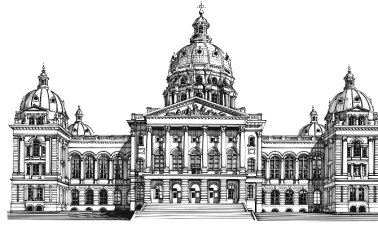

Iowa Legislative Fiscal Bureau

Dennis Prouty
(515) 281-5279
FAX 281-8451



State Capitol
Des Moines, IA 50319
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Federal Income Tax Deductibility

ISSUE

Iowa currently allows taxpayers to deduct 100% of federal taxes from their Iowa individual taxable income. Recent federal law changes have brought into question the complications that this deduction creates as well as the tax incidence effects the policy has on Iowa taxpayers.

AFFECTED AGENCIES

Department of Revenue and Finance (DRF)

CODE AUTHORITY

Chapter 422.9 and 422.35, Code of Iowa

BACKGROUND

The 1993 Omnibus Budget Reconciliation Act (OBRA)¹ brought to the forefront the issue of federal deductibility. Because the federal government increased income tax rates on high income individuals, states that allow the federal deduction will face 2 concerns. Initially, revenue shortfalls will occur because higher federal taxes have the effect of reducing taxable income. Secondly, the tax burden shifts such that lower income individuals pay a greater proportional share of state income taxes than before OBRA.

According to a recent survey completed by the National Conference of State Legislatures (NCSL), 8 states allow individuals to deduct from taxable income the amount that is paid in federal income taxes. In addition to Iowa, 3 states (Alabama, Louisiana, and Missouri) allow a 100% deduction without qualification. The other 4 states (Oklahoma, North Dakota, Utah, and Oregon) have a variety of policies that include capping the deduction, limiting the percentage that can be deducted, and requiring those who use the deduction to use a higher tax rate schedule.

All things being equal, the policy of federal deductibility is regressive because the federal income tax is progressive. Since higher income individuals pay a larger percentage in federal tax, they receive a proportionally larger deduction from their state income tax.

¹You may contact the Legislative Fiscal Bureau for a previous *Issue Review* (dated September 20, 1993) that discusses the effects of the 1993 OBRA in detail.

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CURRENT SITUATION

Each tax year, taxpayers filing Iowa tax returns deduct more than \$5.0 billion in federal taxes from their State income taxes. This translates into approximately \$325.0 million² in lost revenue. This figure is subject to change when the federal government changes tax policy. The figures are also sensitive to the performance of the economy. When personal income increases, so does federal tax. As a result, when the State economy grows, much like when federal rates are increased, high income taxpayers are given a smaller proportional share of the Iowa tax burden. Similarly, in recessions, those with federal income tax savings will absorb a larger proportional share of the State tax burden.

Currently, Iowa's top marginal tax rate is 9.98%. Actual tax burden, however, is a combination of both the tax rate and deductions. Factoring federal deductibility at the new federal tax level of 36.0%, the top marginal tax rate is effectively 6.39%. When the new federal surtax is considered, the effective marginal tax rate on Iowa's highest income taxpayers drops to 6.03%.

ALTERNATIVES

Many options exist with regard to federal deductibility. Any options that curtail the deduction will reduce the sensitivity of State revenues to federal tax rate changes.

There are 3 alternatives to the present system. The first is to cap federal deductibility at a dollar amount or percentage. Federal deductibility for corporations is already limited to 50.0% of federal taxes. A percentage change in the allowable deduction would result in a similar change in State revenues. Reducing the deduction by 50.0%, for example, would recoup approximately 50.0% of the impact from the deduction. A "dollar cap" behaves differently, because low income filers will be far less affected than high income filers. The marginal tax rates could be adjusted to reverse the progressivity that a cap would induce. The following table illustrates the impact of capping federal deductions at various amounts.

Cap Level	Increase in State Revenues (millions)
45,000	23.3
50,000	21.4
55,000	19.8
65,000	17.3
75,000	15.5
85,000	14.0
100,000	12.4

A second option would allow the deduction without qualification, but institute a different rate structure. Under this scenario, if a taxpayer chose to deduct federal taxes, the individual's taxable income would be subject to a higher rate schedule. While this alternative softens the regressive nature of the deduction, it adds complexity to the tax system. Additionally, such a policy would fail to achieve the objective of stabilizing the budgeting process. Although the impact of federal tax changes could conceivably be reduced under this plan, the State would still experience federally induced revenue swings.

²This figure represents a DRF estimate for tax year 1991.

The third alternative is to eliminate the deduction completely. This option might entail changing the rate structure to provide revenue neutrality. Due to the magnitude of federal deductibility, however, it is not possible to maintain current effective tax rates for each income class without having declining marginal tax rates for upper income brackets. The following table shows marginal tax rate changes that come close to revenue neutrality across income classes.

The following table compares effective tax rates for individual income taxpayers by Adjusted Gross Income (AGI). The effective rates reflect the 2 rate schedules listed in the previous table. The effective rates take into account all deductions and the effects of OBRA.

