces net General Fund revenue, beginning in FY 2014. The General Fund is reimbursed through a transfer from the Taxpayer Trust Fund Tax Credit Fund. Money remaining in the Taxpayer Trust Fund Tax Credit Fund is transferred back to the Taxpayer Trust Fund at the end of the fiscal year.

This Bill takes effect on enactment and applies retroactively to tax year 2013 and after. Portions of this Bill impacting the Taxpayer Trust Fund apply retroactively to FY 2013.

Characteristics of the Alternative Tax System

- The income tax base is federal Adjusted Gross Income less interest income earned from federal securities and before net operating losses.

- A standard deduction is allowed: $6,235 for a single individual or married individual filing separately, or $12,470 for married individuals filing jointly, surviving spouses, and head of household returns. The deduction amounts are not indexed for inflation.
- A tax rate of 4.5% will be applied to taxed income. This is equal to the base income minus the allowed standard deduction.
- Taxpayers may calculate their tax liability under both systems and choose the system each tax year that produces the lowest income tax liability.

Background – Taxpayer Trust Fund

The Taxpayer Trust Fund was created during the 2011 Legislative Session for the purpose of providing future tax reductions to Iowans and was first funded in FY 2013. Under current law, the fund is eligible to receive up to $60.0 million annually from the Economic Emergency Fund excess after the reserve funds are fully funded. Moneys in the trust fund can only be used pursuant to appropriations made by the General Assembly for tax reductions. The amount that the Taxpayer Trust Fund can receive in a given fiscal year is limited to $60.0 million or the difference between the actual net General Fund revenue for the preceding fiscal year and the adjusted revenue estimate used in establishing the budget for that fiscal year, whichever is less. For example, the amount the fund will receive in FY 2013 is calculated by subtracting the Adjusted Revenue Estimate for the FY 2012 budget from the actual year-end net General Fund receipts for FY 2012. The trust fund received $60.0 million in FY 2013 and it appears likely that it will receive an additional $60.0 million in FY 2014. To date, the General Assembly has not established any appropriations from the trust fund.

Assumptions – Dual Tax System

The Department of Revenue utilized a microsimulation model to estimate the individual income taxes owed by every taxpayer in Iowa, using actual 2010 tax returns. The tax liability for each tax return was estimated for tax year 2013 through tax year 2017 under the current tax system, and also for the same return under the proposed alternative system. For each tax return, the tax liability that was the lower of the two was used as the tax revenue received by the state under the proposed dual system.

The department projects that the dual individual income tax system initiated in this Bill will reduce taxpayer income tax liability by $396.5 million for tax year 2013, with a projected reduction of $469.9 million by tax year 2017. With a minor exception, all individual income tax is deposited to the State General Fund. The estimated impact on the State General Fund by fiscal year is contained in the following table.

Fiscal Impacts by Fiscal Year
in millions of dollars

Fiscal Year	State General Fund Impact
FY 2013	$ -6.0
FY 2014	-412.1
FY 2015	-537.0
FY 2016	-437.5
FY 2017	-458.8

The department estimate does not provide an adjustment for taxpayers utilizing the ability to choose one system for a tax year and then the other system for the next tax year, potentially benefiting from a two-year tax avoidance strategy.

School districts may impose a surtax on income tax payers residing within the school district. A surtax of up to 20.0% of the taxpayer's income tax liability, prior to refundable credits, is allowed. Statewide, the local option surtax currently raises an amount equal to 2.7% of Iowa individual income tax revenue. For any tax reduction that is not a refundable tax credit, reducing state income taxes owed by Iowa taxpayers reduces the statewide yield of the income surtax by 2.7%. To adjust for the income surtax decrease that may result from the reduced state income tax, this Bill applies a surtax rate that is 22.0% higher than the actual surtax rate in effect for that year.

