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## FISCAL TOPICS

Fiscal Services Division

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# Contingent Individual Income Tax System

## Background

2018 Iowa Acts, chapter [1161](#), division IX, makes future, contingent changes to the manner in which Iowa calculates individual income tax liability. Implementation of the changes is contingent upon State General Fund revenue achieving two revenue targets, or triggers, at the conclusion of a fiscal year. The trigger calculations are based on net General Fund revenue for a fiscal year, including transfer revenue.<sup>1</sup> 2018 Iowa Acts, chapter [1161](#), section 133, specifies the triggers and how the triggers are to be calculated, and further specifies that the calculations shall be completed by the Department of Management (DOM) in consultation with the Department of Revenue. The DOM is required to adopt rules specifying the method of calculation.

The two triggers are:

- General Fund net revenue for the fiscal year equals or exceeds \$8,314,600,000.
- General Fund net revenue for the fiscal year equals or exceeds 104.0% of the General Fund net revenue calculation for the previous fiscal year.

Under the provisions of the Act, the first year the two triggers may be met is FY 2022. If both triggers are met for FY 2022, the changes contained in the contingent income tax system will become effective for tax years beginning on or after January 1, 2023. If both triggers are not met at the close of FY 2022, then the requirement that both triggers be met applies to each succeeding fiscal year, with the new tax system put in place on January 1 following the conclusion of the fiscal year for which both triggers are first met. Once the changes in the contingent system become effective, the changes remain in effect for succeeding tax years.

The contingent individual income tax system is significantly different than the existing Iowa system.<sup>2</sup> The contingent system:

- Aligns the basis of Iowa individual income taxation more closely with federal income taxation.
- Reduces individual income tax rates. Under the current system, Iowa's top individual income tax rate is 8.53%. Under the contingent system, the top rate is 6.50%.
- Reduces the number of taxable income brackets from nine brackets to four brackets.
- Reduces or eliminates specific tax exemptions and deductions, including the ability of taxpayers to deduct individual income taxes paid to the federal government (federal deductibility).

## Current Situation and Recent General Fund Growth History

Based on the General Fund estimates developed at the October 13, 2020, Revenue Estimating

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<sup>1</sup> While transfer revenue (like annual profits from the Iowa Lottery) is included in the trigger calculations, transfers to the State General Fund from any State reserve fund are specifically excluded.

<sup>2</sup> A description of the major individual income tax calculation changes contained in the contingent system is available from the [Legislative Services Agency](#) (see division IV of the linked document). The triggers also activate law changes that will impact the calculation of corporate and bank franchise tax liability. The fiscal impacts of those changes are not discussed in this *Fiscal Topic*.

### More Information

State Taxation Overview: [www.legis.iowa.gov/docs/publications/LG/1062336.pdf](http://www.legis.iowa.gov/docs/publications/LG/1062336.pdf)

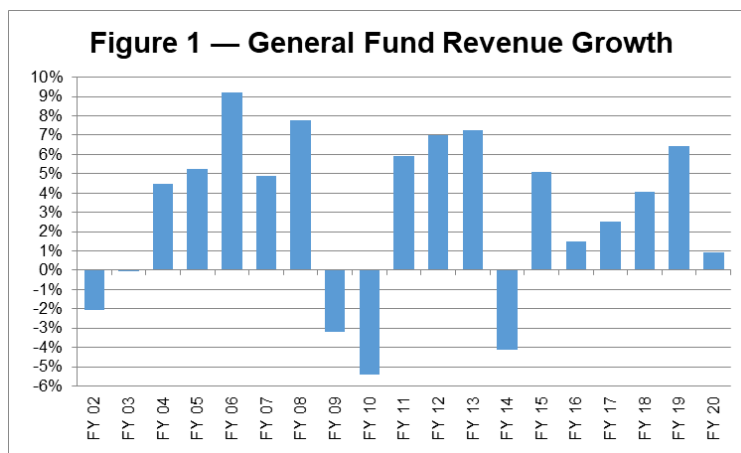
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Conference (REC) meeting, the net General Fund revenue projections for FY 2021 and FY 2022 are:

- FY 2021 = \$7,991.7 million, a -0.2% rate of growth compared to actual FY 2020 net revenue.
- FY 2022 = \$8,230.8 million, a 4.0% rate of growth compared to estimated FY 2021 net revenue.

