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[HF 352](#) – Pass-Through Business Entity Tax and Deduction (LSB1209HV)  
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Fiscal Note Version – New

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**Description**

[House File 352](#) creates a new voluntary pass-through entity income tax (PTE tax) to be paid by partnerships and Subchapter S Corporations (S Corporations) business pass-through entities.

The Bill also creates a new income tax credit to be passed through to the individual owners of a partnership or S Corporation that has elected to pay the PTE tax. The credit is equal to the amount of PTE tax paid by the entity, and the credit is distributed to the entity's owners in the same proportion that income of the entity is distributed to its owners. The credit, to be used by the entity's owners and not the entity itself, is not refundable, but any remaining credit may be used by the taxpayer for up to five additional tax years or until fully utilized, whichever occurs first.

The Bill is effective upon enactment, and the new PTE tax and tax credit apply to tax years (TY) 2022 through 2025.

**Background**

Pass-through entities such as partnerships and S Corporations are generally not subject to federal or State income tax. Instead, the income generated by the entities is passed through to the owners of the entities, where it becomes income to the entities' owners.

Federal legislation enacted in 2017 increased the standard deductions and limited the amount of State and local taxes (property tax and either income or sales tax) a taxpayer may deduct in a tax year from the taxpayer's income for federal tax purposes.

The increased standard deduction changed a significant percentage of taxpayers from itemized deduction filers to standard deduction filers. For standard deduction filers, the amount of State and local taxes paid does not enter into the calculation of federal income taxes. For itemized deduction filers, any amount of State and local taxes above \$10,000 (\$5,000 for married taxpayers filing separate returns) does not enter into the calculation of federal income taxes. The portion of the 2017 federal tax legislation that created the State and local tax (SALT) limit expires at the end of calendar year 2025.

This Bill is a SALT limit workaround that would allow certain individual income taxpayers (owners of partnerships and S Corporations who make a voluntary election) to pay an Iowa income tax through their pass-through partnerships and S Corporation businesses. That State PTE tax would be treated as a business expense, which would lower the taxable income that flows out of the pass-through entity to the individual tax returns of the owners of the pass-through entities. The Bill also provides a tax credit in the amount of the Iowa PTE tax paid, and that tax credit is split between the owners of the pass-through entity to be used when filing individual income tax returns. In this manner, the entity owners are allowed to deduct State taxes at the entity level that would be useless to them for federal income tax purposes if the taxes were paid at the individual income tax level.

## Assumptions

Note: For this **Fiscal Note**, partnerships and S Corporation pass-through entities are referred to as “PTE businesses,” and the owners of the PTE businesses are referred to as “owners” and “taxpayers.”

General fiscal impact considerations include the following:

- The federal SALT deduction limitation workaround contained in this Bill will lower the income distributed by PTE businesses for federal tax purposes (if the PTE makes the voluntary election), and this will lower the federal individual income taxes owed by the PTE taxpayers.
- Since distributed PTE business income for federal tax purposes is also used as income for Iowa income tax calculations, the Bill will also lower the taxpayers’ Iowa income tax.
- In addition to the lowered income for State tax purposes, the taxpayers will also receive a tax credit equal to 100.0% of the PTE tax paid by the PTE business to be used on the individual income tax returns of the PTE’s owners (taxpayers).
- For Iowa taxpayers living within a school district that has in place a local option income surtax for schools, tax items that lower Iowa individual income tax liability (with the exception of refundable tax credits) also lower the income surtax owed by the taxpayer.
- The local option income surtax for schools does not apply to the PTE taxes paid by PTE businesses.

