Iowa's Claim of Right Tax Credit

Tax Credits Program Evaluation Study

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By
Angela Gullickson

Tax Research and Program Analysis Section
Iowa Department of Revenue

Preface

During the 2005 Legislative Session the Iowa Department of Revenue received an appropriation to establish the Tax Credits Tracking and Analysis Program to track tax credit awards and claims. In addition, the Department was directed to perform periodic evaluations of tax credit programs. This is the first evaluation study completed for this administrative tax credit.

This study and other evaluations of Iowa tax credits can be found on the Tax Credits Tracking and Analysis Program web page on the Iowa Department of Revenue website.

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I. Introduction

The Claim of Right (COR) Tax Credit went into effect for tax years beginning on or after January 1, 1996. A taxpayer is eligible for the COR Tax Credit if they were required to repay income in the current tax year that was reported and taxed on a prior Iowa tax return. The tax credit is refundable and cannot be transferred to another taxpayer. The tax credit can only be claimed against individual income tax.

Section II of this study provides information about the COR Tax Credit. Section III discusses if the federal government and other states offer a similar Claim of Right Tax Credit. Section IV looks at the statistics related to the Claim of Right Tax Credit and the related income tax deduction. Estimates of the amount of income repaid will also be provided in Section IV. The study will conclude in Section V.

II. Claim of Right Tax Credit

The Claim of Right Tax Credit is considered an administrative tax credit because its existence allows taxpayers to not pay Iowa individual income tax on taxable income that they received in one year but ended up repaying in another year. To make a COR Tax Credit claim, the taxpayer is only required to report the claim on the IA 148 Tax Credit Schedule. There is no additional tax credit form where the taxpayer provides the reason for the income repayment underlying the claim, required to claim the tax credit. Therefore, there is little data available as to why taxpayers repay income and thus become eligible for the tax credit. Based on voluntary information reported on reviewed returns, types of income that are repaid and thus generate a COR Tax Credit claim are disability payments and pension payments.

To calculate the tax credit, the income tax liability for the prior tax year when the income was first reported must be recomputed without the repaid income. The difference between tax paid in the prior tax year and the recomputed tax that was calculated is the amount of the COR Tax Credit that can be claimed.

As an alternative to claiming the COR Tax Credit, taxpayers also have the option of reporting the amount of repaid income as an adjustment to their income in the tax year when the income was repaid on Line 24 of the IA 1040. Instead of claiming a tax credit for the amount of tax that was paid on the income in a prior year, the returned income is subtracted from the taxpayer’s adjusted gross income in the later tax year. Under the progressive individual income tax rates in Iowa, if the taxpayer’s marginal tax rate was higher in the year when the income was first received than the marginal tax rate in the tax year in which the income was repaid, the COR Tax Credit would be of greater advantage to the taxpayer. Alternatively, if the taxpayer’s marginal tax rate is higher in the tax year the income was repaid, the deduction from income would be of greater advantage than the tax credit. The taxpayer can choose whether to claim either the deduction or the tax credit, but they cannot claim both.

The Claim of Right Tax Credit is refundable, which means if the tax credit exceeds the tax liability in the tax year of claim, the taxpayer will receive a refund. The tax credit is only available to be claimed against individual income tax.

III. Claim of Right Tax Credits in the United States

Under federal individual income tax law, either a federal Claim of Right Tax Credit or a deduction is allowed. In order to take the federal COR Tax Credit the amount of income repaid must exceed $3,000. If the amount of income repaid is less than $3,000 then the taxpayer must use the income deduction.

The type of deduction allowed in the year of repayment depends on the type of income included in the earlier year. In most cases, the taxpayer deducts the repayment on the same form or schedule on which they previously reported it as income. For example, if the income was reported as self-employment income or farm income, then it should be deducted as a business expense on Schedule C (Form 1040) or Schedule F (Form 1040). If the income was reported as a capital gain, it should be deducted as a capital loss on Schedule D (Form 1040). If the income was reported as wages, unemployment compensation, or other nonbusiness income such as pension or disability income, then it should be deducted as a miscellaneous itemized deduction on Schedule A (Form 1040).

To determine if the amount repaid exceeds $3,000, the taxpayer is allowed to combine all income repaid if multiple types of income were repaid during the tax year; repayment amounts do not need to be considered separately. If the amount of income repaid exceeds $3,000, then the taxpayer should calculate the amount of the federal COR Tax Credit as well as the income deduction and compare the results. The taxpayer should select the method that results in paying the least amount of tax.

Similar to federal tax law, Iowa also allows for taxpayers to claim either the COR Tax Credit or to claim a deduction. However, unlike federal law, Iowa does not have a threshold of repaid income to become eligible to claim the tax credit. In Iowa the taxpayer is always allowed to determine whether taking the deduction or the COR Tax Credit is to their advantage.