Assumptions – Taxpayer Trust Fund and Trust Fund Tax Credit

- Under the provisions of this Bill, the Taxpayer Trust Fund and the new Taxpayer Trust Fund Tax Credit Fund are separate State funds. To simplify the discussion, they are treated below as one fund and referred to collectively as the Taxpayer Trust Fund.
- The March 2012 General Fund estimates of the Revenue Estimating Conference (REC) for FY 2013 and FY 2014 are used in this analysis. For FY 2015, General Fund revenue is assumed to equal 104.3% of the FY 2014 REC estimate. The REC estimate for FY 2013 equals $6,637.0 million and the estimate for FY 2014 equals $6,870.6 million. For this fiscal note, FY 2015 revenue is projected to equal $7,169.1 million.
- Appropriation adjustments for FY 2013 will equal $46.5 million and expenditures from the Economic Emergency Fund for the Executive Council Performance of Duty standing unlimited appropriation will total $35.6 million in FY 2014 and $34.5 million in FY 2015.
- Expenditure limitations under current law for FY 2014 and FY 2015 will equal $7,433.8 million and $8,041.4 million, respectively.
- The base scenario assumes the General Assembly will not appropriate at the full expenditure limitation level, appropriating instead $6,587.4 million for FY 2014 (5.0% above the FY 2013 estimated level) and $6,870.7 million for FY 2015 (4.3% above the FY 2014 estimated level). Both the base and the HF 478 projections include an adjustment for $5.0 million in assumed reversions.
- Under HF 478, FY 2014 and FY 2015 appropriation levels will be constrained due to the expenditure limitation law. Appropriations are assumed to equal $6,219.8 million (0.8% below the FY 2013 estimated level) and $6,555.3 million for FY 2015 (5.4% above the estimated FY 2014 level under HF 478).
- Assumes that under current law, the balance in the Taxpayer Trust Fund will grow from the current $60.0 million in FY 2013 to $120.0 million in FY 2014 and to $180.0 million in FY 2015. Under HF 478, it is projected an additional $832.1 million will flow to the Taxpayer Trust Fund in FY 2014 and $170.2 million in FY 2015.
- With a projected $952.1 million in the Taxpayer Trust Fund and an estimated 2.1 million taxpayers, the estimated maximum tax credit per taxpayer will equal $453 for tax year 2013 (impacting FY 2014). For tax year 2015, the projected maximum tax credit is $189. Due to lack of some taxpayers having sufficient tax liability to benefit from the maximum tax credit, the projected total of all tax credits is $725.4 million in FY 2014 and $302.4 million in FY 2015. The difference between the amount available in a year and the amount claimed remains in the Taxpayer Trust Fund to fund tax credits in the next year.

Fiscal Impact Categories

The Bill impacts the State General Fund by:

1. The income tax revenue reductions associated with the new dual income tax system.
2. The change in the destination of any reserve fund dollars in excess of $60.0 million. Under current law, the excess reserves over $60.0 million flow into the General Fund revenue for the next fiscal year. This Bill required all excess reserve funds that flow to the Taxpayer Trust Fund to be used to calculate the tax credit for each tax year, and then to reimburse the State General Fund for the impact of the new credit.
3. The reduction in individual income tax revenue due to the creation of the new Taxpayer Trust Fund Tax Credit.
4. The reimbursement to the General Fund, from the Taxpayer Trust Fund, for the revenue reduction attributable to the new tax credit.
5. The reduction in the General Fund expenditure limitation that is the result of numbers 1 and 2 above.

Fiscal Impact

For FY 2013, the Bill reduces net General Fund revenue by $6.0 million.

For FY 2014, the Bill:

- Reduces net revenue $412.1 million due to the new dual income tax system.
- Reduces net revenue $725.4 million due to the new Taxpayer Trust Fund Tax Credit.
- Requires a $362.6 million reduction in FY 2014 appropriation levels in order to meet the expenditure limitation, when compared to the appropriation level assumed in the base scenario.
- Reduces reserve fund and General Fund carry-forward balances at the conclusion of FY 2014 by $780.9 million.

For FY 2015, the Bill:

- Reduces net revenue $537.0 million due to the new dual income tax system.
- Reduces net revenue $302.4 million due to the new Taxpayer Trust Fund Tax Credit.
- Requires a $310.4 million reduction in FY 2015 appropriation levels in order to meet the expenditure limitation, when compared to the appropriation level assumed in the base scenario.
- Reduces reserve fund and General Fund carry-forward balances by an additional $529.0 million by the conclusion of FY 2015.

Over the three years (FY 2013 to FY 2015), the tax credit will reduce income taxes paid by all taxpayers with Iowa income tax liability by a total of $1,027.7 million and the new dual tax system will reduce the income tax owed by a subset of Iowa taxpayers by a total of $955.1 million. Under this projection, the combination of reserve fund balances and General Fund carry-forward funds are reduced $1,309.9 million at the conclusion of FY 2015, from $2.144.4 million under the base scenario to $834.5 million under the HF 478 projection. Compared to the assumed based scenario, general Fund appropriation levels for FY 2014 and FY 2015 will be reduced by a combined $673.0 million.

