Iowa's Personal Income Tax: Reform for Iowans at Any Age

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April 2005

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Tax Issue Brief: Iowa's Personal Income Tax

Reform for Iowans at Any Age

By Charles Bruner and Mike Crawford, with Ian Bruner

States need revenue to fund essential services – public safety, education, health and environmental protection. States also have the major financial responsibility for caring for the elderly and for persons with disabilities, and for protecting and supporting children whose parents cannot perform those roles.

Like most states, Iowa relies upon personal income taxes, property taxes, and sales and use taxes, to fund government services. Such a broad tax base that does not rely too heavily on one revenue source is sound fiscal policy. The personal income tax is an essential component because it represents the primary way states can ensure fairness in their overall tax system, as the personal income tax is based on ability to pay.

Currently, the General Assembly is considering a variety of proposals to change Iowa's personal income tax system. For instance, Governor Vilsack has proposed exempting all pension income and Social Security income from taxation. Republican leadership this year proposed eliminating the personal income tax for persons under the age of 30. Both proposals have major revenue implications to the state, for the present and for the future. In fact, through a variety of tax exemptions and cuts to the state personal income tax over the last decade, the personal income tax system's share of overall state and local taxes has declined substantially (from 24.6 percent of taxes in 1992 to 21.8 percent in 2002),[1] placing pressure on other parts of the state tax system. During this period, Iowa went from collecting above the national average in personal income tax collections as a proportion of state personal income to below the national average. In 1992, Iowa personal income tax was 2.67 percent of state personal income, above the national average of 2.16 percent (which included states that did not have personal income taxes). In 2002, Iowa personal income tax declined to 2.21 percent of state personal income, below the national average, which had risen over the decade to 2.29 percent of national personal income. Iowa now ranks 33rd among states in its reliance upon income taxes as a source of revenue, above only eight states that have a personal income tax. This shift away from the personal income tax as a revenue source has narrowed Iowa's tax base and moved it away from being based upon ability to pay. Further cuts, particularly of the magnitude posed by those proposals, could further threaten the stability of Iowa's overall tax system.

[1] U.S. Bureau of the Census, Census of Governments, accessed online 4/14/05
< http://www.census.gov/govs/estimate/92sl16ia.html> and < http://www.census.gov/govs/estimate/0216iasl_1.html>

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In addition, special exemptions for seniors or young people also raise questions of tax fairness because they result in different tax obligations for individuals with the same disposable income. Both proposed exemptions have been presented as incentives to keep either young people or seniors in the state. Yet, there is no evidence to suggest that they will actually achieve this objective.

This article examines Iowa's current personal income tax system as it affects different tax filers with the same amount of gross income. For simplicity, it assumes that all tax filers do not itemize and do not claim any special exemptions or credits. All income for working tax filers is ordinary income, and income for retired tax filers is a representative mix of ordinary income, Social Security income, and income from pensions or retirement accounts. The analysis examines six different types of tax filers:

- A **single individual** under 65 with no children
- A **retired individual** over 65 with no children
- A **single parent with two children** with parent under 65
- A **married couple with no children** with couple both under 65
- A **retired couple** with no children with both over 65
- A **married couple with two children** with both parents under 65

It examines these six different types of tax filers at four gross income levels: $20,000, $35,000, $55,000, and $80,000. These calculations were based upon current tax law for 2004 income and performed using TurboTax. For the purposes of calculating state personal income tax, deductions for federal taxes paid were calculated based upon the calculated federal tax owed in 2004.

Results from these tax calculations first are used to describe Iowa's current tax treatment of Social Security and pension income and the implications for expanding Iowa's current exemptions. They are next used to discuss the overall lateral tax equity – the fairness of Iowa's income tax in its treatment of tax filers with similar abilities to pay. Conclusions from these analyses are provided in the final summary.

