701—40.17(422) Income of part-year residents. A taxpayer who was a resident of Iowa for only a portion of the taxable year is subject to the following rules of taxation:

1. For that portion of the taxable year for which the taxpayer was a nonresident, the taxpayer shall allocate to Iowa only the income derived from sources within Iowa.

2. For that portion of the taxable year for which the taxpayer was an Iowa resident, the taxpayer shall allocate to Iowa all income earned or received whether from sources within or without Iowa.

A taxpayer moving into Iowa may adjust their gross income by the amount of the moving expense to the extent allowed by the Internal Revenue Code. Any reimbursement of moving expense shall be included in Iowa income. A taxpayer moving from Iowa to another state or country may not adjust their gross income by the amount of moving expense, nor should any reimbursement of moving expense be allocated to Iowa.

This rule is intended to implement Iowa Code sections 422.5, 422.7, and 422.8.

701—40.18(422) Net operating loss carrybacks and carryovers. Net operating losses shall be allowed or allowable for Iowa individual income tax purposes and will be computed using a method similar to the method used to compute losses allowed or allowable for federal income tax purposes. In determining the applicable amount of Iowa loss carrybacks and carryovers, the adjustments to net income set forth in Iowa Code section 422.7 and the deductions from net income set forth in Iowa Code section 422.9 must be considered.

40.18(1) *Treatment of federal income taxes.*

a. Refund of federal income taxes due to net operating loss carrybacks or carryovers shall be reflected in the following manner:

(1) Accrual basis taxpayers shall accrue refunds of federal income taxes to the year in which the net operating loss occurs. See Revenue Ruling 69-372 for similar federal treatment of state income tax.

(2) Cash basis taxpayers shall reflect refunds of federal income taxes in the return for the year in which the refunds are received.

(3) Refunds reported in the year in which the net operating loss occurs which contain both business and nonbusiness components shall be analyzed and separated accordingly. The amount of refund attributable to business income shall be that amount of federal taxes paid on business income which are being refunded.

b. Federal income taxes paid in the year of the loss which contain both business and nonbusiness components shall be analyzed and separated accordingly. Federal income taxes paid in the year of the loss shall be reflected as a deduction to business income to the extent that the federal income tax was the result of the taxpayer's trade or business. Federal income taxes paid which are not attributable to a taxpayer's trade or business shall also be allowed as a deduction but will be limited to the amount of gross income which is not derived from a trade or business.

40.18(2) *Nonresidents doing business within and without Iowa.* If a nonresident does business both within and without Iowa, the nonresident shall make adjustments reflecting the apportionment of the operating loss on the basis of business done within and without the state of Iowa, according to rule 40.16(422). The apportioned income or loss shall be added or deducted, as the case may be, to any amount of other income attributable to Iowa for that year.

40.18(3) *Loss carryback and carryforward.* The net operating loss attributable to Iowa as determined in rule 40.18(422) shall be subject to the federal 3-year carryback and 15-year carryover provisions. This loss shall be carried back or over to the applicable year as a reduction or part of a reduction of the taxable income attributable to Iowa for that year. However, a net operating loss shall not be carried back to a year in which the taxpayer was not doing business in Iowa. If the election under Section 172(b)(3) of the Internal Revenue Code is made, the Iowa net operating loss shall be carried forward 15 taxable years.

40.18(4) *Loss not applicable.* No part of a net loss for a year for which an individual was not subject to the imposition of Iowa individual income tax shall be included in the Iowa net operating loss deduction applicable to any year prior to or subsequent to the year of the loss.

40.18(5) *Special adjustments applicable to net operating losses.* Section 172(d) of the Internal Revenue Code provides for certain modifications when computing a net operating loss. These modifications refer to, but are not limited to, such things as considerations of other net operating loss deductions, treatment of capital gains and losses, and the limitation of nonbusiness deductions. Where applicable, the modifications set forth in Section 172 of the Internal Revenue Code shall be considered when computing the net operating loss carryover or carryback for Iowa income tax purposes.

40.18(6) *Distinguishing business or nonbusiness items.* In computing a net operating loss, nonbusiness deductions may be claimed only to the extent of nonbusiness income. Therefore, it is necessary to distinguish between business and nonbusiness income and expenses. For Iowa net operating loss purposes, an item will retain the same business or nonbusiness identity which would be applicable for federal income tax purposes.

40.18(7) *Examples.* The computation of a net operating loss deduction for Iowa income tax purposes is illustrated in the following examples:

a. Individual A had the following items of income for the taxable year:

Gross income from retail sales business		$125,000
Interest income from federal securities		2,000
Salary from part-time job		12,500
Individual A's federal return showed the following deductions:		
Business deductions (retail sales)		$150,000
Itemized (nonbusiness) deductions:		
Interest	$400	
Real estate tax	600	
Iowa income tax	800	$ 1,800

Individual A paid $3,000 federal income tax during the year which consisted of $2,500 federal withholding (business) and a $500 payment (nonbusiness) which was for the balance of the prior year's federal tax liability.

The federal computations are as follows:

	Per Return	Computed NOL
Income:		
Retail Sales	$125,000	$125,000
Interest income-federal securities	2,000	2,000
Salary	12,500	12,500
Subtotal	$139,500	$139,500
Deductions:		
Business	$150,000	$150,000
Itemized deductions	1,800	1,800
(Loss) per federal	($ 12,300)	
Computed net operating loss		($ 12,300)

Since the nonbusiness deductions do not exceed the nonbusiness income, the loss per the federal return and the computed net operating loss are the same.

