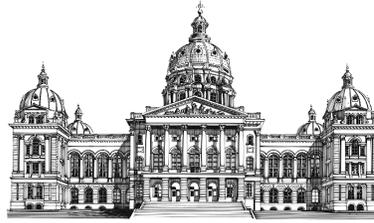


# Iowa Legislative Fiscal Bureau

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## Taxpayer Relief Act of 1997

### ISSUE

On August 5, 1997, the President signed HR 2014 (Taxpayer Relief Act of 1997). The Act has numerous provisions that affect various federal tax sources. This **Issue Review** describes the major provisions contained in the Act. Following the text explanations is a spreadsheet listing provisions expected to have a significant impact on General Fund receipts.

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The estimates provided in this **Issue Review** do not include the ramifications of a coupling bill, if one is passed by the 1998 General Assembly. A coupling bill (or Internal Revenue Code (IRC) Update Bill) is usually required to reconcile Iowa tax law with federal tax law. Most of the provisions discussed in this **Issue Review**, however, are not expected to have significant coupling costs. The Department of Revenue and Finance is in the process of issuing a more comprehensive explanation of the provisions in the federal tax bill, as well as a report on the issue of coupling.

### MAJOR PROVISIONS

#### **CHILD TAX CREDIT**

- Child and Dependent Tax Credit - A \$400 Child and Dependent Tax Credit is available for tax year 1998, and the credit will be increased to \$500 for subsequent tax years. Taxpayers are allowed to take the credit for each dependent under the age of 17. The credit is reduced by \$50 for each \$1,000 of modified adjusted gross income (AGI) in excess of \$110,000 (\$75,000 for singles).

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- **Interaction with EITC** - The credit is applied prior to the Earned Income Tax Credit (EITC). Although the Child Tax Credit is technically non-refundable, this provision will result in larger EITC refunds for certain low-income taxpayers.
- **Withholding Tables Unchanged** - The final version of HR 2014 was stripped of a provision that required an adjustment of the federal withholding tables. As a result, wage earners who do not make estimate payments will see no reduction in tax liability until they file their federal tax returns in the Spring of 1999 unless they specifically request their employers to adjust their withholding. (It should also be noted that federal withholding tables will not be adjusted due to any of the other provisions in the Act. As a rule, taxpayers will receive their tax benefit (increase) when they make estimate payments and when they file their final return.)

## Education Provisions

### Hope and Lifetime Learning Credits

- **Hope Tax Credit** - A Hope Income Tax Credit is provided for qualified tuition and fees for the first two years of a taxpayer's, spouse's, or dependent's post-secondary education. The credit is nonrefundable and is available for up to 100.0% of the first \$1,000 and 50.0% of the next \$1,000 of eligible expenses, beginning with expenses incurred on or after January 1, 1998.
- **Lifetime Learning Credit** - Effective for education expenses paid after June 30, 1998, a nonrefundable Lifetime Learning Tax Credit equal to 20.0% up to \$5,000 (\$10,000 beginning in 2003) is available for students enrolled in classes at an eligible education institution to acquire or improve job skills. This applies to students in degree and non-degree programs.
- **Phase-out and Limitations** - Both credits are phased out for joint filers with modified AGI between \$80,000 and \$100,000 and for single taxpayers with modified AGI between \$40,000 and \$50,000. Both credits may be claimed for eligible expenses of the taxpayer and the taxpayer's spouse and dependents. Although both credits may be taken by the taxpayer, only one credit may be used for each individual student.

### Student Loan Interest Deduction

- **Student Loan Interest Deduction** - A phased-in deduction of up to \$2,500 is available for interest due and paid on qualified education loans after 1997. The deduction is an adjustment to income, so taxpayers taking the standard deduction will be eligible.
- **Limitations** - The adjustment applies to any loan during the first five years that interest payments are required. Maximum deductions are: for 1998, \$1,000; for 1999, \$1,500; for 2000, \$2,000, for 2001 and subsequent years, \$2,500. A taxpayer may claim the interest deduction only if not claimed as a dependent by another taxpayer for the tax year.
- **Phase-out** - The deduction is phased out for taxpayers with modified AGI between \$60,000 and \$75,000 for joint return filers (\$40,000 and \$55,000 for singles and heads of households).

