

More Tax Cuts in Latest Reform Plan

Changes Include Bigger Standard Deduction, Student Tax Credit

Amendments made to the Democratic income-tax reform proposal now before the House and Senate substantially increase the share of low- and middle-income Iowans who will see tax decreases as a result of the plan. In its original form, the proposal used revenue from the elimination of a tax provision called federal deductibility to lower rates for all Iowa taxpayers and expand specific credits targeted at low- and middle-income earners with children. Amendments to the proposal do two additional things:

- increase the standard deduction, and
- create a \$100 refundable tax credit for Iowans enrolled at least part time in post-secondary education. As a result of these amendments, more Iowans benefit from tax reform, bringing the total share of taxpayers who either see a tax cut or no change in their taxes to 73 percent, but the proposal is no longer revenue neutral.

Table 1. Key Changes Would Reach More Households
Selected Proposed Changes in Deductions and Credits in Reform Plan

	Federal Income Tax	Current Iowa Income Tax	Original Iowa Tax Reform Plan	Iowa Tax Reform Plan With Amendments
Standard Deduction				
Single individual	\$5,450	\$1,750	\$1,750	\$2,710
Married couple	\$10,900	\$4,310	\$4,310	\$5,420
Single head of household	\$8,000	\$4,310	\$4,310	\$5,420
Maximum EITC				
No children	\$438	\$31	\$35	\$35
One child	\$2,917	\$204	\$233	\$233
Two or more children	\$4,824	\$338	\$386	\$386
Other Major Credits				
Maximum Child and Dependent Care Credit	\$2,100	\$1,575	\$1,680	\$1,680
Refundable Higher Ed. Credit	\$0	\$0	\$0	\$100

Source: IRS and Iowa Department of Revenue

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Increasing the standard deduction

The standard deduction is an amount that is subtracted from a taxpayer's gross income in order to lower a filer's taxable income. Under Iowa law, taxpayers must choose to either take the standard deduction or to file a return with itemized deductions, for such things as property taxes, mortgage interest, car registration fees, or donations to charity. Taxpayers who take the standard deduction are therefore most often those who don't own their own home and aren't paying property taxes or making mortgage payments. Since homeownership tends to be more prevalent among middle- and upper-income taxpayers, these groups make up a greater share of taxpayers filing itemized deductions. Data from the Department of Revenue shows that 87 percent of people making over \$50,000 choose to file itemized deductions, while only 38 percent of those with Iowa AGI under \$20,000 do the same.¹

Currently, the Iowa standard deduction is \$1,750 for single persons or for each spouse in a married couple filing separately. Married couples filing jointly, single parents, and widows/widowers receive a \$4,310 standard deduction. The proposed amendment to the Democratic tax reform plan would raise the standard deduction to \$2,710 for single persons or for each spouse in a married couple filing separately. The standard deduction for married couples, single parents, and widows/widowers would rise to \$5,420.

Because the standard deduction is a set amount, it has the biggest impact in terms of reducing taxable income for low-income taxpayers. Someone who makes only \$20,000 a year sees an 8.8 percent decrease in taxable income, to \$18,250, as a result of taking the current \$1,750 standard deduction for a single adult. However, a single adult making \$80,000 a year sees only a 2.2 percent decrease in taxable income by applying the same deduction. Increasing the standard deduction to \$2,710 would mean that someone making \$20,000 a year would see a 14 percent reduction in taxable income, to \$17,290.

Refundable tax credit for post-secondary education

The second new amendment to the income-tax reform proposal now in the Iowa Legislature is a \$100 refundable tax credit for any Iowan enrolled at least part time in post-secondary education. When a credit is refundable, it means that a taxpayer receives the full value of the credit regardless of the amount of taxes owed. For instance, if someone owes \$60 in state taxes, but is eligible for a \$100 refundable credit, he or she will receive a refund from the state of \$40, which is the difference between the filer's tax liability and the amount of the credit.

Many Iowans who would be eligible for a post-secondary education credit pay little or no state taxes because, as students, they have no income or only a small income from part-time work. As a result, many of these Iowans may not file a tax return, and they would have to do so in order to claim this credit. Outreach similar to that done for low-income families around the Earned Income Tax Credit (EITC) may be necessary to ensure that eligible students in Iowa claim the credit.

Taking steps to make Iowa's tax system more progressive

Amendments to the income-tax reform proposal mean that this plan, more so than its predecessor, disproportionately delivers its benefits to low- and middle-income taxpayers. The income-tax reform proposal first offered by Democratic legislators at the end of March resulted in tax cuts for 49 percent of Iowa taxpayers, produced no change for 18 percent, and raised taxes for 33 percent of taxpayers. The amended plan now being offered by Democrats results in tax cuts for 60 percent of Iowa taxpayers, produces no change for 14 percent, and raises taxes for 26 percent of taxpayers.

Under the new plan, 73 percent of Iowa taxpayers would see either no change or a tax decrease in tax year 2010. The majority of these taxpayers have an Adjusted Gross Income (AGI) of less than \$60,000.

¹ Iowa Department of Revenue. *2005 Iowa Individual Income Tax Annual Statistical Report: 2005 Returns Filed in 2006*.

In fact, 72 percent of all the taxpayers who would see their taxes go down as a result of the Democratic plan have an AGI of less than \$60,000. Recent discussion about income-tax reform has also focused on how these changes to the income tax system will affect taxpayers over the next several years. Data from the Department of Revenue shows that in tax years 2011-13, the majority of Iowa taxpayers (around 56 percent) would continue to see either a decrease or no change in their state income taxes.