Iowa's Personal Income Tax and Pension and Social Security Income

As stated earlier, Governor Vilsack recommended exempting all Social Security and pension and retirement income (the exemption includes pension income and other tax deferred retirement income, such as IRAs and 504b plans) from taxation under Iowa's personal income tax. The House Ways and Means Committee has placed on the calendar a bill, HF461, that would phase in complete exemption of Social Security and pension and retirement income. When fully phased in by 2010, the estimated revenue loss from these exemptions is $224.6 million for that year, or a loss in revenue equivalent to about 4 percent of the state budget.

What many Iowans may not recognize, however, is that Iowa already provides substantial tax preferences for retirement income. Iowa tax law provides a $6,000 exemption for an individual (and $12,000 for a married couple) for pension or other retirement income. Iowa tax law provides a more generous exemption than the federal government in its tax treatment of Social Security income. Like the federal government, Iowa does not tax Social Security income for individuals whose "provisional" income is at or below $25,000, and it does not tax Social Security income for married couples whose provisional income is at or below $32,000. (Provisional income is defined as money income excluding half of Social Security benefits.) For incomes above these amounts, an increasing portion of Social Security benefits are taxed, but only up to a maximum of 50 percent for higher income filers. The federal government taxes up to 85 percent of Social Security income for very high income tax filers, but Iowa never taxes more than 50 percent of that income.

According to an Iowa Department of Revenue report in 2001, in large measure due to the current exemptions, only 31 percent of Iowans receiving Social Security benefits paid any income taxes at all on those benefits. Most of the actual taxes paid on Social Security benefits are paid by those with incomes above $40,000.

An Iowa Department of Revenue and Finance report, *Iowa Tax Expenditures 2000*, estimated the cost to the Iowa treasury of Iowa's preferential treatment of Social Security and pension and retirement income. For tax year 2000, the report estimated that the cost to the state treasury of Iowa's preferential treatment of Social Security income was $85.8 million (including about $64.2 million for conforming with federal tax treatment plus about $21.6 million for Iowa's additional and more generous exemption). The report estimated the cost of the then $5,000/$10,000 pension and other retirement income exemption was $59.0 million. Since that time, the exemption for pension and retirement income was raised by 20 percent to $6,000/$12,000 and the amount of Social Security and pension income has grown, so a reasonable estimate of these tax expenditures for the 2005 tax year would be around $175 million. In other words, Iowa's preferential treatment results in $175 million less in taxes placed into the Iowa treasury.

There is justification for exempting a part of Social Security income from taxation, as the half paid in by employees was subject to tax at the time it was paid into the Social Security system. Exempting more than half of benefits, however, represents an exemption for income that was not taxed at the time it was earned. If income that is set aside for retirement is not taxed either at the time it is earned nor taxed at the time it is received, this substantially narrows the state's overall tax base. People placing money into retirement accounts already receive a substantial benefit simply from deferring tax payments, let alone having them forgiven entirely.

Iowa's current tax treatment already provides substantial benefits to people with retirement income. The impact of Iowa's current tax law with respect to retirement income is shown in Table 1.

Table 1. Iowa Income Tax Obligations
Tax Filers with Retirement Income vs. Regular Income, 2004

	Type of Iowa Tax Filer			
Adjusted Gross Income	**Retired Individual**	**Working Individual**	**Retired Couple**	**Working Couple**
$20,000	none	$ 667	none	$ 504
$35,000	$ 356	$ 1,503	none	$ 1,485
$55,000	$ 1,572	$ 2,622	$ 640	$ 2,870
$80,000	$ 2,904	$ 4,185	$ 2,211	$ 4,840

Source: Tax calculations using Turbotax. See Appendix for more detail and additional calculations for other incomes.

As Table 1 shows, Iowa provides substantial tax preferences for retirement income. At all income levels, retired individuals or couples pay substantially less than working individuals or couples, because of the preferential tax treatment of retirement income. Retired couples, for instance, have no state income tax obligation when they have $35,000 in income, while working couples pay $1,485 in taxes. The current tax preferences mean that retired individuals and couples receive tax-free income to meet their basic living needs, while working individuals and couples with the same income do not.