The Iowa computations are as follows:

	Per Return	Computed NOL
Income:		
Retail sales	$125,000	$125,000
Salary	12,500	12,500
Subtotal	$137,500	$137,500
Deductions:		
Business	$150,000	$150,000
Federal tax deductions	3,000	2,500
Itemized deductions	1,000	-
(Loss) per return	($ 16,500)	
Computed Iowa NOL		($ 15,000)

NOTE: Itemized (nonbusiness deductions) are eliminated due to the lack of nonbusiness income. The only nonbusiness income, interest from federal securities, is not taxable for Iowa income tax purposes under Iowa Code section 422.7. The only federal tax deduction allowable is that related to business activity.

b. Individual B had the following items of income for the taxable year:

Gross income from restaurant business		$300,000
Wages		12,000
Business long-term capital gain @100%		1,000
Municipal bond interest (nonbusiness)		1,000
Federal tax refund of prior year taxes		500
Iowa tax refund of prior year taxes		100
Individual B's federal return showed the following deductions:		
Business deductions from restaurant		$333,000
Itemized deductions:		
Interest (nonbusiness)	$590	
Real estate tax (nonbusiness)	780	
Iowa income tax*	520	
Alimony (nonbusiness)	600	
Union dues (business)	100	2,590

*Iowa estimated payments totaled $220 of which $70 related to nonbusiness income and $150 related to business capital gains and business profits. $300 in Iowa tax was withheld from his wages.

Individual B paid $2,000 in federal income taxes during the tax year. $1,500 of this amount was withholding on wages and $500 was a federal estimated payment based on capital gains and projected business profits.

In the previous year 75 percent of B's income was from business sources and 25 percent was from nonbusiness sources.

The federal computations are as follows:

	Per Return	Computed NOL
Income:		
Retail sales	$300,000	$300,000
Wages	12,000	12,000
Capital gains	500(a)	1,000(a)
Iowa refund	100	100
Subtotal	$312,600	$313,100
Deductions:		
Business	$333,000	$333,000
Itemized deductions	2,590	575(b)
(Loss) per federal	($ 22,990)	
Computed net operating loss		($ 20,475)

(a) Capital gains are reduced by 50 percent in computing adjusted gross income, but must be reported in full in computing a net operating loss.

(b) Itemized deductions are limited to business deductions consisting of $100 for union dues, $450 for Iowa tax on business income, and nonbusiness deductions to the extent of nonbusiness income which amounts to $25. The only nonbusiness income is 25 percent of the $100 Iowa refund.

The Iowa computations are as follows:

	Per Return	Computed NOL
Income:		
Retail sales	$300,000	$300,000
Wages	12,000	12,000
Capital gains	500	1,000
Municipal bond interest	1,000	1,000
Federal refund	500	500
Subtotal	$314,000	$314,500
Deductions:		
Business	$333,000	$333,000
Federal tax	2,000	2,000
Itemized deductions	2,070(c)	1,225(d)
(Loss) per return	($ 23,070)	
Computed Iowa NOL		($ 21,725)

(c) Iowa income tax is not an itemized deduction for Iowa income tax purposes.

(d) Itemized deductions are limited to business deductions of $100 for union dues and nonbusiness deductions to the extent of nonbusiness income of $1,125. Nonbusiness income includes $1,000 of municipal bond interest and 25 percent ($125) of the federal tax refund.

40.18(8) *Net operating losses for nonresidents and part-year residents for tax years beginning on or after January 1, 1982.* For tax years beginning on or after January 1, 1982, nonresidents and part-year residents may carryback/carryforward only those net operating losses from Iowa sources. Nonresidents and part-year residents may not carryback/carryforward net operating losses which are from all sources.

Before the Iowa net operating loss of a nonresident or part-year resident is available for carryback/carryforward to another tax year, the loss must be decreased or increased by a number of possible adjustments depending on which adjustments are applicable to the taxpayer for the year of the loss. Iowa Net Operating Loss (NOL) Worksheet (41-123) may be used to make the adjustments to the net operating loss and compute the net operating loss deduction available for carryback/carryforward.

If the net operating loss was increased by an adjustment for an individual retirement account or H.R.10 retirement plan, the net operating loss should be decreased by the amount of the adjustment. The net operating loss should also be decreased by the amount of any capital loss or by the capital gain deduction to the extent the capital loss or capital gain deduction was from the sale or exchange of an asset from an Iowa source.

In a situation where the nonresident or part-year resident taxpayer received a federal income tax refund in the year of the NOL, the refund should reduce the loss in the ratio of the Iowa source income to the all source income for the tax year in which the refund was generated.

The net operating loss should be increased by any federal income tax paid in the loss year for a prior year in the ratio of the Iowa income for the prior year to the all source income for the prior year. Federal income tax withheld from wages or other compensation received in the loss year may be used to increase the Iowa net operating loss to the extent the tax is withheld from wages or other compensation earned in Iowa.

Federal estimate tax payments would be allocated to Iowa and increase the net operating loss on the basis of the Iowa income not subject to withholding to total income not subject to withholding. In any case where this method of allocation of federal estimate payments to Iowa is not considered to be equitable, the taxpayer may allocate the payments using another method as long as this method is disclosed on the taxpayer's Iowa individual income tax return for the year of the loss. However, the burden of proof is on the taxpayer to show that an alternate method of allocation is equitable.

Nonbusiness deductions included in the itemized deductions paid during the year of the net operating loss may be used to increase the NOL to the extent of nonbusiness income which is reported to Iowa in computation of the net operating loss. In most instances of net operating losses for nonresidents, no itemized deductions will be allowed in computing the net operating loss deduction. This is because most nonresidents will have no nonbusiness income reported to Iowa. Business deductions included in the federal itemized deductions may be used to increase the net operating loss deduction to the extent the deductions pertain to a business, trade, occupation or profession conducted in Iowa.