### Penalty-free Withdrawals from Individual Retirement Accounts (IRAs) for Education

Expenses Taxpayers are permitted to make withdrawals from IRAs for higher education expenses

of the taxpayer and the taxpayer's spouse, child, and grandchild without a penalty. The distribution will be taxed under standard IRA rules. This provision is effective beginning with the 1998 tax year for all income levels.

### Education IRAs

- **Education IRA - Beginning with the 1998 tax year, taxpayers will be permitted to contribute up to \$500 each year per child under age 18 to an education IRA.**
- **Tax Treatment - Education IRA contributions are not deductible, but withdrawals used to pay qualified higher education expenses will generally be tax free. Traditional IRAs are backloaded such that contributions are deductible at the beginning, but withdrawals are taxed.**
- **Other Rules - Education IRA earnings not used for qualified expenses are included in the income of the distributee and are subject to a 10.0% penalty.**
- **Phase-out and Limitations - The annual contribution limit is phased out for joint filers with modified AGI between \$150,000 and \$160,000 (\$95,000 and \$110,000 for single filers).**

### SAVINGS AND INVESTMENT INCENTIVES

#### Traditional IRAs

- **Increased Income Threshold - The income limits for deductible contributions to traditional IRAs will be increased over the next ten years to \$80,000 for married filers and \$50,000 for single filers (currently \$40,000). For tax year 1998, they will be increased to \$50,000 and \$30,000 for married and single filers, respectively. The previous caps were set at \$40,000 and \$25,000.**
- **Penalty-free Withdrawals - Individuals are allowed to make penalty-free withdrawals of up to \$10,000 from any IRA for amounts used to purchase a first home and any amount to pay for qualified higher education expenses.**
- **Expanded Spousal Contributions - Spouses of individuals who are in an employer-sponsored retirement plan are allowed to make deductible contributions to traditional IRAs. Deductions for such contributions are phased out for taxpayers with AGI between \$150,000 and \$160,000.**

#### Roth IRAs

- **Roth IRAs - Beginning in tax year 1998, "Roth IRAs" are created. Under traditional IRAs, contributions are deductible but distributions are taxable. Under Roth IRAs, contributions are taxable, but distributions are not taxable. Individuals may contribute, on a non-deductible basis, up to \$2,000 per year. However, the sum of contributions to all IRAs by an individual can not exceed \$2,000 in any year.**
- **Tax Treatment - Distributions from Roth IRAs are non-taxable provided they are made more than five years after the first year for which a contribution is made, and are made after the taxpayer turns 59 ½ years of age. The 10.0% penalty rules that apply to traditional IRAs also apply to Roth IRAs.**

- Phase-out and Limitations - The \$2,000 maximum contribution is phased out for joint filers making between \$150,000 and \$160,000 (\$95,000 and \$110,000 for singles).
- Conversion Option - Traditional IRAs can be converted into Roth IRAs during the 1998 tax year, which entails tax implications for the taxpayer. Taxpayers with AGI in excess of \$100,000 are not eligible for the conversion option.

### **Capital Gains Provisions**

- Capital Gains Rate Reduction - The maximum tax rate on long-term net capital gains is reduced from 28.0% to 20.0%, retroactive to May 7, 1997. Long-term gains that would have been taxed at 15.0% will now be taxed at a 10.0% rate.
- Long-term Gains - The Act also extended the time property must be held to qualify for long-term treatment. For gains realized between May 7, 1997, and July 28, 1997, the property must have been held at least one year. Beginning with realizations after July 28, 1997, property must be held for 18 months. Property held between one year and 18 months will continue to be taxed at a top rate of 28.0%.
- Additional Rate Reduction - Beginning in tax year 2001, gains from property held longer than five years (from January 1, 2001) will be subject to a top rate of 18.0%. The corresponding rate for taxpayers in the 15.0% ordinary income bracket will be 8.0%.
- Depreciated Assets - For assets that were subject to depreciation, the top rate will be 25.0%.
- Interaction with AMT - The changes in rates are also incorporated for the purpose of calculating the Alternative Minimum Tax (AMT).
- Principal Residence Provision - The sale of property used as a principal residence will be qualified for an exclusion of up to \$500,000 (\$250,000 for single filers). Principal residence requirements include owning and living in the property for at least two years during the five years prior to the sale.