Given the latest REC estimate for FY 2022, it is projected that while the 4.0% revenue growth percentage trigger will be met for FY 2022, the dollar threshold trigger is expected to fall \$83.8 million short of the level required to activate the contingent income tax system for TY 2023. If this projected revenue situation does turn out to be the case, the contingent income tax system will not be activated until at least TY 2024.

**Figure 1** shows the percentage growth history for net General Fund revenue, including transfer revenue, for the past 19 fiscal years.<sup>3</sup> The average percentage growth for all 19 years is 3.0% per year. If four years that were significantly impacted by economic recessions are excluded (fiscal years 2002, 2003, 2009, and 2010), the average for the remaining 15 years is 4.5%. For the 15 nonrecession years, net revenue growth for 11 of the years exceeded 4.0%.



## Revenue Projections

**Figure 2** provides actual and projected net General Fund revenue amounts for FY 2019 through FY 2027, without considering the impact of the contingent individual income tax system.

**Figure 2**  
**State General Fund Projection**  
Net Receipts Plus Transfers — Dollars in Millions

		<u>Net Receipts</u>	<u>% Change</u>
FY 2019	Actual	\$ 7,858.8	6.4%
FY 2020	Actual	7,930.6	0.9%
FY 2021	REC	7,911.7	-0.2%
FY 2022	REC	8,230.8	4.0%
FY 2023	LSA	8,601.2	4.5%
FY 2024	LSA	8,876.0	3.2%
FY 2025	LSA	9,158.1	3.2%
FY 2026	LSA	9,449.0	3.2%
FY 2027	LSA	9,750.1	3.2%

<sup>3</sup> The actual growth percentages presented in **Figure 1** are calculated from REC documents. For fiscal years 2001, 2002, 2008, 2009, and 2017, transfers to the State General Fund from State reserve funds are removed from the annual totals prior to calculation of the percentage growth.

The receipts projections in **Figure 2** for fiscal years 2021 through 2027 were developed using the following assumptions:

- The October 2020 REC projections for FY 2021 and FY 2022 are accurate.
- FY 2023 net General Fund Revenue will not be impacted by an economic recession and the fiscal year will experience net revenue growth equal to the average of the 15 nonrecession years from FY 2002 through FY 2020 (4.5%).
- Net General Fund revenue growth for FY 2021 through estimated FY 2027 will equal the average revenue growth for all years, including recession years, for FY 2002 through FY 2020 (3.0%). Given the first two assumptions, this assumption requires growth for FY 2024 through FY 2027 to equal 3.2% per year.

### Contingent Individual Income Tax General Fund Revenue Reduction

The projected revenue levels in **Figure 2** for FY 2022 and FY 2023 make FY 2023 the first fiscal year in which both triggers are projected to be met. This situation would activate the contingent individual income tax system beginning January 1, 2024 (TY 2024). With the contingent individual income tax system activated, Iowa individual income taxes will decrease beginning January 1, 2024. The tax reduction will begin to reduce net General Fund revenue in the second half of FY 2024 as income tax withholding tables are adjusted to the new tax rates and taxpayers lower their individual income tax estimate payments. The projected individual income tax reduction (by tax year) and the State General Fund revenue reduction (by fiscal year) are presented in **Figure 3**.<sup>4</sup>

Tax Year	Income Tax Reduction	Fiscal Year	Gen. Fund Revenue Reduction
TY 2024	\$ -341.5	FY 2024	\$ -9.9
TY 2025	-291.3	FY 2025	-344.0
TY 2026	-762.1	FY 2026	-502.3
TY 2027	-825.6	FY 2027	-788.1

This **Fiscal Topic** uses assumptions to produce a scenario in which the contingent income tax system that exists in current Iowa law will be activated beginning January 1, 2024. Other scenarios with different assumptions could be developed that would produce the same result. In addition, activation of the contingent system on January 1, 2023, or on or after January 1, 2025, remains a reasonable possibility.

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<sup>4</sup> The tax reduction projections provided in **Figure 3** were developed by the Department of Revenue in October 2020. The projection was developed using the individual income tax micromodel available at that time and is subject to revision when a new model becomes available.