EXAMPLE A. A nonresident taxpayer had the following all source income and Iowa source income for 1982:

Category	All Source Income	Iowa Source Income
Wages	$20,000	$20,000
Interest	5,000	0
Rental income	5,000	5,000
Business loss	(50,000)	(10,000)
Iowa net income (loss)	($20,000)	$15,000

The nonresident taxpayer did not have an Iowa net operating loss available for carryback/carryforward for Iowa income tax purposes because the taxpayer's Iowa source income was not negative. The taxpayer's all source loss of ($20,000) does not qualify for carryback/carryforward on the Iowa return. However, since the taxpayer's all source income is negative, the taxpayer will not have an Iowa income tax liability for the year of the all source loss.

EXAMPLE B. A nonresident taxpayer received a federal refund of $1,000 in 1983. The refund was from the taxpayer's 1981 federal return where the taxpayer's Iowa income was 20% of the total income. $2,000 of federal income tax was withheld from the taxpayer's Iowa wages in 1982. The taxpayer had $10,000 in itemized deductions in 1982. However, the taxpayer had no Iowa nonbusiness income in 1982. In addition, no Iowa business deductions were included in the itemized deductions available on the federal return. The individual had the following all source income and Iowa source income in 1982:

Category	All Source Income	Iowa Source Income
Wages	$60,000	$10,000
Interest	3,000	0
Rental income	5,000	5,000
Farm income loss	(30,000)	(30,000)
Capital gain	2,000	2,000
Total incomes	$40,000	($13,000)

The taxpayer's Iowa source loss of ($13,000) was decreased by $200 of the federal refund since 20% of the refund was considered to be from Iowa income. The loss was decreased by $3,000 which was the capital gain deduction of the Iowa source asset sold in 1982. The loss was increased by the federal income tax withheld of $2,000 from Iowa wages. Because there is no Iowa source nonbusiness income nor Iowa source business deductions, the taxpayer's itemized deductions will not affect the net operating loss deduction.

Shown below is a recap of the net operating loss deduction for the nonresident taxpayer.

Iowa source net loss	($13,000)
Iowa portion of federal refund	200
Federal tax withheld on Iowa wages	(2,000)
Capital gain deduction	3,000
Total	($11,800)

The taxpayer's net operating loss deduction available for carryback/carryforward to another tax year is ($11,800).

After all adjustments are made to the Iowa net operating loss to compute the net operating loss deduction available for carryback/carryforward, the NOL deduction is applied to the carryback/carryforward tax year as described in paragraph *"a"* and paragraph *"b"* below:

a. Application of net operating losses to tax years beginning prior to January 1, 1982. In cases where a net operating loss deduction for a nonresident or part-year resident for a tax year beginning on or after January 1, 1982, is applied to a tax year beginning prior to January 1, 1982, the net operating loss deduction is applied to the taxable income for the carryback/carryforward year unless the NOL deduction is greater than the taxable income. If the NOL deduction is greater than the taxable income, the taxable income is increased by any Iowa source capital loss or any Iowa source capital gain deduction before the NOL deduction is applied against the taxable income.

EXAMPLE 1. A nonresident taxpayer has an Iowa net operating loss deduction of ($15,000) from the taxpayer's 1982 Iowa return. The taxpayer is carrying the NOL deduction back to 1979 where taxpayer's Iowa taxable income was $14,000. The taxpayer had a net capital loss of $3,000 in 1979. Because the taxpayer's 1979 taxable income of $14,000 was $1,000 less than the NOL deduction, the taxable income was increased by $1,000 of the net capital loss so there would be no carryover of the NOL to 1980. However, since the NOL deduction erased all the taxable income for 1979, the taxpayer would be granted a refund of all the Iowa income tax paid for the carryback year of 1979, plus applicable interest.

b. Application of net operating losses to tax years beginning on or after January 1, 1982. In situations where a net operating loss of a nonresident or part-year resident for a tax year beginning on or after January 1, 1982, is carried back/carried forward for application to a tax year beginning on or after January 1, 1982, the net operating loss deduction is applied to the Iowa source income of the taxpayer for the carryback/carryforward year. The Iowa source income is the income on line 25 of Section B of Schedule IA-126 for the 1982 and 1983 Iowa returns and line 26 of Section B of Schedule IA-126 for the 1984 Iowa return and the incomes on similar corresponding lines of Section B of Schedule IA-126 for tax years after 1984. In situations where the net operating loss deductions are larger than the Iowa source incomes, the Iowa source incomes are increased by any Iowa source capital gains or capital losses that are applicable, not to exceed the NOL deduction.

The Iowa source net income after reduction by the NOL deduction is divided by the all source income for the taxpayer. The resulting percentage is the adjusted Iowa income percentage. This percentage is subtracted from 100 percent to arrive at the revised nonresident/part-year resident credit for the taxpayer. The taxpayer's overpayment as a result of the net operating loss is the amount by which the revised nonresident/part-year credit exceeds the nonresident/part-year credit prior to application of the net operating loss deduction.

