

Resolving Inequities in Iowa Taxes

Improving Tax Treatment of Working Families with Children

By Charles Bruner

The 2012 legislative session offers lawmakers a timely opportunity to review and expand Iowa's Earned Income Tax Credit (EITC). A policy brief published in December by the Iowa Fiscal Partnership spelled out the rationale for expanding the EITC.¹ This paper shows Iowa's overall income-tax treatment of working families with children is out of line with the way we treat other tax filers. While expanding the state Earned Income Tax Credit alone cannot provide full equity for working Iowa families with children, it can begin to correct some of the most egregious impacts upon Iowa families working to raise their children well.

Working Families Pay Taxes

Working Iowa families with children pay taxes. These include federal payroll taxes, sales taxes on purchases of goods, gasoline taxes for getting to and from work, property taxes (either with mortgages or as a share of the rent they pay), and, frequently, income taxes. Studies show that families with children pay a greater share of their income in taxes than other families because they have greater basic needs, including more expensive housing.

The income tax represents the one part of the overall tax system that can take into account family size and the cost of raising children. The basic tax principle is that income that is needed to meet basic household needs, particularly earned income, should not be subject to income tax.

The federal income tax does this by providing for personal exemptions, a child tax credit, a child and dependent care tax credit, and an Earned Income Tax Credit. Iowa's income tax system, however, does not have a personal exemption at all, and the personal credit is a meager \$40 per child compared to a maximum of \$1,000 for the federal child tax credit. The Iowa Earned Income Tax Credit (7 percent of the federal) is also very small in relation to the federal EITC. While Iowa's child and dependent care tax credit is large at the very low end of the income scale (where those families are likely to use the subsidy program instead of the credit), the credit phases out completely at \$45,000 in income.

Overall, the amount taxpayers pay in Iowa income taxes is about 30 percent of what they pay in federal income taxes, but Iowa's provisions for recognizing the cost of raising a family are much lower than that.²

The comparisons of additional tax provisions benefiting working families with children between the federal income tax and the Iowa income tax are shown in Table 1 at right.

Table 1. Federal and Iowa Income Tax Provisions Affecting Families with Children (2011 Tax Year)

	Federal	Iowa
Personal exemption	\$3,700	None
Child tax credit, per child	up to \$1,000	\$40
EITC	up to \$5,751	7% of federal
Child/dependent care credit	up to 35% of qualifying expenses	starts at 75% of federal but phases out at \$45,000

As a consequence, Iowa families with children begin paying Iowa income taxes at much lower income levels than they do at the federal level. In fact, many Iowa families with children receive refund checks from the federal government and then have to pay some of those refunds back to cover state income taxes. Ultimately, tax reform should dramatically increase Iowa's child tax credit, consider including a personal exemption, and raise the child/dependent credit to better reflect the cost of raising children. Absent such changes, raising the EITC is the most effective and efficient way to reduce these tax inequities for families with the greatest economic need.

Table 2 provides hypothetical examples of two families in this situation and what they will be paying in federal and state income taxes on their 2011 incomes. As Table 2 shows, these working Iowa families with children receive substantial breaks from the federal government to offset their payroll and other taxes, but Iowa imposes significant income taxes on them. The \$830 in taxes paid by the family with two working parents is 2.4 percent of its income; the \$515 tax on the single-parent family is 2.1 percent of its income. While raising the state Earned Income Tax Credit from 7 percent of the federal credit to 20 percent would not eliminate the Iowa income tax for these families, it would reduce the tax by \$316 for the family with \$35,000 in income and by \$436 for the family with \$25,000 in income, both significant benefits to families with lower levels of income.

Table 2: Hypothetical Working Iowa Families with Children* Who Qualify for the Earned Income Tax Credit

	Federal Tax	Iowa Tax
Married couple family with two children \$20,000 and \$15,000 incomes	\$3,437 refund**	\$830 tax***
Single parent with one child, \$25,000 Income	\$3,444 refund****	\$515 tax

* Assumes families with children have only earned income and take the standard deduction and personal exemptions and credits, including the Earned Income Tax Credit, but have no other special deductions.

** The federal EITC is \$2,320, the remaining part of the refund is from the child tax credit.

*** If the couple had a single \$35,000 income, their taxes would be higher, \$1,197. State figures do not include any school district taxes.

**** The federal EITC is \$3,357, the remaining part of the refund is from the child tax credit.

All calculations done using the 2011 version of H&R Block At Home Basic tax software.

Last year, the General Assembly twice passed a small increase in the Earned Income Tax Credit (from 7 percent to 10 percent). That proposal was vetoed each time by the Governor, on the grounds that making changes to the EITC should be part of more comprehensive tax reform. This year, the EITC needs to be examined in its own right, and it needs to be increased to at least 20 percent of the federal level. This will begin to address the most unfair feature of Iowa's overall tax code — its treatment of working families with children.

¹ Bruner, Charles (2011). *Support for Working Iowa Families: Iowa's Earned Income Tax Credit: Expansion is in Order in 2012*. <http://www.iowafiscal.org/2011research/111229-IFP-EITC.html>.

² In 2010, Iowa collected \$2.438 billion from its resident taxfilers, while the federal government collected \$7.478 billion from Iowans (32.6 percent). The actual overall value of the child and dependent credit on the state income tax for resident filers was \$7.7 million, compared with the value at the federal level of \$38.3 million, or (20.1 percent). Sources: Iowa Department of Revenue. 2009 Iowa Individual Income Tax Annual Statistical Report. <http://www.iowa.gov/tax/educate/09incred.pdf>. United States Internal Revenue Service. Table 2: Individual Income and Tax Data, by State and Size of Adjusted Gross Income, Tax Year 2009. <http://www.irs.gov/taxstats/article/0,,id=171535,00.html>.

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