



HF 604 – Optional Flat Tax for Individuals (LSB1400HV)
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Fiscal Note Version – New

Description

House File 604 creates an alternative individual income tax system for the State of Iowa. The Bill allows taxpayers to choose to file under the existing income tax system or to select to file under the system created in the Bill. A taxpayer may select one system or the other system each tax year, but once the system is selected for a tax year through the filing of a tax return, the taxpayer may not amend the return later and select the other tax system. The changes are effective beginning tax year 2015.

Significant features of the alternative income tax system include:

- 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 of \$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 indexed for inflation.
- Most tax credits, deductions, and exemptions beyond federal Adjusted Gross Income are not allowed.
- Social Security income is exempt from income tax.
- Pension income up to \$6,000/\$12,000 is exempt.
- All military retirement income is exempt from income tax.
- A filing threshold for taxpayers 65 years of age or older is provided. Taxpayers below the income threshold are not required to file a tax return and are therefore exempt from State income tax for that tax year. The threshold is \$32,000 for married taxpayers filing jointly or separately on a combined return, filing as a head of household, or filing as a surviving spouse. For all other tax returns, the threshold is \$24,000.
- A tax rate of 5.0% is applied to taxed income.
- An additional 22.0% is applied to the local option income surtax for schools for those taxpayers choosing the alternative system and subject to a school surtax.

Assumptions

The Department of Revenue utilized a microsimulation model to estimate the individual income tax owed by every taxpayer in Iowa, using actual 2012 tax returns as the taxpayer database. The tax liability for each tax return was estimated for tax year 2015 through tax year 2019 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 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 taxpayers 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, and for FY 2014, the local option surtax raised an amount equal to 3.2% of Iowa

individual income tax revenue, net of tax refunds issued. 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 an estimated 3.2%. To adjust for the income surtax decrease that results from 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.

Fiscal Impact

The Department projects that the alternative individual income tax system initiated in this Bill will reduce aggregate taxpayer income tax liability by \$372.0 million for tax year 2015, with a projected reduction of \$414.1 million by tax year 2019. Tax year impacts are spread across two fiscal years, so tax year impacts are converted to fiscal year impacts by the Department of Revenue using historical withholding, estimate payment, and final returns data. With a minor exception, all individual income tax is deposited in the State General Fund. The estimated tax reduction by tax year and the resulting impact on the State General Fund by fiscal year is contained in the following table.

Alternative Tax System Projected Impact				
In Millions				
	Tax Reduction		State General Fund	
	Tax Year Basis		Revenue Reduction	
			FY Basis	
TY 2015	\$	373.0	FY 2015	\$ 11.1
TY 2016		381.8	FY 2016	482.4
TY 2017		393.9	FY 2017	393.8
TY 2018		399.9	FY 2018	396.1
TY 2019		414.1	FY 2019	405.0

In addition to the State General Fund tax reduction, the alternative tax system with the local option income tax set 22.0% higher than the surtax under the current tax system does not generate sufficient surtax to keep the school surtax system whole on a statewide basis. The Department of Revenue micro model projects, that across all school districts utilizing the surtax, the surtax will generate \$2.2 million per year less under the alternative income tax system.

The creation of a new tax form and the related technical work associated with tracking and administering a new alternative income tax system will result in additional administrative costs for the Department of Revenue. The Department estimates the additional administrative costs to be \$796,000.

Additional Fiscal Considerations

Since the proposed alternative system allows taxpayers to switch back and forth between tax systems, taxpayers may find it beneficial to “crowd” federal tax payments, Iowa income tax credits, and itemized deductions into a tax year where taxpayers choose the current tax system that allows those deductions and credits, and then for the following tax year, a tax year where taxpayers receive a federal tax refund and have reduced itemized deductions and no tax credits, choose the new flat tax system.

In addition, taxpayers with sufficient control over the timing of receipt of 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 5.0% 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 will be larger.

Source

Department of Revenue Individual Income Tax microsimulation model

/s/ Holly M. Lyons

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The fiscal note for this bill was prepared pursuant to [Joint Rule 17](#) and the Iowa Code. Data used in developing this fiscal note is available from the Fiscal Services Division of the Legislative Services Agency upon request.
