Common Good **Iowa**
Bold Policy for Families & Communities

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Reckless tax policy proposals would make Iowans pay twice

Senate, House bills jeopardize half a billion dollars in COVID relief, recovery

Legislation is advancing in both houses of the Legislature that — already costly, as well as shaky on principles of sound tax policy — could cost the state hundreds of millions of dollars in federal pandemic relief and recovery funding. Among those bills:

- **Senate File 576,** which has passed the Senate, would both phase out Iowa's inheritance tax, giving a preference to those with income from inherited wealth instead of earned income, through work, and accelerate income tax cuts that were approved to take effect only after Iowa reached established revenue targets.
- **House File 841,** which would reduce the already severely limited application of the inheritance tax and then eliminate it, at a cost of over $90 million a year.
- **Senate File 587,** which entails a wide range of tax policy and funding changes, including an acceleration of the income-tax cuts, but has gained more attention for its changes to mental health funding and eliminating the state backfill for property-tax cuts.

In addition, various other proposals on tax credits cause net tax revenue reductions in the next 3 1/2 years, and will come at **twice their stated price tag**. This is where the new federal COVID relief and recovery law comes in.

Federal COVID relief may not pay for state tax cuts, but does not prohibit them

The American Rescue Plan Act, which will provide an estimated $1.38 billion in state relief to Iowa for various approved uses, has a caveat: Any changes in law that cause revenue cuts (tax cuts) during the covered period of March 3, 2021, through Dec. 31, 2024, will reduce the COVID relief by the same amount. Here is the language in the law:

> "A State or territory shall not use the funds ... to either directly or indirectly offset a reduction in the net tax revenue of such State or territory resulting from a change in law, regulation, or administrative interpretation during the covered period that reduces any tax (by providing for a reduction in a rate, a rebate, a deduction, a credit, or otherwise) or delays the imposition of any tax or tax increase."

The law goes on to order that any state failing to comply will have to repay "the amount of the applicable reduction to net tax revenue attributable to such violation." In other words, a clawback of the COVID relief equaling the state tax reduction.

It is inaccurate — but a common argument by politicians opposing the American Rescue Plan — to claim that the provision bars states from making tax cuts. Senator Joni Ernst promoted that argument in late March.[1] Rather, the plain language of the law conditions Rescue Plan funds on an assurance that the money is not used to offset state tax cuts. Conditions placed on the acceptance and use of federal funds are routine, and done for accountability. States can still make choices but there will be consequences — fewer dollars.

To learn more, contact deputy director Mike Owen (mowen@commongoodiowa.org)

Senate-passed bills include significant, new net tax cuts

SF576 makes a net revenue cut of $458.7 million from FY2022-24.[2] Unless offsetting revenue increases are passed, that impact of lost revenue is doubled by the loss of federal COVID support in the same amount. That adds up to a total loss to the state coffers of over $900 million, from that one bill alone.

SF576 includes both of the key provisions that are included in other ways in other bills:

- **Inheritance tax phaseout**: Iowa's inheritance tax already fully exempts lineal relatives (children, grandchildren, parents). Phasing out the state inheritance tax for siblings, cousins and other relatives — and nonrelatives, nonresidents and corporations — would cost $17.9 million in FY2022, $40.8 million in FY2023, $65.3 million in FY2024.[3] (Full repeal is expected to cost $102.3 million in FY2027 and similar levels beyond that year.)
- **Accelerating future scheduled tax cuts**: In 2018, lawmakers approved "revenue triggers" that would ignite reductions in tax rates. SF 576 would repeal those triggers — new action that puts lower tax rates into effect Jan. 1, 2023, and reduces revenue. These triggers in individual and corporate income taxes, and the bank franchise tax, would cost an estimated $154.6 million in FY2023 and $180.1 million in FY2024.[4]

We focus here on FY2022 through FY2024 because those fiscal years are totally within the "covered period" of the federal COVID relief package and those tax revenue cuts are projected to be $458.7 million. A share of $121.6 million in tax cuts in FY2025 also would be counted.

Official guidance from the Treasury Department should provide clarity of the impact of the law — one reason to wait to make any changes. But there are other reasons.

The inheritance tax cuts are irresponsible and ignore ability to pay

From a fiscal standpoint as noted above, the inheritance tax proposals are expensive, and combined with the ARP provisions doubling their impact, are an irresponsible waiver of funding that could be used to enhance Iowa's recovery from the still-spreading COVID pandemic or to fund schools as we used to fund them.