Table 1 goes further to show that this tax preference extends, and even increases, at the higher income levels. An income level of $80,000 or more puts an Iowa household in the top 20 percent of tax filers, well above the level where it could be argued that a state income tax rate of 6 percent would constitute a financial burden on one's ability to meet basic needs. At this level, couples with substantial retirement income get a tax break of $2,629 in state income taxes, compared with working couples earning the same amount. Iowa's additional preferential treatment of Social Security income (above the federal government's treatment) and the $12,000 exemption for other pension income produces this disparity.

Clearly, the current Iowa exemptions provide substantial tax reductions to Iowans with retirement income – well above those that are necessary simply to help retirees make ends meet.

There are major long-term implications for the tax treatment of Social Security and other retirement income. This is both because society is aging and because a variety of retirement savings options, primarily used by people with substantial incomes in their earning years, have increased the amount of money sheltered from immediate income taxation that will be drawn out in future years. Table 2 shows the projected growth nationally in three types of retirement income over the next 70 years, as a share of gross domestic product.

Table 2. Projected Growth in Social Security, Defined Benefit and Defined Contribution Payouts as a Share of Gross Domestic Product (GDP) – 2003-2075

	2003	2013	2025	2050	2075
Social Security	4.36%	4.80%	5.64%	6.37%	6.85%
Def. Contr. Ret.	1.36%	2.33%	3.70%	5.18%	5.96%
Def. Ben. Ret.	2.90%	3.15%	3.51%	3.33%	3.51%
Total	8.62%	10.28%	12.85%	14.88%	16.32%
% Growth from 2003	——	19.26%	49.07%	72.62%	89.33%

Source: United States Congressional Budget Office.

As Table 2 shows, as American society ages and as the amount of funds invested in tax deferred retirement increases and becomes eligible for payout, the proportion of the country's income that is from retirement savings increases dramatically. The amount of these retirement payouts will increase substantially between 2003 and 2013 (from 8.62 percent to 10.28 percent of GDP), and increase by nearly 50 percent in the next 20 years. This means that, without any action at all, the cost to the treasury of Iowa's current tax preferences for such income ($110 million in 1999) will increase by at least one-half during the next 20 years. This is the reason for a careful and serious examination of Iowa's current tax treatment of retirement income, and a very strong argument against expanding the preferences further.

The Family Impact of Iowa's Personal Income Tax

In addition to examining the tax treatment of retirement income, the analysis here also examines differences in the tax treatment of income by tax filing status. The proposal to exempt income taxes from Iowans under thirty, who are more likely to be single, raises the issue of current tax treatment of different types of Iowa families.

Again, tax principles indicate that there should be fairness of tax treatment across taxpayers with the same ability to pay, recognizing that households of different size and composition have different income needs. In general, federal and state income tax systems seek to take family size and characteristics into account by providing personal exemptions, standard deductions, and child and dependent credits that exempt from taxation the amount needed to meet basic needs. At the federal level, the combined personal exemption ($3,100 per individual) and child tax credit ($1,000 per child) essentially exempt from taxation the amount of income that is generally recognized as needed to meet the basic needs for a child.

Therefore, at the federal level, taxes on families with the same income but of different sizes are different. Table 3 provides information on federal and state income tax obligations for the six different family types for whom taxes were calculated, at a gross income level of $55,000 (roughly the median family income in Iowa).

Table 3. Federal and State Income Taxes
Different Types of Tax Filers with $55,000 in Income – 2004 Income

Tax Filer Type	Iowa Tax Obligation	Federal Tax Obligation
Retired Couple	$ 640	$ 1,906
Single Retiree	$ 1,672	$ 7,381
Single Worker	$ 2,622	$ 8,506
Single Worker, Two Children	$ 2,727	$ 3,370
Married Workers, No Children	$ 2,870	$ 5,154
Married Workers, Two Children	$ 2,905	$ 2,224

Source: Tax calculations using Turbotax. See Appendix for more detail and additional calculations for other incomes.