EXAMPLE 1. A nonresident taxpayer had a net operating loss deduction of $11,800 for the 1996 tax year. When the 1996 Iowa return was filed, the taxpayer elected to carry the loss forward to the 1997 tax year. The taxpayer's all source net income and Iowa source net income for 1997 were as shown below. The net operating loss carryforward from 1996 is deducted only from the Iowa source income for 1997:

Category	All Source Income	Iowa Source Income
Wages	$ 60,000	$ 20,000
Interest	3,000	0
Rental income	10,000	3,000
Farm income	25,000	25,000
Capital gain	2,000	2,000
Net operating loss carryforward	—	(11,800)
Iowa net income	$100,000	$ 38,200

The Iowa source income of $38,200 after reduction by the NOL carryforward is divided by the all source income of $100,000 which results in an Iowa income percentage of 38.2. This percentage is subtracted from 100 percent to arrive at the nonresident/part-year resident credit percentage of 61.8. When the tax after credit amount of $7,364 is multiplied by the nonresident/part-year credit percentage of 61.8, this results in a credit of $4,551. This credit is $869 greater than the nonresident/part-year credit of $3,682 would have been for 1997 without application of the net operating loss deduction which was carried forward from 1996.

This rule is intended to implement Iowa Code sections 422.5, 422.7, and 422.9(3)*"c."*

701—40.19(422) Casualty losses. Casualty losses may be treated in the same manner as net operating losses and may be carried back three years and forward seven years in the event said casualty losses exceed income in the loss year.

This rule is intended to implement Iowa Code section 422.7.

701—40.20(422) Adjustments to prior years. When Iowa requests for refunds are filed, they shall be allowed only if filed within three years after the tax payment upon which a refund or credit became due, or one year after the tax payment was made, whichever time is the later. For tax years ending prior to January 1, 1979, the period of time was five years. Even though a refund may be barred by the statute of limitations, a loss shall be carried back and applied against income on a previous year to determine the correct amount of loss carryforward.

This rule is intended to implement Iowa Code section 422.73.

701—40.21(422) Additional deduction for wages paid or accrued for work done in Iowa by certain individuals. For tax years beginning on or after January 1, 1984, but before January 1, 1989, a taxpayer who operates a business which is considered to be a small business as defined in subrule 40.21(2) is allowed an additional deduction for 50 percent of the first 12 months of wages paid or accrued during the tax years for work done in Iowa by employees first hired on or after January 1, 1984, or after July 1, 1984, where the taxpayer first qualifies as a small business under the expanded definition of a small business effective July 1, 1984, and meets one of the following criteria.

A handicapped individual domiciled in this state at the time of hiring.

An individual domiciled in this state at the time of hiring who meets any of the following conditions:

1. Has been convicted of a felony in this or any other state or the District of Columbia.
2. Is on parole pursuant to Iowa Code chapter 906.
3. Is on probation pursuant to Iowa Code chapter 907 for an offense other than a simple misdemeanor.
4. Is in a work release program pursuant to Iowa Code chapter 247A.

An individual, whether or not domiciled in this state at the time of the hiring, who is on parole or probation and to whom the interstate probation and parole compact under Iowa Code section 913.40 applies.

For tax years beginning on or after January 1, 1989, the additional deduction for wages paid or accrued for work done in Iowa by certain individuals is 65 percent of the wages paid for the first 12 months of employment of the individuals, not to exceed $20,000 per individual. Individuals must meet the same criteria to qualify their employers for this deduction for tax years beginning on or after January 1, 1989, as for tax years beginning before January 1, 1989.

For tax years ending after July 1, 1990, a taxpayer who operates a business which does not qualify as a small business specified in subrule 40.21(2) may claim an additional deduction for wages paid or accrued for work done in Iowa by certain convicted felons provided the felons are described in the four numbered paragraphs above and the following unnumbered paragraph and provided the felons are first hired on or after July 1, 1990. The additional deduction is 65 percent not to exceed $20,000 for the first 12 months of wages paid for work done in Iowa.

The qualifications mentioned in subrules 40.21(1), 40.21(4), 40.21(5) and 40.21(6) and in subrule 40.21(3), paragraphs "*f*" and "*g*," apply to the additional deduction for work done in Iowa by a convicted felon in situations where the taxpayer is not a small business as well as in situations where the taxpayer is a small business.

40.21(1) The additional deduction shall not be allowed for wages paid to an individual who was hired to replace an individual whose employment was terminated within the 12-month period preceding the date of first employment. However, if the individual being replaced left employment voluntarily without good cause attributable to the employer or if the individual was discharged for misconduct in connection with the individual's employment as determined by the division of job service of the department of employment services, the additional deduction shall be allowed.

The determination of whether an individual left employment voluntarily without good cause attributable to the employer or if the individual was discharged for misconduct is a factual determination which must be made on a case-by-case basis.

40.21(2) The term "small business" means a business entity organized for profit including but not limited to an individual proprietorship, partnership, joint venture, association or cooperative. It includes the operation of a farm, but not the practice of a profession. The following conditions apply to a business entity which is a small business for purposes of the additional deduction for wages:

a. The small business shall not have had more than 20 full-time equivalent employee positions during each of the 26 consecutive weeks within the 52-week period immediately preceding the date on which an individual for whom an additional deduction for wages is taken was hired. Full-time equivalent position means any of the following:

1. An employment position requiring an average work week of 40 or more hours;
2. An employment position for which compensation is paid on a salaried full-time basis without regard to hours worked; or
3. An aggregation of any number of part-time positions which equal one full-time position. For purposes of this subrule each part-time position shall be categorized with regard to the average number of hours worked each week as a one-quarter, half, three-quarter, or full-time position, as set forth in the following table:

Average Number of Weekly Hours	Category
More than 0 but less than 15	¼
15 or more but less than 25	½
25 or more but less than 35	¾
35 or more	1 (full-time)

b. The small business shall not have more than $1 million in annual gross revenues, or after July 1, 1984, $3 million in annual gross revenues or as the average of the three preceding tax years. "Annual gross revenues" means total sales, before deducting returns and allowances but after deducting corrections and trade discounts, sales taxes and excise taxes based on sales, as determined in accordance with generally accepted accounting principles.