Fiscal impact considerations for specific tax years include:

- TY 2023 — Iowa’s top income tax rate for TY 2023 is 6.00%.
  - A PTE business electing to be subject to the PTE tax will pay to Iowa an amount equal to 6.0% of the PTE business’s income.
  - The PTE business’s income distribution to its owners will be reduced by the amount of the PTE tax paid. This will reduce the income of the owners for federal individual income tax purposes and thereby reduce the federal individual income tax owed by the PTE business owners by the amount of the PTE tax paid times the marginal federal income tax rate of the PTE taxpayer (10.00% to 37.00%, depending on the federal taxable income bracket of the individual PTE taxpayer).
  - The reduction in the PTE business’s income distribution will also reduce the Iowa income of the PTE business owners by the same amount that their federal taxable income is reduced. This will in turn reduce the Iowa individual income tax liability of the PTE business owners by an amount equal to the amount of the PTE tax paid times the marginal Iowa income tax rate of the PTE taxpayer (4.40% to 6.00%, depending on the Iowa taxable income bracket of the individual PTE taxpayer).
  - The PTE taxpayers will receive an Iowa individual income tax credit to be distributed to the PTE owners, and that tax credit will equal the 6.00% tax paid to Iowa by the PTE business. The tax credit will be used by the PTE taxpayers to reduce their Iowa income tax liability.
- TY 2024 and TY 2025 — The TY 2023 assumption and discussion above applies to TY 2024 and TY 2025 also. Due to codified reductions in the Iowa top individual income tax rate, the references to 6.00% are changed to 5.70% for TY 2024 and 4.82% for TY 2025.
- TY 2022 — While the TY 2023 assumptions and discussion also apply retroactively to TY 2022, the situation for that tax year will be significantly more complicated due to the following factors:
  - As a retroactive change, many PTE businesses and their collective owner/taxpayers may need to file amended returns to elect to pay the voluntary PTE tax and benefit from the PTE tax credit. The resulting Department of Revenue processing and auditing expenses that will result from the additional amended returns will be significant.

- The TY 2022 Iowa top individual income tax rate was 8.53%, so the PTE tax, tax credit, and Iowa taxable income reduction will be considerably higher for that year than for TY 2023 through TY 2025.
- Iowa allowed individual income taxpayers to deduct federal income taxes paid (federal deductibility) from their Iowa income in TY 2022. This will further complicate the situation for most taxpayers, as electing to pay the voluntary PTE tax will lower their federal income tax, and through federal deductibility, increase their Iowa individual income tax. Without federal deductibility (TY 2023 and after), this complication and concern does not apply to the analysis of TY 2023 through TY 2025 fiscal impacts.

For this analysis, the fiscal impact implications of the previous bullet items are assumed to be as follows, for all tax years impacted by the Bill:

- The State will receive PTE tax from PTE businesses that choose to be subject to the tax in an amount equal to the net income of the PTE business times the top Iowa individual income tax rate of the particular tax year (ranging from 8.53% for TY 2022 to 4.82% for TY 2025).
- The PTE tax credit received by the taxpayer/owners of the PTE business will equal the tax paid by the PTE business for that year.
  - To the extent that the Iowa income tax situation of individual taxpayers is such that the taxpayer can benefit from the entirety of the tax credit received, the tax credit will fully offset the PTE tax paid by the PTE business.
  - To the extent that individual taxpayers do not have sufficient Iowa income tax liability to fully utilize the PTE tax credit received for a given year, the State will receive a temporary benefit (positive State General Fund fiscal impact) for that particular year and the taxpayer will have a carryforward credit to be utilized over the next five tax years.
  - Just as payment of the PTE tax reduced the taxable income of the PTE business owners for federal tax purposes, the PTE tax credit also reduces the owners' income for Iowa income tax purposes. The amount of the Iowa income reduction will equal the amount of PTE tax paid times the marginal tax rate of the taxpayer for that tax year. This reduction is not offset by taxes paid at the PTE business level, and it represents a State income tax reduction for the taxpayer and a negative fiscal impact for the State General Fund.
  - The PTE tax and tax credit created in this Bill do not continue past TY 2025, when the federal SALT tax limitations expire. At that point, any taxpayers who possess carryforward PTE tax credits from TY 2022 through TY 2025 will be able to use those credits to offset any income tax that is due from PTE businesses or other income. It is likely that the carryforward redemptions shown on TY 2026 returns will be large, given that they represent four years of PTE tax credit carryforwards. This will produce a negative State General Fund fiscal impact.
  - The reduction of the Iowa income due to the inclusion of the PTE tax as an expense of the PTE business, combined with the redemption of the nonrefundable PTE tax credit by Iowa taxpayers, will have a negative fiscal impact on the revenue generated by the local option income surtax for schools.