In regard to State income taxes, upper income lowans would realize an increase in the effective tax

Taxable Income		Current	Alternative
Over	Not Over	Marginal Rates	Marginal Rates
\$ 0	\$ 1,060	0.40%	0.31%
1,060	2,120	0.80	0.62
2,120	4,240	2.70	2.20
4,240	9,540	5.00	4.40
9,540	15,900	6.80	6.00
15,900	21,200	7.20	6.00
21,200	31,800	7.55	6.00
31,800	47,700	8.80	6.00
47,700		9.98	6.00

rate of approximately 0.3%. This increase is offset, however, by the federal government's policy of state tax deductibility. In the same manner that the federal government shifted the tax burden to states that allow federal deductibility, the State can shift the burden back to the federal government. Filers in the top 2 AGI classes listed above would pay an average of \$697.61 more in State income taxes than under the current system. On the other hand, this same group of filers will save an average of \$358.09 on their federal taxes. In effect, the federal government picks up more

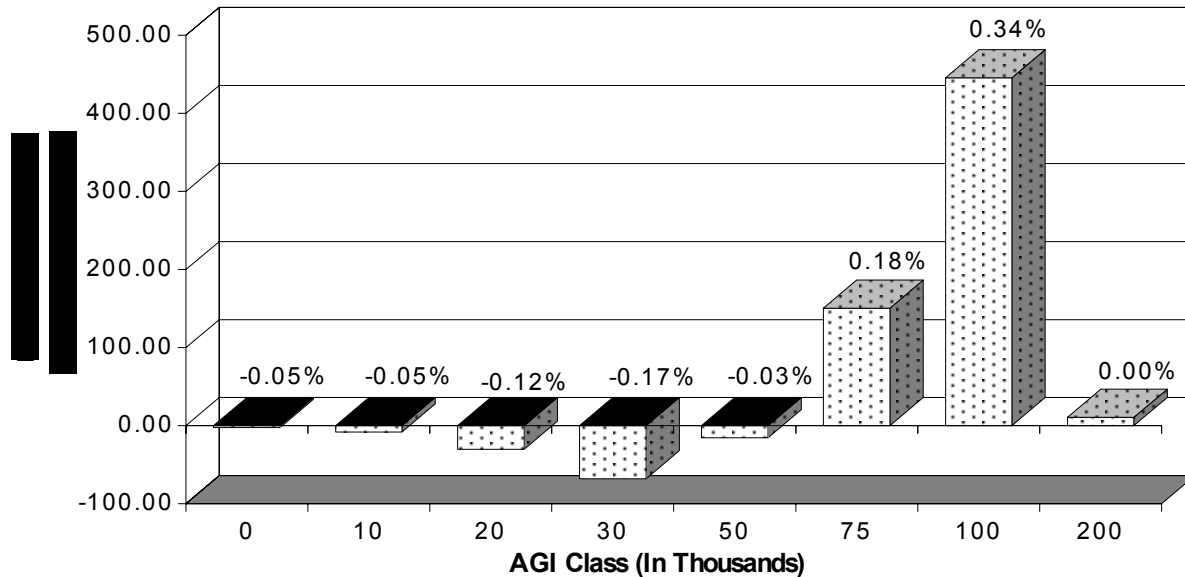
Adjusted Gross Income (AGI)		Current Effective Rate	Effective Rate Without Federal Deductibility	Change in Tax (Per Filer)
Over	Not Over			
\$ 0	\$ 10,000	0.60%	0.55%	-2.24
10,000	20,000	2.29	2.23	-7.97
20,000	30,000	3.24	3.12	-29.74
30,000	50,000	3.76	3.59	-67.08
50,000	75,000	4.29	4.27	-10.75
75,000	100,000	4.63	4.87	201.53
100,000	200,000	3.03	3.33	621.05
200,000		6.64	6.87	934.78
Average		3.83%	3.84%	\$ 3.92

than half of the tab. The net result will be that the State will receive approximately \$5.3 million in additional revenue, and citizens of the State of Iowa will pay approximately \$11.4 million less in their combined State and federal tax bill. In general, those individuals who save on their federal taxes are upper income itemizers, and those who save on their State taxes are lower income lowans who generally take the standard deduction. The following chart illustrates that overall change in tax burden for Iowa taxpayers, taking into account both federal and State taxes. The

numbers above the columns indicate the percentage increase in taxes for a taxpayer with the average income for the given AGI class.

Average Change in Total Tax Burden by AGI Class

The taxpayers that would be most affected by the elimination of the federal tax deduction are those in the seventh bracket, \$100,000 - \$200,000. The average taxpayer in this bracket has an AGI of approximately \$130,000, and taxable income of approximately \$91,000. The impact on these taxpayers could be decreased to \$277 (0.21% of AGI) by incorporating a marginal rate of 5.0% on taxable incomes between \$70,000 and \$110,000. This would transform the \$5.3 million gain into a \$1.3 million loss. This is due to the fact that it is this AGI class that benefits the most from federal deductibility. In terms of effective tax rates, the average taxpayer in this class currently pays a lower percentage tax than the average taxpayer who earns \$25,000.



BUDGET IMPACT

With an adequate change in the rate structure, the budget impact from the elimination of federal deductibility would be negligible. In the illustration shown in the previous section, the State would collect approximately \$5.3 million in additional revenue each tax year.

The estimates in this *Issue Review* are for tax years rather than fiscal years. They do not take into account any windfall (for the taxpayer or the State) that the implementation of the policy might produce. The situation is slightly different when fiscal years are considered. Legislation would need to handle such issues as retroactivity and transition, which might allow the deduction for the tax year prior to the year of the policy change. It is conceivable that the first year of the policy change could have a budget impact, depending on how the deduction is phased out. These impacts, however, are not inherent, and could be minimized for both the State and the taxpayer.

The elimination of federal deductibility would give the State a more stable tax structure that would not be adversely affected by changes in the federal tax code, and the change could be adopted without disrupting either the General Fund, or the disposable income of Iowa taxpayers.

STAFF CONTACT: Jon Muller (Ext. 14611)

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