c. The small business shall not be an affiliate or subsidiary of a business which is dominant in its field of operation. "Dominant in its field of operation" means having more than 20 full-time equivalent employees and more than $1 million of annual gross revenues, or after July 1, 1984, $3 million of annual gross revenues or as the average of the three preceding tax years. "Affiliate or subsidiary of a business dominant in its field of operations" means a business which is at least 20 percent owned by a business dominant in its field of operation, or by partners, officers, directors, majority stockholders, or their equivalent, of a business dominant in that field of operation.

d. "Operation of a farm" means the cultivation of land for the production of agricultural crops, the raising of poultry, the production of eggs, the production of milk, the production of fruit or other horticultural crops, grazing or the production of livestock. Operation of a farm shall not include the production of timber, forest products, nursery products, or sod and operation of a farm shall not include a contract where a processor or distributor of farm products or supplies provides spraying, harvesting or other farm services.

e. "The practice of a profession" means a vocation requiring specialized knowledge and preparation including but not limited to the following: medicine and surgery, podiatry, osteopathy, osteopathic medicine and surgery, psychology, psychiatry, chiropractic, nursing, dentistry, dental hygiene, optometry, speech pathology, audiology, pharmacy, physical therapy, occupational therapy, mortuary science, law, architecture, engineering and surveying, and accounting.

40.21(3) Definitions.

a. The term *"handicapped person"* means any person who has a physical or mental impairment which substantially limits one or more major life activities, has a record of such impairment, or is regarded as having such an impairment.

The term handicapped does not include any person who is an alcoholic or drug abuser whose current use of alcohol or drugs prevents the person from performing the duties of employment or whose employment, by reason of current use of alcohol or drugs, would constitute a direct threat to the property or the safety of others.

b. The term *"physical or mental impairment"* means any physiological disorder or condition, cosmetic disfigurement, or anatomical loss affecting one or more of the following body systems: neurological; musculoskeletal; special sense organs; respiratory, including speech organs; cardiovascular; reproductive; digestive; genitourinary; hemic and lymphatic; skin and endocrine; or any mental or psychological disorder, such as mental retardation, organic brain syndrome, emotional or mental illness, and specific learning disabilities.

c. The term *"major life activities"* means functions such as caring for one's self, performing manual tasks, walking, seeing, hearing, speaking, breathing, learning, and working.

d. The term *"has a record of such impairment"* means has a history of, or has been misclassified as having, a mental or physical impairment that substantially limits one or more major life activities.

e. The term *"is regarded as having such an impairment"* means:

1. Has a physical or mental impairment that does not substantially limit major life activities but that is perceived as constituting such a limitation;
2. Has a physical or mental impairment that substantially limits major life activities only as a result of the attitudes of others toward such impairment; or
3. Has none of the impairments defined as physical or mental impairments, but is perceived as having such an impairment.

f. The term *"successfully completing a probationary period"* includes those instances where the employee quits without good cause attributable to the employer during the probationary period or was discharged for misconduct during the probationary period.

g. The term *"probationary period"* means the period of probation for newly hired employees, if the employer has a written probationary policy. If the employer has no written probationary policy for newly hired employees, the probationary period shall be considered to be six months from the date of hire.

40.21(4) If a newly hired employee has been certified as either a vocational rehabilitation referral or an economically disadvantaged ex-convict for purposes of qualification for the targeted jobs tax credit under Section 51 of the Internal Revenue Code, that employee shall be considered to have met the qualifications for the additional wage deduction.

A vocational rehabilitation referral is any individual certified by a state employment agency as having a physical or mental disability which, for the individual constitutes or results in a substantial handicap to employment. In addition, the individual must have been referred to the employer after completion or while receiving rehabilitation services pursuant to either a state or federal approved vocational rehabilitation program.

For all other newly hired employees, the employer has the burden of proof to show that the employees meet the qualifications for the additional wage deduction.

40.21(5) The taxpayer shall include a schedule with the filing of its tax return showing the name, address, social security number, date of hiring and wages paid of each employee for which the taxpayer claims the additional deduction for wages.

40.21(6) If the employee for which an additional deduction for wages was allowed fails to successfully complete a probationary period and the taxpayer has already filed an Iowa corporation income tax return taking the additional deduction for wages, the taxpayer shall file an amended return adding back the additional deduction for wages. The amended return shall state the name and social security number of the employee who failed to successfully complete a probationary period.

This rule is intended to implement Iowa Code section 422.7 and 1990 Iowa Acts, Senate File 2413.

701—40.22(422) Disability income exclusion.

40.22(1) Effective for tax years beginning on or after January 1, 1984, a taxpayer who is permanently and totally disabled and has not attained age 65 by the end of the tax year or reached mandatory retirement age can exclude a maximum of $100 per week of payments received in lieu of wages. In order for the payments to qualify for the exclusion, the payments must be made under a plan providing payment of such amounts to an employee for a period during which the employee is absent from work on account of permanent and total disability.

40.22(2) In the case of a married couple where both spouses meet the qualifications for the disability exclusion, each spouse may exclude $5,200 of income received on account of disability.

40.22(3) There is a reduction in the exclusion, dollar for dollar, to the extent that a taxpayer's federal adjusted gross income (determined without this exclusion and without the deduction for the two-earner married couple) exceeds $15,000. In the case of a married couple, both spouses' incomes must be considered for purposes of determining if the disability income exclusion is to be reduced for income that exceeds $15,000. The taxpayers' disability income exclusion is eliminated when the taxpayers' federal adjusted gross income is equal to or exceeds $20,200. The deduction of the taxpayers' disability income exclusion because the taxpayers' federal adjusted gross income is greater than $15,000 is illustrated in the following example:

A married couple is filing their 1984 Iowa return. The husband retired during the year and received $8,000 in disability income during the 40-week period in 1984 that he was retired. The husband's other income in 1984 was $2,500 and the wife's income was $7,500.