They also fail standards of responsible tax policy. The eventual repeal of the inheritance tax, in SF576 and HF841, takes Iowa further away from a central tenet of tax fairness — the equitable tax treatment of income for similarly situated taxpayers. If an Iowan derives $50,000, or $500,000, in a given year from work or from an inheritance or from investments, the most equitable treatment would be to ignore the source of income and focus on the amount.

Already, current law assures that immediate family members receive all bequests up and down the family line without a dime in state tax. These generous inheritance tax exemptions already protect family wealth. The changes would give shirttail relatives, nonrelatives — even nonresident nonrelatives and out-of-state corporations — tax-free windfalls.

More attention should be focused on equity impacts resulting from the amount of new inheritance exemptions, rather than equity in who gets them. Good tax policy should focus on the obligation of those who have better ability to pay for public services. Already, current exceptions to the inheritance tax excuse lineal relatives from that obligation no matter the size of the estate or inheritance. Phaseout or repeal extends that benefit to people who may have had nothing to do with the creation of the one-time income — much of which may never have been taxed to the person who earned it — while others at similar incomes from wages receive no such benefit.

As a Department of Revenue analysis in 2019 showed, the state derives significant revenue from the inheritance tax from large estates — more than half of inheritance tax receipts came from the top one-fifth of estates, which averaged in size near or above $3 million, each year from 2014-18.[5] "The distribution of inheritance tax liability demonstrates a high concentration in the largest estates," the department reported. A smaller share of all estates — the wealthiest — produces the largest share of inheritance tax revenue. Repeal of the inheritance tax would remove one of the few progressive elements of Iowa's tax system, as the overall tax system of income, sales and property tax requires lower- and middle-income earners to pay a larger share of income in tax than high-income taxpayers.

▶ The income-tax cuts are expensive and promoted on faulty grounds

What the trigger repeal proposals ignore is the very real possibility, especially with the boost to the economy that will be coming with the federal ARP assistance, that the triggers will be met in Fiscal Year 2022. This would make the repeal legislation unnecessary. The Revenue Estimating Conference last month projected the state would meet one trigger — revenue exceeding about $8.135 billion — but narrowly miss the other one, projecting 3.8 percent growth in general fund revenue, when 4 percent is needed.

The coming income tax cuts — which are scheduled to happen when revenue expectations are reached without the artificial boost of repealing those "triggers" — rest on inaccurate representations about Iowa taxes, denying the undeniable fact that Iowa taxes remain below average for business, and have been cut repeatedly for individuals, particularly high-income individuals. At the same time, critical services, including education, have been chronically shortchanged.

Iowa needs more fairness in its tax system. Slashing revenues regardless of the impacts on public services is not sustainable for a state that wants to lure — let alone keep — families and good, clean businesses.

For immediate purposes, the revenue loss created by either the affirmative repeal of the triggers — or by the revenue targets being reached naturally — means a significant cut in resources that could be used to fund public services across the board, from education, to human services, to environmental quality, to public health and safety. The "triggered" cuts in tax rates are the second part of a process set in motion in 2018 with an income-tax package that already is costing the state revenue.

▶ Return the focus to principles of fairness and revenue adequacy

Iowa needs more fairness in its tax system. Slashing revenues regardless of the impacts on public services is not sustainable for a state that wants to lure — let alone keep — families and good, clean businesses.

We already knew Iowans would pay for this approach. Now, with a reduction of anticipated help in the COVID recovery from the federal government, we may pay doubly for it.

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[1] Senator Joni Ernst, news release, March 29, 2021. https://www.ernst.senate.gov/public/index.cfm/press-releases?id=84CCDC4E-993D-4A2A-A699-9AC1032979A1

[2] Iowa Legislative Services Agency, Fiscal Note for SF576, April 5, 2021.

[3] Ibid.

[4] Ibid.

[5] Department of Revenue letter to Jeff Robinson, Legislative Services Agency, March 2019. Table 2, page 11. The table notes that information for 2018 was incomplete.

Common Good Iowa is a nonpartisan, nonprofit organization built on the collective 50 years of experience of the Child and Family Policy Center and Iowa Policy Project. Common Good Iowa informs policymaking to turn Iowa values into concrete solutions that advance opportunity for all Iowans. Learn more at **www.commongoodiowa.org**.