States have several different ways of handling income taxed in a prior that was subsequently repaid. This study focuses on how the states neighboring Iowa handle repaid income. Like Iowa, Wisconsin also allows a deduction or a tax credit (the Repayment Credit). Illinois and Nebraska allow only an income tax deduction. South Dakota does not have an individual income tax, so the issue is not relevant to their tax system. Alternatively, Minnesota and Missouri do not allow a deduction from income or a tax credit, thus those states do not recognize the repayment of income for tax purposes.

IV. Analysis of Claim of Right Tax Credit Claims and Claim of Right Income Deductions

A. Tax Credit Claims and Income Tax Deductions

While the COR Tax Credit has been available to be claimed since the 1996 tax year. Information about those claims has only been available since the 2006 tax year when the IA 148 Tax Credit Schedule was implemented. Since 2006, there have been nearly 300 claims totaling almost $290,000 (see Table 1). Annual claims average $31,799 each tax year. On average, 32 taxpayers claim the COR Tax Credit each year with an average claim of $985. If it is assumed these taxpayers were subject to the highest marginal income tax rate in the year in which the income was first taxed, the repaid income associated with the average claim is $10,969.

Detailed information about the Claim of Right income tax deduction has only been available since the 2012 tax year when Modernized E-Filing was implemented. Therefore, only detailed information is available for returns that were filed electronically. During tax years 2012 through 2014, electronically-filed returns accounted for 85 to 90 percent of filed returns. On average, 228 income tax deductions are taken each year (see Table 2). It should be noted that this number is heavily driven by a large number of deductions in tax year 2012. In 2013 and 2014, the number of deductions averaged only 52 deductions. The average deduction between tax years 2012 and 2014 was $3,665.

If the income claimed for the average Claim of Right income tax deduction was originally taxed at the highest individual income marginal tax rate of 8.98 percent, the equivalent amount of the COR Tax Credit would be $329. Recall, taxpayers are instructed to use the deduction or tax credit, whichever results in a lower tax liability. Based on the estimated $10,969 in repaid income associated with the average COR Tax Credit claim to the average $3,665 Claim of Right income tax deduction, it appears that taxpayers who have repaid larger amounts of income choose to claim the COR Tax Credit instead of take the income tax deduction.

The majority of COR Tax Credit claims and deductions are claimed by taxpayers with an adjusted gross household income less than $80,000 (see Figure 1). However, the distribution of taxpayers with COR Tax Credit claims and deductions does skew more toward incomes over $30,000 than the rest of Iowa households filing individual income tax returns.

B. Estimate of Repaid Income Claimed Annually in Iowa

As noted in Section II, some states offer no tax adjustments when income taxed in a prior year is repaid while Iowa offers two. This suggests that although the tax credit and associated deduction are considered administrative, they are not necessary tax expenditures. Therefore, it is instructive to estimate how much repaid income Iowans report each year and an estimated total tax expenditure for these adjustments. Using the limited data, that estimate can be done for tax years 2012 and 2013 by combining the Claim of Right income tax deductions and tax credits.

While Claim of Right Tax Credit claims are captured from all individual income tax returns, recall that data for income tax deductions are only available on electronically-filed returns. To account for the income tax deductions reported on paper returns, the estimated number of deductions was increased by the share of paper returns filed in the respective calendar year, assuming the number of deductions on paper returns is proportionate to the number on electronic returns and the average amount of the income tax deduction matches that reported on electronic returns (see Table 3). This suggests $3.0 million in total income tax deductions were reported in tax year 2012 and $0.3 million in tax year 2013.

The amount of repaid income associated with the COR Tax Credits claims must be estimated, because it is not known what marginal tax rate the taxpayer faced in the year when the income was first reported. Using taxable income reported in the year of the tax credit claim, the applicable marginal tax rate for that tax year was estimated. Taxpayers were assumed to have faced the same marginal tax rate in the year the income was first reported. To calculate the amount of repaid income that marginal tax rate was multiplied by the amount of the COR Tax Credit claim. Based on these calculations it is estimated that $1.6 million in repaid income was associated with tax credit claims in tax year 2012 and $0.8 million in tax year 2013 (see Table 4).

Summing over the repaid income associated with the COR Tax Credits and income tax deductions results in total annual repaid income of $4.6 million in tax year 2012 and $1.2 in tax year 2013 (see Table 4). Notice that 2012 is quite a bit higher than the amount of income estimated to have been repaid in 2013. However, with only two years of complete data available, it is uncertain which of the two years is typical. Additional years of data will provide a clearer understanding of the true revenue impact of these provisions in a typical tax year.