Of the $8,000 in disability payments received by the husband in the 40-week period he was retired in 1984, only $4,000 is eligible for the exclusion. This is because the maximum amount that can be excluded on a weekly basis as a result of the disability exclusion is $100.

However, the $4,000 that qualifies for the exclusion must be reduced to the extent that the taxpayer's federal adjusted gross income exceeds $15,000. In this example, the taxpayer's federal adjusted gross income is $18,000, which exceeds $15,000 by $3,000. Therefore, the amount eligible for exclusion of $4,000 must be reduced by $3,000. This gives the taxpayers an exclusion of $1,000.

40.22(4) For purposes of the disability income exclusion, "permanent and total disability" means the individual is unable to engage in any substantial gainful activity by reason of a medically determinable physical or mental impairment which (a) can be expected to last for a continuous period of 12 months or more or (b) can be expected to result in death. A certificate from a qualified physician must be attached to the individual's tax return attesting to the taxpayer's permanent and total disability as of the date the individual claims to have retired on disability. The certificate must include the name and address of the physician and contain an acknowledgment that the certificate will be used by the taxpayer to claim the exclusion. In an instance where an individual has been certified as permanently and totally disabled by the Veterans Administration, Form 6004 may be attached to the return instead of the physician's certificate. Form 6004 must be signed by a physician on the VA disability rating board.

40.22(5) Mandatory retirement age is the age at which the taxpayer would have been required to retire under the employer's retirement program.

40.22(6) The disability income exclusion is not applicable to federal income tax for tax years beginning after 1983. There are many revenue rulings, court cases and other provisions which were relevant to the disability income exclusion for the tax periods when the exclusion was available on federal returns. These provisions, court cases and revenue rulings concerning the disability income exclusion are equally applicable to the disability income exclusion on Iowa returns for tax years beginning on or after January 1, 1984.

This rule is intended to implement Iowa Code section 422.7.

701—40.23(422) Social security benefits. For tax years beginning on or after January 1, 1984, social security benefits received are taxable on the Iowa return. Although Tier 1 railroad retirement benefits were taxed similarly as social security benefits for federal income tax purposes beginning on or after January 1, 1984, these benefits are not subject to Iowa income tax. 45 U.S.C. section 231m prohibits taxation of railroad retirement benefits by the states.

The following subrules specify how social security benefits are taxed for Iowa individual income tax purposes for tax years beginning on or after January 1, 1984, but prior to January 1, 1994, and for tax years beginning on or after January 1, 1994:

40.23(1) *Taxation of social security benefits for tax years beginning on or after January 1, 1984, but prior to January 1, 1994.* For tax years beginning on or after January 1, 1984, but prior to January 1, 1994, social security benefits are taxable on the Iowa return to the same extent as the benefits are taxable for federal income tax purposes. When both spouses of a married couple receive social security benefits and file a joint federal income tax return but separate returns or separately on the combined return form, the taxable portion of the benefits must be allocated between the spouses. The following formula should be used to compute the amount of social security benefits to be reported by each spouse on the Iowa return:

$$\text{Taxable Social Security Benefits on the Federal Return} \times \frac{\text{Total Social Security Benefit Received by Husband (or Wife)}}{\text{Total Social Security Benefits Received by Both Spouses}}$$

The example shown below illustrates how taxable social security benefits are allocated between spouses:

A married couple filed a joint federal income tax return for 1984. They filed separately on the combined return form for Iowa income tax purposes. During the tax year the husband received $6,000 in social security benefits and the wife received $3,000 in social security benefits. $2,000 of the social security benefits was taxable on the federal return.

The $2,000 in taxable social security benefits is allocated to the spouses on the following basis:

Husband

$$\$2{,}000 \times \frac{\$6{,}000}{\$9{,}000} = \$1{,}333.40$$

Wife

$$\$2{,}000 \times \frac{\$3{,}000}{\$9{,}000} = \$666.60$$

In situations where taxpayers have received both social security benefits and Tier 1 railroad retirement benefits and are taxable on a portion of those benefits, the formula which follows should be used to determine the social security benefits to be included in net income:

$$\text{Taxable Social Security Benefits and Railroad Retirement Benefits on Federal Return} \times \frac{\text{Total Social Security Benefit Received}}{\text{Total Social Security Benefits and Railroad Retirement Benefits Received}}$$

40.23(2) *Taxation of social security benefits in 1994 and thereafter.* For tax years beginning on or after January 1, 1994, although up to 85 percent of social security benefits received may be taxable for federal income tax purposes, no more than 50 percent of social security benefits will be taxable for state individual income tax purposes. Thus, in the case of Iowa income tax returns for 1994 and subsequent tax years, social security benefits will be taxed as the benefits were taxed from 1984 through 1993 as described in subrule 40.23(1).

The amount of social security benefits that is subject to tax is the lesser of one-half of the annual benefits received in the tax year or one-half of the taxpayer's provisional income over a specified base amount. The provisional income is the taxpayer's modified adjusted gross income plus one-half of the social security benefits and one-half of the railroad retirement benefits received. Although railroad benefits are not taxable, one-half of the railroad retirement benefits received may be used to determine the amount of social security benefits that is taxable for state income tax purposes. Modified adjusted gross income is the taxpayer's federal adjusted gross income, plus interest that is tax-exempt on the federal return, plus any of the following incomes:

1. Savings bond proceeds used to pay expenses of higher education excluded from income under Section 135 of the Internal Revenue Code.
2. Foreign source income excluded from income under Section 911 of the Internal Revenue Code.
3. Income from Guam, American Samoa, and the Northern Mariana Islands excluded under section 931 of the Internal Revenue Code.
4. Income from Puerto Rico excluded under Section 933 of the Internal Revenue Code.