The Iowa Department of Revenue reports that for TY 2021, 79,211 Iowa resident tax filers reported positive pass-through income on their federal tax return ([Schedule E, Part II](#)). The total positive income reported was \$10.1 billion for an average per return of \$128,000.

- Assuming 2.0% pass-through income growth for TY 2022 and for TY 2023 results in estimated pass-through income for TY 2023 of \$10.5 billion.
- The percent of pass-through income that will be represented by PTE businesses that elect to utilize the PTE tax and tax credit process is not known. For this estimate, 30.0% of pass-through income is assumed to be impacted by the election process, representing

\$3.2 billion in taxable income and \$189.5 million in PTE tax at the TY 2023 top Iowa individual income tax rate of 6.00%.

- To fully utilize the PTE tax credit received by the PTE business owners/taxpayers within the tax year of the PTE tax, the taxpayers will need sufficient other Iowa income that is not subject to the PTE tax. The LSA calculates that \$20,000 to \$30,000 in other Iowa income is necessary to fully utilize the PTE credit and avoid a tax carryforward for TY 2023. It is assumed that 10.0% of the PTE tax credit amount will carry forward beyond the year in which the PTE tax credit was received.
- The fiscal impact of the State income tax reduction for TY 2022 and TY 2023 is assumed to be realized 50.0% in FY 2024 and 50.0% in FY 2025. The fiscal impact for TY 2024 is assumed to be realized 50.0% in FY 2025 and 50.0% in FY 2026. The fiscal impact for TY 2025 is assumed to be realized 50.0% in FY 2026 and 50.0% in FY 2027.
- The fiscal impact of the State income tax reduction associated with the redemption of the accumulated carryforward credits for those taxpayers who were not able to fully utilize PTE tax credits received for TY 2022 through TY 2025 is assumed to occur in FY 2028.
- The statewide average local option income surtax for school rate is assumed to equal 2.4%. Depending on the school district, the surtax ranges from 0.00% (no surtax in place) to the maximum allowed rate of 20.00% of State income tax liability.

### **Fiscal Impact**

The creation of a new PTE tax and PTE tax credit is projected to reduce the federal individual income tax owed by owners of partnerships and S Corporations where the owners elect to pay the PTE tax on the net income of partnerships and S Corporations. The creation of the tax and tax credit is also projected to reduce Iowa individual income taxes owed by the owners by the following estimated amounts:

- FY 2024 = \$10.1 million
- FY 2025 = \$15.4 million
- FY 2026 = \$10.5 million
- FY 2027 = \$7.6 million
- FY 2028 = \$2.3 million

The creation and utilization of the PTE tax credit, along with the income tax reductions estimated above, will also reduce the amount of revenue generated by the local option income surtax for schools. The total reduction over five fiscal years (FY 2024 through FY 2028 inclusive) is estimated at \$1.1 million.

The creation of a new tax and new tax credit, along with the potential for a significant number of amended returns filed for TY 2022, will increase administrative expenses incurred by the Department of Revenue. The Department was not able to provide an estimate for the expense increase.

### **Sources**

Department of Revenue  
Legislative Services Agency analysis

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/s/ Jennifer Acton

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The fiscal note for this Bill was prepared pursuant to [Joint Rule 17](#) and the Iowa Code. Data used in developing this fiscal note is available from the Fiscal Services Division of the Legislative Services Agency upon request.

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