Impact on General Fund Revenue, Reserves Balances, and Carryforward

In millions of dollars

	FY 2014			FY 2015		
	Current Law	With HF 478	Difference	Current Law	With HF 478	Difference
Base Revenue Projection	$ 6,870.6	$ 6,870.6	$ 0.0	$ 7,169.1	$ 7,169.1	$ 0.0
Excess Reserve Funds Deposited to the G.F.	796.9	0.0	-796.9	944.1	0.0	-944.1
Taxpayer Trust Fund Tax Credit	0.0	-725.4	-725.4	0.0	-302.4	-302.4
Taxpayer Trust Fund Reimbursement	0.0	725.4	725.4	0.0	302.4	302.4
Dual Income Tax System *	0.0	-412.1	-412.1	0.0	-537.0	-537.0
Total General Fund Revenue	$ 7,667.5	$ 6,458.5	$ -1,209.0	$ 8,113.2	$ 6,632.1	$ -1,481.1
Assumed Appropriation Level	$ 6,582.4	$ 6,219.8	$ -362.6	$ 6,865.7	$ 6,555.3	$ -310.4
G.F. Carryforward (Revenue Minus Approp.)	$ 1,085.1	$ 238.7	$ -846.4	$ 1,247.5	$ 76.8	$ -1,170.7
Cash Reserve Ending Balance	502.8	471.9	-30.9	537.7	497.4	-40.3
Economic Emergency Fund Ending Balance	167.6	157.3	-10.3	179.2	165.8	-13.4
Taxpayer Trust Fund Ending Balance	120.0	226.7	106.7	180.0	94.5	-85.5
Total Reserve Fund and Carry-Forward	$ 1,875.5	$ 1,094.6	$ -780.9	$ 2,144.4	$ 834.5	$ -1,309.9

* The Dual Income Tax System also has a projected revenue impact of negative $6.0 million in FY 2013.

For FY 2016 and beyond, the dual tax system will result in approximately $450.0 million less General Fund revenue each year compared to the base projection. The Taxpayer Trust Fund Tax Credit will reduce taxes paid when sufficient money is in the Trust Fund to allow the Credit. Each $60.0 million deposited to the Taxpayer Trust Fund will result in a maximum tax credit of $30 for that tax year.

Additional Fiscal Considerations

Since the proposed dual system allows taxpayers to switch back and forth between tax systems, some taxpayers may find it beneficial to “crowd” federal tax payments and itemized deductions into a tax year where they choose the current tax system that allows those deductions, and then for the following tax year, a tax year where they receive their federal tax refund and have reduced itemized deductions, choose the new flat tax system.

In addition, taxpayers with sufficient control of when they receive income could, in a similar fashion, crowd income into every other tax year, with the majority of income received in a year where the new 4.5% tax system is selected, and much less income received in the year the current system is selected.

These tax avoidance strategies will result in those taxpayers owing less in state income taxes over the two tax years than contemplated by the modeling process of the Department of Revenue. To the extent that this tax avoidance process is utilized by taxpayers, the tax reduction for taxpayers able to benefit from the strategy and the resulting reduction in income tax and surtax revenue will be larger.

The portion of the tax reduction that is financed through the reduction in state carryover balances has the potential to create revenue feedback as those dollars are spent, invested, or saved by the taxpayer. The carryforward reduction of $1.3 billion over two years will represent approximately 0.52% of Iowa disposable (after tax) income across the two years. In FY 2012, the Iowa General Fund received approximately $70.2 million for every $1.3 billion in disposable income.

The portion that is financed through a reduction in state expenditures has the same potential for feedback. However, any tax reduction that is offset by reductions in expenditures will be countered somewhat by the economic reduction associated with the required lower state expenditures.

The creation of a new tax form and the related technical work associated with tracking and administering a new dual income tax system will result in additional administrative costs for the Department of Revenue. The department estimates the costs will exceed $65,000 per year in FY 2013 and in FY 2014.

Sources

Department of Revenue
Legislative Services Agency Analysis

/s/ Holly M. Lyons

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