A taxpayer's base amount is: *(a)* $32,000 if married and a joint federal return was filed, *(b)* $0 if married and separate federal returns were filed by the spouses and *(c)* $25,000 for individuals who filed federal returns and used a filing status other than noted in *(a)* and *(b)*.

The IA 1040 booklet and instructions for 1994 and later years will include a worksheet to compute the amount of social security benefits that is taxable for Iowa income tax purposes. An example of the social security worksheet follows. Similar worksheets will be used for computing the amount of social security benefits that are taxable for years after 1994.

1. Enter amount(s) from box 5 of all of Form(s) SSA-1099. If a joint return was filed, enter totals from box 5 of Form(s) SSA-1099 for both spouses. Do not include railroad retirement benefits from RRB-1099 here. See line 3. 1. _____

2. Divide line 1 amount above by 2. 2. _____

*3. Add amounts of the following incomes from Form 1040: wages, taxable interest income, dividend income, taxable state and local income tax refunds, alimony, business income or loss, capital gain or loss, capital gain distributions, other gains, taxable IRA distributions, taxable pensions and annuities, incomes from Schedule E, farm income or loss, unemployment compensation, other income and 1/2 of railroad retirement benefits from RRB 1099. 3. _____

4. Enter amount from Form 1040, line 8b for interest that is federally tax-exempt. 4. _____

5. Add lines 2, 3 and 4. 5. _____

6. Enter total adjustment to income from Form 1040. 6. _____

7. Subtract line 6 from line 5. 7. _____

8. Enter on line 8 one of the following amounts based on the filing status used on Form 1040: Single, Head of Household, or Qualifying Widow(er), enter $25,000. Married filing jointly, enter $32,000. Married filing separately, enter $0 ($25,000 if you did not live with spouse any time in 1994). 8. _____

9. Subtract line 8 from line 7. If zero or less enter 0. If line 9 is zero, none of the social security benefits are taxable. If line 9 is more than zero, go to line 10. 9. _____

10. Divide line 9 amount above by 2. 10. _____

11. Taxable social security benefits enter smaller of line 2 or line 10 here and on line 14 IA 1040. 11. _____

*If applicable, include on line 3 the following incomes excluded from federal adjusted gross income: foreign earned income, income excluded by residents of Puerto Rico, American Samoa, and Guam and proceeds from savings bonds used for higher education.

Married taxpayers who filed a joint federal return and are filing separate Iowa returns or separately on the combined return form can allocate taxable social security benefits between them with the following formula.

$$\text{Taxable Social Security Benefits From Worksheet} \times \frac{\text{Total Social Security Benefit Received by Husband (or Wife)}}{\text{Total Social Security Benefits Received by Both Spouses}}$$

This rule implements Iowa Code Supplement section 422.7 as amended by 1994 Iowa Acts, Senate File 2215.

701—40.24(99E) Lottery prizes. Prizes awarded under the Iowa Lottery Act are Iowa earned income. Therefore, individuals who win lottery prizes are subject to Iowa income tax in the aggregate amount of prizes received in the tax year, even if the individuals were not residents of Iowa at the time they received the prizes.

This rule is intended to implement Iowa Code section 99E.19.

701—40.25(422) Certain unemployment benefits received in 1979. For the 1979 tax year, unemployment benefits included in net income on a return for that period which was filed before January 1, 1981, are excluded from net income to the extent that those benefits were excluded for federal income tax purposes under Section 1075 of the Tax Reform Act of 1984. In any situation where the exclusion of the unemployment benefits results in an overpayment, a refund will be granted if the refund claim is filed with the department on or before June 30, 1986. However, the fact that a refund is granted on a return because of the unemployment benefits exclusion does not open the statute of limitations for refund for that return for any other reason.

This rule is intended to implement Iowa Code sections 422.7 and 422.73.

701—40.26(422) Contributions to the judicial retirement system. Contributions made to the judicial retirement system on or after July 1, 1986, but prior to January 1, 1989, are included in the net income of the judge to the extent that the contributions are not included in the individual's federal adjusted gross income. The contributions are 4 percent of the basic salary of the judge. The contributions are paid by the state for deposit with the state treasurer for credit to the judicial retirement system.

This rule is intended to implement Iowa Code section 422.7.

701—40.27(422) Incomes from distressed sales of qualifying taxpayers. For tax years beginning on or after January 1, 1986, taxpayers with gains from sales, exchanges, or transfers of property must exclude those gains from net income, if the gains are considered to be distressed sale transactions.

40.27(1) *Qualifications that must be met for transactions to be considered distressed sales.* There are a number of qualifications that must be met before a transaction can be considered to be a distressed sale. The transaction must involve forfeiture of an installment real estate contract, the transfer of real or personal property securing a debt to a creditor in cancellation of that debt, or from the sale or exchange of property as a result of actual notice of foreclosure. The following three additional qualifications need to have been met.

a. The forfeiture, transfer, or sale or exchange was done for the purpose of establishing a positive cash flow.

b. Immediately before the forfeiture, transfer, or sale or exchange, the taxpayer's debt-to-asset ratio exceeded 90 percent as computed under generally accepted accounting principles.

c. The taxpayer's net worth at the end of the tax year was less than $75,000.