### **PROVISIONS SPECIFIC TO FARM OPERATIONS**

- Income Averaging - Farmers may elect to compute 3-year income averaging. For example, if a taxpayer has taxable farm income of \$60,000 this year, \$20,000 would be added to the taxable income of the three prior years, and the resulting change in tax will be due. The provision is effective first in 1998 (returns filed in 1999). The provision is scheduled to expire on December 31, 2001.
- AMT Treatment of Installment Sales - For the purposes of calculating the AMT, farmers will only need to include the cash receipts portion of certain installment sales. The provision applies to dispositions made since tax year 1987. This has the effect of reducing the taxes paid by farmers subject to the AMT.

### **ESTATE AND GIFT TAX**

- Increased Unified Credit - The estate and gift tax unified credit is gradually increased from the existing exemption level of \$600,000 to \$1.0 million in 2006. The exclusion will increase to \$625,000 in 1998.

- Inflation Indexing - Effective for deaths on or after January 1, 1999, the \$10,000 annual exclusion for gifts and several other estate and gift tax provisions (including the \$1.0 million generation-skipping transfer tax exemption) are indexed for inflation.
- Family-owned Businesses - Effective for estates of decedents dying after December 31, 1997, an additional estate tax exclusion is available for the value of an estate attributable to a "qualified family-owned business interest" under certain circumstances. When combined with the unified credit, the exclusions may not exceed \$1.3 million. Qualified estates will be family-owned interests in which the decedent owned and materially participated in the business.
- Interest on Time Payments - The interest rate on estate tax paid over time by closely held businesses (allowed under current law) is reduced from 4.0% to 2.0%. The preferred interest rate applies only to estate taxes resulting from the first \$1.0 million in taxable estate value. This provision is effective for deaths occurring after December 31, 1997, but the Act does include a procedure that will enable eligible estates of persons deceased prior to 1998 to opt for the new interest rate provisions.

#### **OTHER PROVISIONS AFFECTING INDIVIDUAL INCOME TAXES**

- Home Office Deduction - Beginning with the 1999 tax year, a home office will generally qualify as the principal place of business if it is used exclusively and regularly by the taxpayer to conduct administrative or management activities of a trade or business, and there is no other fixed location of the business where the taxpayer conducts these activities. This amounts to an easing of current rules concerning the deduction.
- Contributions of Stock to Private Foundations - This Act reinstates an expired provision that allows taxpayers who donate qualified stock to private foundations to claim a deduction for the fair market value of the stock. This provision expires on July 1, 1998, and applies retroactively to June 1, 1997.
- Individual Estimated Tax Provisions - The \$500 individual estimated tax de minimis threshold is increased to \$1,000, effective for estimate payments made for 1998 and subsequent tax years.
- Mileage Rate for Charitable Deduction for Use of Automobiles - The mileage rate for computing the charitable deduction for use of an automobile for charitable purposes is increased from 12 cents per mile to 14 cents per mile, beginning with tax year 1998.
- Self-Employed Health Insurance Deduction - The deduction for health insurance of self-employed individuals is increased from 35.0% to 40.0% for the 1997 tax year. From 1998 to 2007, the deduction will gradually be increased to 100.0% of self-employed health insurance costs. Iowa tax law already provides for a 100.0% deduction.
- Safe Harbor - As a result of various provisions of the Taxpayer Relief Act, some individuals may have an increase in tax liability. The safe harbor provision specifies these individuals will not be required to pay a penalty as a result of paying less than the required amount.

#### **OTHER PROVISIONS AFFECTING BUSINESS TAXATION**

- Exemption for Small Corporations from AMT - The corporate AMT is repealed for small business corporations for tax years beginning after 1997. A small business corporation is

one that had average gross receipts of less than \$5.0 million for the three-year period beginning after 1994. A corporation that meets the \$5.0 million gross receipts test will continue to be exempt from the AMT so long as its average gross receipts do not exceed \$7.5 million. A corporation that fails to meet the \$7.5 million gross receipts test will become subject to the AMT only with respect to preferences and adjustments that relate to transactions and investments entered into after the corporation loses its status as a small business corporation.

