

Passing through a special break for wealthiest filers

Qualified Business Income Deduction (QBID) adds complexity, cost

By Charles Bruner for the Iowa Fiscal Partnership

The tax bill that recently passed the Iowa Senate included a provision from the recent federal tax cut bill that provides preferential tax treatment for certain kinds of business income earned mostly by the highest income taxpayers. The “Qualified Business Income Deduction” (QBID) provides a 20 percent exemption of that income from the personal income tax. This is one of the most complicated and least understood provisions in the federal legislation, and one of the most amenable to manipulation. It also is one of the costliest and is skewed to very high-income tax filers. It applies to income (known as pass-through income) from partnerships and other non-corporate businesses reported on the individual income tax. The federal QBID alone is estimated to account for over one-third of the total costs of the federal tax bill by 2023, and could be more as tax accountants and attorneys seek ways to maximize the QBID benefits.¹

This complicated, poorly understood, and most easily manipulated ‘pass-through’ provision is costly and skewed to very high-income filers.

The pass-through deduction was included in the tax that bill passed the Iowa Senate on March 1 (SF2383) with the same 20 percent exemption from income that exists in the federal law. Governor Reynolds’ proposal (HSB671) provides for a 5 percent exemption.

The Iowa Department of Revenue (DOR) provided an estimate to the Iowa Legislative Services Agency (LSA) on the cost and distribution of this one change to Iowa’s income tax system.² That analysis shows the cost of the full 20 percent exemption to income tax revenues would be \$106.7 million in FY2019, rising to \$118.0 million in FY2020. In FY 2019, \$54.9 million (51 percent) would go to the 5 percent of tax filers with adjusted gross incomes over \$200,000 — extremely skewed toward very high-income individuals.

Since the Governor’s proposal offers a QBID or “pass-through,” of 5 percent, its impact would be about one-quarter of the Senate plan, but still over \$25 million a year. Further, these estimates do not reflect any large growth in the size of such pass-through income, but some tax experts are concerned that the presence of the deduction will lead to substantially more transfer of income to pass-through income from income taxed at the standard rate.

The Institute on Taxation and Economic Policy (ITEP), which models the state and federal tax codes, came up with a similar estimate: \$108 million. The table below shows ITEP’s estimates of the benefits of the QBID by household income for Iowa residents.³

Pass-Through Plan: Benefit Mostly to Richest 5 Percent of Iowa Households

Iowa Resident Taxpayers, by Total Household Income

Share of Iowa Taxpayers	Income Range	Average Income	Percent with Tax Cut	Average Tax Cut*	Percent of Total Cuts
Bottom 20%	Under \$25,000	\$ 14,000	5%	\$ (40)	1%
Second 20%	\$25,000-\$43,000	\$ 35,000	3%	\$ (30)	0%
Middle 20%	\$43,000-\$65,000	\$ 53,000	10%	\$ (84)	2%
Fourth 20%	\$65,000-\$105,000	\$ 82,000	9%	\$ (224)	6%
Next 15%	\$105,000-\$191,000	\$ 134,000	22%	\$ (277)	12%
Next 4%	\$191,000-\$426,000	\$ 265,000	43%	\$ (1,613)	38%
Top 1%	\$426,000 or more	\$ 1,065,000	75%	\$ (3,996)	41%

*Among those with a cut. The average cut for all resident taxpayers would be the percent receiving the tax cut times this average size, about \$22 in the fourth 20 percent and \$3,000 in the top 1 percent.

a continuing benefit for those filing on income from a subchapter S corporation, limited partnership, or sole proprietorship through the individual income tax. (The top tax rate on the personal income tax is higher, remaining above 35 percent). In Iowa, however, the top corporate income tax rate remains above the individual income tax rate (and corporate income, unlike individual income, is taxed both through the corporate income tax and shareholder taxes on dividends). Thus, the federal rationale simply does not hold within Iowa's tax system.

Other arguments made for the federal exemption are to provide incentives for entrepreneurship. Even these arguments, however, are harder to make when applied to Iowa's income tax, as tax filers already will receive the substantial federal break, even without an additional but much smaller Iowa exemption. Further, a disproportionate share of the Iowa benefit is likely to accrue to wealthy, nonresident tax filers, who make a share of their profits in Iowa but don't live in the state. Moreover, the state of Kansas abandoned its recent experiment exempting 100 percent of pass-through income after it failed to produce measurable increases in new business formation while costing the state millions in lost revenue.⁴

Adopting any QBID would reduce overall Iowa income tax revenue, disproportionately benefiting the wealthiest, and with considerable uncertainty surrounding its use (and misuse) in the future. More experience with the use of this break and its costs at the federal level would give state lawmakers a better understanding of who benefits, how they benefit, and any public purpose.

¹ The Joint Committee on Taxation (which provides official fiscal notes on federal tax legislation) estimates the federal cost of the QBID provision is \$47.1 billion for tax year 2019, or 24.9 percent of overall personal income tax costs of changes in the income tax code. This grows as a share of costs to 37.2 percent in tax year 2023. Joint Committee on Taxation. JCX-67-17 (December 18, 2017) Estimated Budget Effects of the Conference Agreement For H.R.1, "Tax Cuts And Jobs Act."

<https://www.jct.gov/publications.html?func=startdown&id=5053>

² Letter to Jeff Robinson and Legislative Services Agency from John Good, Iowa Department of Revenue

³ The Iowa Department of Revenue also provided a distributional table, but for residents and non-residents combined, with married couples filing separately reported as separate tax filers instead of as a household, and by adjusted gross income rather than total family income. The ITEP estimates provide a more accurate view of how the benefits are distributed among residents by total household income.

⁴ Michael Mazerov. "Kansas Provides Compelling Evidence of Failure of Supply Side Tax Cuts. Center on Budget and Policy Priorities, Jan. 22, 2018. <https://www.cbpp.org/research/state-budget-and-tax/kansas-provides-compelling-evidence-of-failure-of-supply-side-tax-cuts>

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The primary rationale for this provision at the federal level is that the reduction in federal corporate income tax rates from 35 percent to 21 percent requires some adjustment in individual income tax rates for pass-through business income to provide