Iowa Fiscal Partnership

POLICY BRIEF

March 2, 2016
www.iowafiscal.org

The High Cost of Conformity

Coupling with Federal Tax Changes Would Dent Iowa's General Fund

By Peter S. Fisher

Introduction

Late last year Congress passed a law extending various federal income tax deductions and credits that were set to expire and preserving more generous versions of those deductions and credits. If the State of Iowa chooses to "couple" with these changes in federal law, the more generous provisions would be available on Iowa income tax returns wherever Iowa has a corresponding deduction or credit that is specifically tied to the federal credit. If the state does not couple, then those deductions and credits would be available on Iowa state tax returns either at the old rates or levels, or not at all.

The Iowa House passed a bill (HF 2092) that would couple Iowa with all of the federal tax changes (with the exception of something called bonus depreciation) for the 2015 tax year. The changes would be retroactive to January 1, 2015, and so would affect the tax returns that are due this April 30 based on last year's income. (For farmers, taxes are due March 1 if they want to avoid a penalty for underpayment.) The bill does not couple Iowa law with the federal changes for 2016 or beyond, though of course that could be done later this session or early in 2017.

The Department of Revenue has estimated that HF 2092 would reduce current year revenues by nearly $100 million. Because it increases deductions Iowans can take on returns filed this spring, it increases refunds that must be paid this fiscal year and reduces collections. This current-year reduction cuts funds available for the Fiscal Year 2017 budget by nearly $100 million, and thus has an impact on funding for education and other priorities.

By far the most costly provision of the tax change is the so-called "Section 179 expensing" of business assets, where coupling will cost the state $79.8 million, nearly 80 percent of the total cost of the coupling legislation. Six other provisions together produce about $17 million in revenue losses. We discuss each of these provisions in turn.

Expensing Business Assets

Normally, when a business purchases assets such as buildings or machinery, the cost of those assets must be spread over a number of years (in theory, over the useful life of the building or machine). A share of the cost is deducted each year as depreciation. Section 179 of the Internal Revenue Code, however, allows businesses to "expense" some assets — that is, to deduct the entire cost in the first year — instead of deducting annual depreciation. It is usually to a business's advantage to deduct a cost now rather than later.*

Without the federal "extender" legislation, businesses would have been allowed to expense up to $25,000 of assets in 2015. This cap is phased down for businesses with more than $200,000 in total purchases of assets that qualify for 179 expensing. The cap is reduced by $1,000 for every $1,000 in asset purchases above $200,000, so that a business with $225,000 in asset purchases can no longer expense any assets. Though any business can use Section 179 expensing, the cap and phaseout effectively target expensing at smaller businesses, since large businesses will tend to purchase more than $225,000 in assets each year.

The federal legislation extended and made permanent a temporary increase in Section 179 limits to $500,000 in asset purchases in any given year. Furthermore, this limit begins to phase out only when total asset purchases exceed $2 million. By coupling with the federal law, Iowa businesses would be able to expense up to $500,000 in purchases of machinery and equipment, buildings and software for the 2015 tax year, instead of $25,000. Businesses with asset purchases of under $2.5 million would be able to use expensing.

Table 1. Iowa Loses Revenue with Conformity to Changes in Federal Tax Law
Fiscal Year 2016

	$ Millions	Percent of Total
More generous provisions for expensing business assets		
Individual income tax	$ 67.9	69.5%
Corporation income tax	10.0	10.2%
Sub-total	$ 77.9	79.7%
Other corporation income tax provisions	2.5	2.5%
Total: Expensing and other corporate provisions	$ 80.3	82.3%
All other individual income tax provisions		
Excluding from income the discharge of indebtedness on a home	$ 7.4	7.6%
Deductibility of mortgage insurance premiums	3.4	3.4%
Deduction for tuition at a postsecondary institution	2.2	2.2%
Deduction for state and local sales taxes	1.5	1.5%
Tax-free charitable IRA distributions	1.5	1.6%
Deduction for teacher classroom expenses	0.7	0.7%
Six other provisions	0.7	0.7%
Total	$ 17.3	17.7%
Total Fiscal Impact	$ 97.6	100.0%

Source: Letter from Anthony Girardi, Senior Fiscal Policy Analyst with the Iowa Department of Revenue, to Jeff Robinson of the Legislative Services Agency, January 26, 2016.