- **Repeal of Depreciation Adjustment for AMT** - For property placed in service after 1998, the recovery periods used for purposes of the AMT depreciation adjustment are conformed to the recovery periods used for depreciation under the regular tax.
- **Business Credit Carryovers** - The carryback period for general business credits is changed from three years to one year and the carryover period is extended from 15 years to 20 years, effective for tax years beginning after 1997.
- **Net Operating Loss Carryovers** - The carryback period for net operating losses (NOLs) is reduced from three years to two years and the carryforward period is extended from 15 to 20 years, effective for NOLs generated in tax years beginning after the date of enactment.
- **Tax-Free Spin-offs** - The ability of a corporation to obtain tax-free treatment for certain "spin-off" transactions after April 16, 1997, is restricted. Corporate level capital gain is recognized on a spin-off that is part of a plan or series of related transactions in which there is an acquisition of 50.0% or more of the vote or value of stock of either the distributing corporation or the controlled corporation. In addition, distributions within an affiliated group of corporations, in connection with such an acquisition transaction, are not treated as tax-free spin-offs. Special transition rules apply for certain transactions.
- **Research Tax Credit** - The research credit is extended retroactively from June 1, 1997, to June 30, 1998.
- **Work Opportunity Tax Credit** - The Work Opportunity Tax Credit is extended from October 1, 1997, to June 30, 1998. A new category of Supplemental Security Income (SSI) recipients is added to the group of workers eligible for the credit. In addition, the minimum employment period is reduced from 400 to 120 hours, but the credit is tiered to provide a 25.0% credit on wages earned by employees with 120 or more but less than 400 hours and a 40.0% credit on wages earned by employees with 400 hours or more hours.
- **Welfare to Work Credit** - A new credit is available for employers who hire qualified long-term family assistance recipients. The credit equals 35.0% of the first \$10,000 of eligible wages in the first year of employment and 50.0% of the first \$10,000 of eligible wages in the second year of employment. The credit is effective for wages paid or incurred to a qualified individual who begins work on or after January 1, 1998, and before May 1, 1999.
- **Extension of Federal Unemployment Surtax** - A temporary surtax of 0.2% that was scheduled to expire in 1998 is extended through 2007.
- **Electronic Transfer of Tax Payments** - Companies required to convert to the Electronic Federal Tax Payment System because their federal tax deposits in 1995 exceeded \$50,000 will not be penalized for a failure to use the system between July 1, 1997, and June 30, 1998.
- **Deductibility of Business Meals** - The deductible percentage of the cost of food and beverages consumed while away from home by certain airline employees, truckers, railroad employees, and sailors during the time their hours of duty are subject to limits by the U.S.

Department of Transportation is gradually increased from 50.0% to 80.0%, beginning in 1998.

- **Constructive Sales** - Recognition of gain (but not loss) is required upon a constructive sale of any appreciated position in stock, a partnership interest, or certain debt instruments, effective generally for constructive sales entered into after June 8, 1997. This provision closes a loophole used to receive the benefits of a capital gain without realizing the gain for income tax purposes.

### **EXCISE TAX PROVISIONS**

- **Aviation Taxes** - The current excise taxes under the Airport and Airway Trust Fund are extended through September 30, 2007. In addition, the 10.0% tax rate for the commercial passenger excise tax is replaced with a combination ad valorem and flight segment tax that will gradually be phased to a rate of 7.5% plus a segment tax of \$3.00 per passenger. The 7.5% portion of the tax is applied to payments to airlines for frequent flyer and similar awards from banks and credit card companies, merchants, frequent flyer program partners, and other businesses. The present \$6.00 per passenger international departure tax is increased to \$12.00 per passenger and is extended to international arrivals. These provisions generally apply to transportation after September 30, 1997.
- **Prepaid Telephone Cards** - Amounts paid to communications service providers for the right to award or otherwise distribute free or reduced-rate telephone service are treated as subject to the 3.0% ad valorem tax rate that applies to other taxable communications services.
- **Cigarette Taxes** - The excise tax on cigarettes is increased by 10 cents per pack effective January 1, 2000, and an additional 5 cents per pack, effective January 1, 2002. Other taxable tobacco products are also increased. Amounts equal to these tax increases are to be credited against payments required under future federal legislation implementing the proposed tobacco industry settlement. This provision was included in HR 2015 (Balanced Budget Act of 1997).

### **BUDGET IMPACT**

The federal legislation, in total, is expected to result in an increase in revenues to the State General Fund of approximately \$45.9 million in FY 1998, \$34.2 million in FY 1999, and \$37.0 million in FY 2000. These impacts are the direct result of two factors.

**Federal Deductibility** - State income tax revenues increase when federal income taxes are reduced. This factor accounts for approximately \$14.2 million in FY 1998, \$11.9 million in FY 1999, and \$25.6 million in FY 2000.

