



HF 3 – Income Tax, Alternative System for Individuals (LSB 1421YH)
Analyst: Jeff Robinson (Phone: (515) 281-4614) (jeff.robinson@legis.iowa.gov)
Fiscal Note Version – New

Description

House File 3 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 takes effect on enactment and applies retroactively to tax year 2013 and after.

Characteristics of the Alternative 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% would be applied to taxed income. This is equal to base income minus the allowed standard deduction.
- Taxpayers will calculate their tax liability under both systems and choose the system each tax year that produces the lowest State income tax liability.

Assumptions

The Department of Revenue utilized a micro-simulation 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 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 raises an amount equal to 2.7% of Iowa State

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%.

Fiscal Impact

The alternative dual individual income tax system proposed in HF 3 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 and on the local option income surtax for schools, by fiscal year is contained in the following table.

	Fiscal Impacts by Fiscal Year	
	in millions of dollars	
	State General Fund Impact	Local Option Income Surtax for Schools
FY 2013	\$ -6.0	\$ -0.2
FY 2014	-412.10	-11.10
FY 2015	-537.00	-14.50
FY 2016	-437.50	-11.80
FY 2017	-458.80	-12.40

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 rate 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 and the resulting reduction in income tax and surtax revenue will be larger.

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.

Source

Iowa Department of Revenue

/s/ Holly M. Lyons

February 28, 2013

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.