In the absence of coupling for 2015, Iowa businesses filing taxes this spring can still take full advantage of the federal changes on their Federal returns. The ability to expense a larger share of

* To see why this is so, imagine that expensing a $1,000 machine reduces taxes by $300 this year. (By taking the deduction the business saves the taxes on $1,000 worth of income, so if the marginal tax rate were 30 percent, it saves $300). In future years, the firm will not have depreciation deductions because they were in effect all used up by expensing this year. So future taxes will be higher by the same amount: $300. However, the $300 taken now could be invested and earn interest, with the principal used up gradually to pay the higher taxes in the future. This still leaves the firm ahead by the amount of interest earned.

asset purchases is worth far more in terms of federal tax savings than Iowa tax savings. In the absence of coupling the typical small business† still gets over three-fourths of the combined federal-state tax benefit.

It is also worth emphasizing that this increase in the Iowa expensing provisions has nothing to do with incentives to invest. Taxpayers who would take advantage of it when they file their taxes this spring can do so only for assets purchased last year. Those assets were bought presumably because they were needed at the time and made economic sense for the farm or business, and the purchase decision was made when an enhanced Iowa tax benefit did not exist.

The proposed Iowa provisions have nothing to do with incentives to invest. Affected purchase decisions were made already, without the enhanced tax benefit.

Canceled Home Mortgage

Some homeowners who were unable to make payments on their home during the recent financial crisis had all or a portion of their mortgage debt canceled. If the home was a principal residence and the cancellation occurred after 2006, the amount of principal canceled (up to $2 million) does not have to be added to income for tax purposes. (Normally, a canceled debt is considered a form of taxable income.) The federal bill extended this provision to cancellations that occur through 2016. In the absence of coupling, debt cancellations occurring during 2015 will not qualify for the exclusion in Iowa and the amount of debt canceled will be added to Iowa gross income.

Deductibility of Home Mortgage Insurance Premiums

This provision of the tax law allows the premiums that homeowners pay for mortgage insurance to be counted and deducted as home mortgage interest. The deduction phases out as a taxpayer's adjusted gross income reaches $110,000. This is of benefit only to taxpayers who itemize deductions. The 2015 federal law extended the deduction through 2016. In the absence of coupling, Iowa taxpayers who itemize would not be able to include mortgage insurance premiums paid in 2015 as deductible interest.

Tuition Deduction

Under this provision, taxpayers can deduct up to $4,000 in higher education tuition and related expenses. The deduction is an adjustment to gross income, so it can be taken regardless of whether the taxpayer uses the standard deduction or itemizes. The federal legislation extended this deduction through 2016.

Deduction for State and Local Sales Taxes

Federal taxpayers have in recent years had the option of claiming an itemized deduction for state and local income taxes, or for state and local sales taxes, but not both. The taxpayer can deduct actual sales taxes paid or use a schedule of deductible taxes specified by the IRS. The sales tax option was set to expire but was made permanent by the 2015 federal law. The Iowa law allowing Iowa itemizers to choose the sales tax deduction instead of an income tax deduction, if they chose

† An Iowa small business or farm with taxable income (after all deductions and exemptions) of $50,000-$65,000, for example, would be in the 7.92 percent Iowa tax bracket but the 25 percent federal bracket. The new federal expensing provision is thus worth over three times the Iowa provision.

the sales tax deduction on their federal return, has expired. HF 2092 would extend the provision to 2015. In the absence of this bill, Iowa taxpayers who itemize and who take the federal sales tax deduction instead of the income tax deduction, will not be able to deduct state and local sales taxes on their Iowa return.

IRA Charitable Distributions

Individuals who are at least 70½ years of age and who have a distribution from an IRA go directly to a charitable organization can avoid paying any income taxes on that distribution. The distribution, up to $100,000 per taxpayer, is excluded from income. The 2015 federal legislation extended this provision permanently. Coupling would allow Iowa taxpayers to exclude the distribution from Iowa taxable income. It should be noted that the advantage of this provision is not as large as it may appear; a taxpayer may still take the IRA distribution personally, and then use the proceeds to contribute to a charitable organization and deduct that when itemizing Iowa deductions.