As Table 3 shows, Iowa's tax system taxes most heavily the $55,000 income families with the greatest needs — those with the most dependents to support. The federal government recognizes the cost of raising families and caring for dependents, while Iowa's system does just the opposite. Because of its small personal credit ($40 per individual) and lack of a personal exemption, Iowa's personal income tax system has the least recognition of the cost of caring for family members of any state income tax system in the country. To more accurately reflect ability to pay among different size families, Iowa's income tax should be much more equivalent in proportion to the federal income tax.

Younger Iowans are more likely to be single or to have no or few dependents. As such, Iowa's current personal income tax system already provides disproportional benefits to them. To be fairer, Iowa's personal income tax system needs to be reformed – not to provide additional benefits to retirees or to single young adults – but to provide greater relative benefits in the opposite direction, to working families with children. An earlier Iowa Fiscal Partnership report has described ways that Iowa's income tax system could be reformed to achieve this end, in a revenue neutral manner.[2]

Observations and Recommendations

It has become part of the political dialogue to propose tax exemptions and cuts as a way to address social issues. The calls for personal income tax exemptions for retirees and for young people were provided in this context, despite little belief that exemption from the state income tax would keep young people in Iowa and no evidence (in fact, some evidence to the contrary) that retirees have left Iowa because of Iowa's income tax and could be lured to stay with further exemptions.

Yet Iowans also recognize that taxes are needed to fund essential services. In a 2004 poll of Iowa registered voters, Iowans showed they want a tax system that meets essential needs – including a strong educational system but also a system that provides health care for poor children and cares for vulnerable citizens, including seniors and people with disabilities who need care and abused and neglected children.[3] In fact, over 50 percent of Iowans favored four tax options to raise revenue regardless of whether it was necessary to avoid cutbacks: raising taxes on cigarettes; raising taxes on liquor, wine or beer; closing tax loopholes; and taxing corporate profits that are transferred out of Iowa to avoid taxes. Iowans also said they wanted taxes to be fair and based on ability to pay. About 65 percent of Iowans (with an opinion on the matter) said that the tax cuts over the last decade have primarily benefited the wealthiest Iowans, and that these Iowans, along with multi-state corporations, pay less than they should in taxes.

The Iowa income tax system needs to be reformed, but not through additional cuts and exemptions. It needs to be made fairer and simpler, and it needs to be capable of continuing to provide needed revenue, over time.

Reforming Iowa's income tax requires changes that ensure that it will be based upon ability to pay and will continue to constitute a key component of Iowa's overall revenue structure.

[2] Iowa Fiscal Partnership. "Rethinking Iowa's Personal Income Tax: Tax Reform Based Upon Recognized Tax Principles." <http://www.iowafiscal.org/research/6_18_04.html>).
[3] Iowa Fiscal Partnership. "Iowa Voters and Taxes: Strong Public Support for Selective Taxes to Maintain Services." <http://www.iowafiscal.org/research/3_8_04.html>).

Appendix 1.

Calculation Assumptions, Calculations and Other State Tax Treatments of Social Security and Retirement Income

Federal and State Income Taxes for Different Iowa Families 2004 Actual Income

Income	Single Working Individual	Retired Individual	Working Single Par. 2 Children	Married Working Couples/No Children Joint/1inc.*	MFS/=**	Retired Couple	Married Working Couples/2 Children Joint/1Inc*	MFS/=Inc**
Federal Income Tax Liability								
$20,000	$ 1,454	$ 286	$ (4,428)	$ 413	N/A	$ -	$ (4,636)	N/A
$35,000	$ 3,704	$ 1,461	$ 276	$ 2,154	N/A	$ 221	$ (798)	N/A
$55,000	$ 8,506	$ 7,381	$ 3,370	$ 5,154	N/A	$ 1,906	$ 2,224	N/A
$80,000	$ 14,808	$ 13,706	$ 9,744	$ 9,506	N/A	$ 7,269	$ 5,974	N/A
State Income Tax Liability								
$20,000	$ 667	$ -	$ 226	$ 504	$ 360	$ -	$ 213	$ 87
$35,000	$ 1,503	$ 356	$ 1,460	$ 1,485	$ 1,072	$ -	$ 1,471	$ 1,160
$55,000	$ 2,622	$ 1,572	$ 2,727	$ 2,870	$ 2,148	$ 640	$ 2,905	$ 2,260
$80,000	$ 4,185	$ 2,904	$ 4,313	$ 4,840	$ 3,544	$ 2,211	$ 4,920	$ 3,702

Calculations by TurboTax based upon assumptions noted in this appendix.
*Joint – Married filing jointly. **MFS – Married filing separately.