**Behavioral Responses** - In most cases, behavioral responses to small or moderate income tax changes are not measured. Specifically, how income taxation affects individual decisions regarding labor and leisure is not reflected in these estimates. However, behavioral implications have been estimated for three of the federal provisions.

- **Capital Gains Rate Reduction** - The reduction in the maximum tax rate for long-term capital gains from 28.0% to 20.0% will encourage more capital gains realizations in the short-run. On the federal level, increased realizations in the first year are expected to more than offset the rate reduction. On the State level, there is no rate reduction, so increased realizations increase income tax collections. This factor accounts for an increase in revenues of; \$31.9 million in FY 1998, \$22.7 million in FY 1999, and \$12.7 million in FY

2000. These estimates assume taxable net capital gains will increase by 30.0%, 20.0%, and 10.0% in the first three years of reduction (compared to the baseline forecast).

- **Penalty-free IRA Withdrawals** - Iowa does not have a penalty for early IRA withdrawals. The federal legislation is expected to result in increased IRA investments because withdrawals can be made for education expenses and first-time homebuyers. As a result, more Iowans will use IRAs as a short-term investment vehicle. This factor accounts for the remainder of the total impact; \$0.0 in FY 1998, \$-600,000 in FY 1999, and \$-600,000 in FY 2000.
- **Cigarette Tax Rate Increase** - The cigarette tax increase will not take effect until FY 2000. The rate increase is expected to result in a decrease in consumption, which leads to lower Iowa cigarette tax receipts. However, since cigarette prices will increase, Iowa sales tax applied per package will increase. The net effect is no significant change to overall General Fund receipts.

The attached spreadsheet shows the expected impact of the federal tax legislation by provision for the next three fiscal years. As indicated in the title, these estimates are subject to change.

**Taxpayer Relief Act of 1997**  
**Impact on State General Fund Revenues - Preliminary**  
(Dollars in Millions)

Provision	Effective Date	FY 1998		FY 1999		FY 2000	
		Deduct. Impact	Behav. Impact	Deduct. Impact	Behav. Impact	Deduct. Impact	Behav. Impact
<b>Child Tax Credit</b>	1/1/98	\$ 1.2		\$ 1.7		\$ 11.4	
<b>Education Provisions</b>							
Hope Credit	1/1/98	0.3		0.7		4.8	
Student Loan Interest Deduction	1/1/98	0.0		0.0		0.1	
Penalty-free IRA withdrawals	1/1/98	0.0	0.0	0.0	-0.6	0.1	-0.6
* Education IRA	1/1/98	0.0		0.1		0.7	
* Other	various	0.4		0.3		0.3	
<b>Savings &amp; Investment</b>							
* Raised IRA Income Limits	1/1/98	0.0		0.2		0.2	
Capital Gains	various	9.3	31.9	9.1	23.3	9.0	13.3
<b>Alternative Minimum Tax Provisions</b>							
Small Corporation Exemption	1/1/98	0.0		0.1		0.1	
Conform AMT Depreciation	1/1/99	0.0		0.3		0.8	
<b>Farm Specific Provisions</b>							
Farm Installment Sales	1/1/88	0.5		0.5		0.5	
Income Averaging	1/1/98	0.0		0.0		0.2	
<b>Other Significant Provisions</b>							
* \$1,000 <i>de minimus</i> Threshold	1/1/98	0.0		0.1		0.0	
Health Insurance Deduction	various	0.0		0.0		0.0	
<b>Estate/Gift Tax Provisions</b>	1/1/98	0.0		-1.1		-1.9	
<b>Cigarette Tax Increase</b> (HR 2015)	1/1/00	0.0		0.0		0.0	
<b>*Safe Harbor Provision</b>	1/1/98	2.5		-0.1		-0.7	
<b>Total</b>		\$ 14.2	\$ 31.9	\$ 11.9	\$ 22.7	\$ 25.6	\$ 12.7
		<b>FY 1998 Total</b>		<b>FY 1999 Total</b>		<b>FY 2000 Total</b>	
		\$ 46.1		\$ 34.6		\$ 38.3	

\*Indicates IRC coupling may be warranted

## SOURCES

Department of Revenue and Finance  
KPMG Peat Marwick, LLP  
Joint Committee on Taxation  
Congressional Budget Office  
National Conference of State Legislatures

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Taxpayer Relief Act of 1997