While it is interesting to estimate the amount of income that is repaid in a given year, it is more useful to estimate the fiscal impact to the General Fund. It is easy to determine the fiscal impact of the tax credit as the amount is equal to the amount of refundable tax credits that are claimed in a tax year. However, the fiscal impact of the income tax deduction needs to be estimated. Using the estimated total amount of income deductions from Table 3, the repaid income can be allocated among household adjusted gross income (AGI) based on the known allocation of claims from electronically filed returns. The average marginal tax rate associated with the AGI groups is then used to estimate the amount of tax that would have been paid on the estimated income deductions. Based on this methodology, the estimated General Fund impact of the claim of right deduction was $0.2 million in 2012 and just over $12,000 in 2013 (see Table 5). Combining the impact of the tax credit and the deduction results in decreased General Funds of approximately $0.3 million in 2012 and $33,000 in 2013.

V. Conclusion

The Claim of Right Tax Credit is an administrative tax credit that allows taxpayers to receive credit for taxes paid in a prior year on income that the taxpayer ended up repaying in a later tax year. As an alternative to the tax credit, taxpayers can elect to reduce their current year income by the amount of prior year income repaid. In the two years that were able to be fully evaluated, it was determined that the overall estimated impact of these two provisions is relatively small, ranging from -$33,000 to -$0.3 million. Although the difference between the two available years is quite large, because there are only two years with complete information it is not clear which year is closer to an average year. That will become clearer once more data is available.

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Tables and Figures

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Table 1. Claim of Right Tax Credit Claims, Tax Years 2006 – 2014

Tax Year	Number of Claim of Right Tax Credit Claims	Amount of Claim of Right Tax Credit Claims	Average Claim of Right Tax Credit Claim
2006	19	$12,071	$635
2007	21	$17,930	$854
2008	47	$39,498	$840
2009	26	$40,879	$1,572
2010	33	$40,851	$1,238
2011	36	$26,713	$742
2012	46	$61,717	$1,342
2013*	34	$21,304	$627
2014*	17	$15,531	$914
Total	279	$276,494	
Average	31	$30,722	$974

* Tax year incomplete

Source: Iowa Department of Revenue, IA 148 Tax Credit Schedule

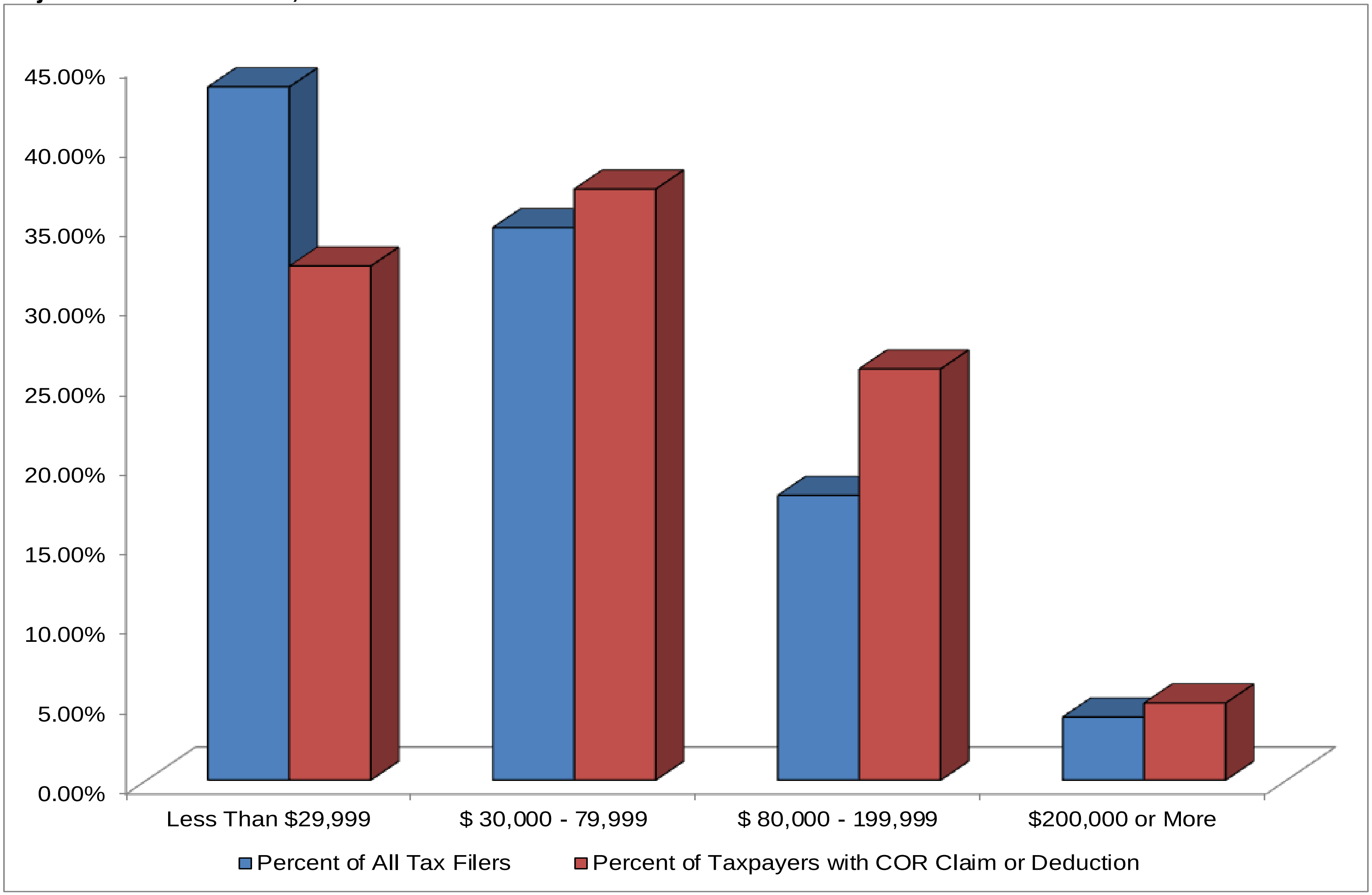
Table 2. Claim of Right Income Tax Deductions, Tax Years 2012 - 2014