Deduction for Classroom Expenses

Elementary and secondary school teachers may deduct up to $250 in classroom and professional development expenses. This is an adjustment to gross income, so it is of benefit whether or not the teacher itemizes deductions. This deduction was set to expire, but the 2015 federal legislation made it permanent. In the absence of coupling, Iowa teachers would not be able to take this deduction on their 2015 Iowa return. Note that the maximum effect, for a teacher in the 8.98 percent tax bracket with $250 in deductible expenses, is $22.45.

Bonus Depreciation

Federal bonus depreciation has allowed business with larger asset purchases that are unable to take full advantage of Section 179 expensing because of the phaseout, to take additional first year depreciation on qualified asset purchases. Iowa has not coupled with bonus depreciation in the past, and this bill excludes it from coupling. In the absence of the bill, Iowa taxpayers would still not be able to use bonus depreciation on their Iowa returns. For that reason, there is no fiscal impact associated with the bonus deprecation provision of HF2092.

Fiscal Impacts Beyond FY2016

Should Iowa couple with all of the federal changes (except bonus depreciation) in future years, we can expect the fiscal impact to be similar. However, HF2092 couples only for tax year 2015. As a result, the fiscal effect of the bill for 2016 and beyond is positive rather than negative. This is because the additional Section 179 expensing that will occur for 2015 as a result of coupling will automatically increase state revenue over the next several years. A business can deduct the cost of a business asset only once; any asset expensed in 2015 does therefore not generate a depreciation deduction in 2016 or later. In the absence of coupling, the business would be depreciating that asset over several years, spreading the reduction in its tax liability (and the state revenue loss) over those years.

An Alternative Approach to Coupling

The Department of Revenue has drafted a bill that would couple with most of the tax credits extended by the 2015 federal legislation. A major difference with HF2092 is that this bill (SSB3107) would not couple with those changes retroactively, but would start in 2016. The changes would be permanent. Most importantly, this bill does not couple with either bonus depreciation or the enhanced version of section 179 expensing.

The Department of Revenue has not produced a fiscal impact estimate for this bill. However, the overall cost in FY2017 would be just a fraction of the FY2016 estimate for HF 2092 because the most costly component of the House bill — section 179 expensing — is not included in SSB 3107.

Conclusion

Federal coupling legislation has been portrayed as little more than an accounting change designed to make it easier to file taxes this spring, and to encourage new investment, but that is not really the impact of the federal coupling legislation that has been proposed in the House. The bulk of the benefits are essentially bonuses to specific taxpayers for decisions they already made, with a significant cost that affects revenues available for the coming fiscal year.

Legislators must decide if the boon to specific Iowans is more important than improving the lives of Iowans in general by doing such things as funding schools and other General Fund items with the revenue otherwise lost.

Peter S. Fisher *is Research Director for the Iowa Policy Project. He holds a Ph.D. in economics from the University of Wisconsin-Madison and is professor emeritus of Urban and Regional Planning at the University of Iowa. A national expert on public finance, Fisher is frequently quoted in the Iowa and national media on issues involving tax policy and economic development strategies. His two published critiques of various state business climate rankings have resulted in a new website, Grading the States, at www.gradingstates.org.*

Iowa Fiscal Partnership

The Iowa Fiscal Partnership (IFP) is a joint budget and tax policy initiative of two nonpartisan, Iowa-based organizations, the Iowa Policy Project in Iowa City and the Child & Family Policy Center in Des Moines. IFP is part of the State Priorities Partnership, http://statepriorities.org, a network of nonpartisan organizations in 41 states and the District of Columbia that share a commitment to rigorous policy analysis, responsible budget and tax policies, and a particular focus on the needs of low- and moderate-income families. IFP research is supported by the Stoneman Family Foundation and by the Annie E. Casey Foundation. Policy conclusions are the responsibility of the Iowa Policy Project and the Child & Family Policy Center and not necessarily the view of either the Stoneman Family Foundation or the Annie E. Casey Foundation. Iowa Fiscal Partnership reports are available to the public at http://www.iowafiscal.org.