The provision at the heart of the income-tax reform debate in Iowa, known as “federal deductibility,” allows Iowans to deduct the amount they pay in federal income tax from their taxable income for the purposes of filing state taxes. Allowing this deduction means that people who pay federal taxes are able to lower the amount of their income that is subject to state taxes, and this lowers the amount that they owe in state taxes. Eliminating the deduction, as the plan proposes, would mean that people paying federal taxes can no longer shrink their taxable income in this manner.

Many Iowans pay no federal income tax at all, so they do not benefit from federal deductibility and would not see their taxes increase as a result of its elimination. Table 2 shows the income thresholds at which a household would begin paying federal tax for the 2009 tax year. Households with income below these thresholds would lose nothing from the elimination of federal deductibility, but would gain from the reduction in rates, and in some cases from the increased credits as well.

Table 2. Iowans Earning Below Federal Tax Thresholds Don't Gain from Federal Deductibility

	2009 Federal Income Tax Thresholds
Single Individuals*	\$9,350
Married couples	
No Children	\$18,700
One Child	\$36,184
Two Children	\$44,900
Three Children	\$55,217
Heads of Households	
One Child	\$31,026
Two Children	\$38,765
Three Children	\$46,933
*If not eligible for EITC	

Source: Maxim Shvedov, “Federal Income Tax Thresholds for Selected Years, 1996 through 2009.” Congressional Research Service, Report RS22337, January 9, 2009.

Income tax reform and small businesses

Like most Iowans, the majority of small business owners would benefit from the proposal now under consideration by the Legislature. This is because a substantial share of small-business owners in Iowa have incomes below \$125,000 and will see lower income-tax payments as a result of income-tax reform.

Table 3. Tax Cuts for Most Business Filers

	No Change	Tax Decrease	Tax Increase	Decrease or No Change
Schedule C (Business Income)	9.4%	63.3%	27.2%	72.8%
Schedule F (Farm Income)	17.9%	61.5%	20.7%	79.3%
Schedule E (S-Corp, LLC, Partnership, Rent, Royalty, Trust Income)	16.3%	51.5%	32.3%	67.7%
All Individual Income Tax Taxpayers	12.7%	60.4%	27.2%	73.1%

Source: Iowa Department of Revenue

As Table 3 shows, over 60 percent of Schedule C and F filers in Iowa will see a tax cut under the income tax reform plan. Farmers, who file Schedule F returns, benefit the most, with almost 80 percent seeing either no change or a tax decrease.

Nationwide, Internal Revenue Service statistics show that Schedule C and Schedule F returns account for 76 percent of small-business taxpayers.²

The remaining share of small-business owners may file a Schedule E return, which is used by partnerships and S-Corps but also by anyone with rental or royalty income or with income from estates and trusts. A majority (51.5 percent) of Schedule E filers in Iowa would also benefit from the proposed income tax plan.

Overall, a larger share of Schedule C and F filers, who make up a substantial majority of small business owners in Iowa, will see a tax decrease under this proposal than will the general population of all taxpayers. Sixty percent of all taxpayers will see a decrease in their taxes, compared to 63 percent of Schedule C filers and 61.5 percent of farmers seeing a tax cut.

Conclusion

While the amendments to the Democrats' income-tax reform proposal mean that more Iowans see a tax decrease than under the original plan, it is also the case that the revised proposal is no longer revenue neutral. The original plan used the revenue from eliminating federal deductibility (\$595 million) to pay for the cost of lowering tax rates and extending various credits, both of which cost the state money by reducing the amount brought in by tax collections. Because the cost of these two changes (\$595 million total) was identical to the savings brought about by eliminating federal deductibility, the original plan neither cost the state any money nor brought in any additional revenue.

The new proposal is estimated to cost the state approximately \$20 million for tax year 2009 and \$35 million for tax year 2010. However, the majority of this investment goes to low- and middle-income Iowans. These steps toward greater progressivity in the Iowa income tax are important, especially in light of most changes to the tax code over the past 20 years that have consistently benefited upper-income taxpayers. In addition, although the income tax is the most progressive of all Iowa taxes — meaning it is based on a taxpayer's ability to pay a tax and recognizes that this ability to pay increases with rising income — it still falls short for many Iowa families. This is particularly true for low- and middle-income families with children, who may pay no federal income tax due to the exemptions and deductions in the federal tax code but then must pay state taxes because Iowa's tax system does not adequately recognize the cost of raising a child.

Amendments to the income-tax proposal now being considered by the Legislature increase the fairness of the Iowa tax code for all families while directing the majority of their benefits to low- and middle-income taxpayers.

² For this calculation, we considered a small business taxpayer to be a filer whose return includes a Schedule C, a Schedule F, or a Schedule E that reports the profits of a partnership or S-Corporation. Schedule E filers that report only rents and royalties, or income from estates and trusts were not included in the calculation. The source is: U.S. Internal Revenue Service, Statistics of Income, Individual Income Tax Returns, 2006, Table 1.4.

Iowa Fiscal Partnership

The Iowa Fiscal Partnership is a joint fiscal policy initiative of two nonprofit, nonpartisan Iowa-based organizations, the Child & Family Policy Center in Des Moines and the Iowa Policy Project in Iowa City. IFP reports are available at www.iowafiscal.org.