Tax Year	Number of Claim of Right Income Tax Deductions	Amount of Claim of Right Income Tax Deductions	Average Claim of Right Income Tax Deduction
2012	708	$2,603,480	$3,677
2013	81	$284,525	$3,513
2014*	51	$215,816	$4,232
Total	840	$3,103,821	
Average	280	$1,034,607	$3,695

* Tax year incomplete

Source: Iowa Department of Revenue, IA 1040 Individual Income Tax Returns

Figure 1. Percent of Taxpayers with a Claim of Right Deduction or Tax Credit Compared to All Tax Filers by Adjusted Gross Income, Tax Years 2012 and 2013



Source: Iowa Department of Revenue, IA 1040 Individual Income Tax Returns and IA 148 Tax Credit Schedule

Table 3. Estimate of Claim of Right Income Tax Deductions, Tax Years 2012 - 2013

Tax Year	Known COR Deductions from Electronic Returns	Number of Claim of Right Income Tax Deductions	Percent of Returns Filed Electronically	Estimated Number of Paper Filed Returns with Deductions	Average Claim of Right Income Tax Deduction	Estimated COR Deductions from Paper Returns	Estimated Total COR Deductions
2012	$2,603,480	708	87%	106	$3,677	$389,026	$2,992,506
2013	$284,525	81	89%	10	$3,513	$35,166	$319,691

Source: Iowa Department of Revenue, IA 1040 Individual Income Tax Returns

Table 4. Estimate of Income Repaid by Taxpayers Claiming Claim of Right Deductions and Tax Credits, Tax Years 2012 - 2013

Tax Year	Number of Taxpayers with COR Deductions	Estimated Total COR Deductions Equal to Income Repaid	Number of Taxpayers with COR Tax Credit Claims	Estimated Income Repaid by COR Tax Credit Claimants	Total Number of Taxpayers	Total Estimated Income Repaid
2012	814	$2,992,506	46	$1,579,341	860	$4,571,847
2013	91	$319,691	34	$838,727	125	$1,158,418

Source: Iowa Department of Revenue, IA 148 Tax Credit Schedule and IA 1040 Individual Income Tax Return

Table 5. Estimated General Fund Impact of Claim of Right Tax Deduction and Tax Credit, Tax Years 2012 - 2013

Household Adjusted Gross Income	Estimated Amount of Income Tax Deductions	Average Marginal Tax Rate	Estimated General Fund Impact of COR Deductions	General Fund Impact of Claim of Right Tax Credit Claims	Total Estimated General Fund Impact
			2012		
Less Than $29,999	$112,686	2.95%	-$3,328	-$18,473	-$21,801
$ 30,000 - 79,999	$409,951	6.45%	-$26,450	-$11,324	-$37,774
$ 80,000 - 199,999	$1,570,284	7.70%	-$120,865	-$14,955	-$135,820
$200,000 or More	$899,585	8.84%	-$79,514	-$16,965	-$96,479
	$2,992,506		-$230,157	-$61,717	-$291,874
			2013		
Less Than $29,999	$202,424	1.64%	-$3,324	-$8,501	-$11,825
$ 30,000 - 79,999	$39,280	6.65%	-$2,611	-$10,388	-$12,999
$ 80,000 - 199,999	$70,439	7.72%	-$5,440	-$1,389	-$6,829
$200,000 or More	$7,548	8.98%	-$678	-$1,026	-$1,704
	$319,691		-$12,053	-$21,304	-$33,357

Source: Iowa Department of Revenue, IA 148 Tax Credit Schedule and IA 1040 Individual Income Tax Returns