Calculating Federal and Iowa 2004 Personal Income Taxes for Different Tax Filers

Calculating federal and income taxes for different tax filers involved entering relevant information on the tax filers into TurboTax. The following assumptions were used both to simplify these calculations and to provide comparability across the different filers. (Results for all the calculations are shown in the table):

1. All tax filers claim the standard deduction
2. All tax filers claim the personal exemptions and credits for their category
3. Both members of the retired couple family are over 65.
4. For state income tax purposes, the deduction for federal income taxes paid is equal to the calculation of federal income taxes for that year.
5. For state income tax purposes, the married couple calculations were performed both as a married filing jointly and as a married filing separately. In the latter case, the income was evenly split (e.g. each spouse makes $10,000 for the $20,000 income level). This provides a range of what actual married couples would pay.
6. For single and married couple filings, all the income is earned income.
7. For single retiree and retired couple, the income is as follows:

Single retiree —	$20,000 ($8,000 Social Security, $6,000 pension, $6,000 ordinary)
	$35,000 ($15,000 Social Security, $12,000 pension, $8,000 ordinary)
	$55,000 ($18,000 Social Security, $20,000 pension, $17,000 ordinary)
	$80,000 ($20,000 Social Security, $28,000 pension, $32,000 ordinary)
Retired couple	$20,000 ($10,000 Social Security, $8,000 pension, $2,000 ordinary)
	$35,000 ($15,000 Social Security, $12,000 pension, $8,000 ordinary)
	$55,000 ($25,000 Social Security, $16,000 pension, $14,000 ordinary)
	$80,000 ($32,000 Social Security, $25,000 pension, $23,000 ordinary)

Appendix 2.

Other State Tax Treatment of Social Security and Retirement Income

Different states with a state income tax treat Social Security and retirement income differently. In addition, they have different other tax treatments for retired or senior tax filers. The AARP *State Handbook of Economic, Demographic, and Fiscal Indicators 2003* provides state-by-state comparisons of income tax treatments of Social Security and retirement income.

Regarding Social Security income, of the 42 states plus the District of Columbia that have a personal income tax, 28 provide full exemptions for Social Security income, two provide a more generous exemption than the federal government (Iowa and Wisconsin), one combines Social Security with other retirement income and sets a ceiling (Colorado), and 11 provide the same exemption as the federal government.

Regarding other retirement income, many states distinguish in their treatment of public and private pension funds and provide different types of benefits that make strict comparison across states difficult. Overall, however, eight states provide no exemption for any retirement income other than Social Security, 11 states plus the District of Columbia provide a smaller exemption than Iowa, eight states provide a larger exemption than Iowa, three states provide a full exemption, and 10 states provide an exemption that is difficult to compare with Iowa.

The following table shows the tax treatment of both Social Security income and retirement income for Iowa's neighboring states:

Neighboring States' Tax Treatment Social Security/Retirement Income

State	Social Security	Private Pension	Public Pension
Illinois	Full	Full	Full
Iowa	Fed/Max 1/2	$6,000 individual/$12,000 joint	
Kansas	Same as Fed	None	Full
Minnesota	Same as Fed	$9,600/$12,000 minus Social Security/ With Phase-Out at $18,000/$42,000	
Missouri	Same as Fed	$6,000 combined/With Phase-Out at $32,000/$44,000	
Nebraska	Same as Fed	None	None
South Dakota	——— No State Income Tax ———		
Wisconsin	Fed/Max 1/2	None	Military + retirees Public retirees before 1964