In determining the taxpayer's debt-to-asset ratio immediately before the forfeiture, transfer, or sale or exchange and at the end of the tax year, the taxpayer must include any asset transferred within 120 days prior to the transaction or within 120 days prior to the end of the tax year without adequate and full consideration in money or money's worth.

Proof of forfeiture of the installment real estate contract, proof of transfer of property to a creditor in cancellation of a debt, or a copy of the notice of foreclosure constitutes documentation of the distressed sale and must be made a part of the return. Balance sheets showing the taxpayer's debt-to-asset ratio immediately before the distressed sale transaction and the taxpayer's net worth at the end of the tax year must also be included with the income tax return. The balance sheets supporting the debt-to-asset ratio and the net worth must list the taxpayer's personal assets and liabilities as well as the assets and liabilities of the taxpayer's farm or other business.

For purposes of this provision, in the case of married taxpayers, except in the instance when the husband and wife live apart at all times during the tax year, the assets and liabilities of both spouses must be considered in determining the taxpayers' net worth or the taxpayers' debt-to-asset ratio.

40.27(2) *Losses from distressed sale transactions of qualifying taxpayers.* Losses from distressed sale transactions meeting the qualifications described above were disallowed prior to the time that the provision for disallowing these losses was repealed in the 1990 session of the General Assembly. Taxpayers whose Iowa income tax liabilities were increased because of disallowance of losses from distressed sales transactions may file refund claims with the department to get refunds of the taxes paid due to disallowance of the losses. Refund claims will be honored by the department to the extent that the taxpayers provide verification of the distressed sale losses and the claims are filed within the statute of limitations for refund given in Iowa Code subsection 422.73(2).

This rule is intended to implement Iowa Code section 422.7.

701—40.28(422) Losses from passive farming activities. For tax years beginning on or after January 1, 1986, but before January 1, 1987, net losses from passive farming activities are disallowed and added to net income to the extent that the net losses exceed $25,000. Net losses from passive farming activities such as from businesses, rents, partnerships, S corporations, estates or trusts, except for losses under Section 1211 or 1231 of the Internal Revenue Code, are combined and netted against net incomes from passive farming activities from businesses, rents, estates and trusts to determine net income or net loss from the passive farming activities. For purposes of this rule, the following definitions and provisions apply:

40.28(1) *Farming.* The term "farming" is defined in Section 464(e) of the Internal Revenue Code. "Farming" means the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity including the raising, shearing, feeding, caring for, training and management of animals. Farming includes the raising of fish, poultry, bees, dogs, flowers or vegetables. Farming does not include the raising of or harvesting of trees (other than fruit or nut trees). Therefore, farming does not include forestry (the care and conservation of forests), the timber and logging industries, and the raising of trees for lumber or pulp. However, farming does include the raising or harvesting of plants grown for home decoration, aesthetic, or landscaping purposes, including ornamental trees, Christmas trees, house plants that are called trees, and house plants with tree-like qualities (such as scheffleras, Norfolk Island pines, ficus decova, weeping figs, areca palms, and parlor palms).

40.28(2) *Passive activity.* The term "passive activity" means an activity where the taxpayer or a member of the taxpayer's family as defined in Section 2032A(c)(2) of the Internal Revenue Code does not materially participate in the activity or provide substantial personal services to the farming business. However, a taxpayer who is retired or disabled as described in Section 2032A(b)(4) of the Internal Revenue Code or is a surviving spouse as described in Section 2032A(b)(5) of the Internal Revenue Code will be treated as materially participating in the farming business.

The determination of whether an individual has materially participated in a farming activity is made under a standard similar to that set forth in Treasury Regulation Section 20.2032A-3(e). Thus, for example, employment of an individual on a full-time basis in the operation of a farm, or performance by the individual of all necessary functions in operating the farm, may constitute material participation.

An individual also may materially participate in a farming operation when the taxpayer's actual activities are on other than a full-time basis or when the individual personally does not perform all necessary functions in operating the farm. In this connection, the fact that the individual utilizes employees or contracts services to accomplish day-to-day functions of the business does not preclude a finding that the taxpayer has materially participated in the farming activity.

When an individual's activities with respect to a farming operation are not on a full-time basis, or the individual utilizes employees or contracts services to accomplish day-to-day functions of the business, no single factor is determinative of whether the individual materially participates in the farming operation. However, physical work and participation in management decisions are two principal factors to be considered. In order to be treated as materially participating due to the latter factor, such an individual must participate in the financial and management decisions of the farming operation by regularly advising or consulting with other managing parties with respect to management decisions and by regularly overseeing production activities of the farming operation.

A limited partner (as defined under applicable state law) is treated as not materially participating, or providing substantial personal services, with respect to the activity. Thus, unless the person is also a general partner, there is, in effect, a conclusive presumption that the person has not materially participated in the activity unless the individual is retired, disabled, or a surviving spouse as mentioned in subrule 40.28(2).

40.28(3) *Loss carried to first succeeding tax year.* To the extent that a loss from a passive farming activity was disallowed in the current tax year, the loss may be carried forward as a deduction to the passive farming activity in the first succeeding tax year.

This rule is intended to implement Iowa Code section 422.7.

701—40.29(422) Intangible drilling costs. For tax years beginning on or after January 1, 1986, but before January 1, 1987, intangible drilling and development costs which pertain to any well for the production of oil, gas, or geothermal energy, and which are incurred after the commencement of the installation of the production casing for the well, are not allowed as an expense in the tax year when the costs were paid or incurred and must be added to net income. Instead of expensing the intangible drilling and development costs which are incurred after the commencement of the installation of the production casing for a well, the expenses must be amortized over a 26-month period, beginning in the month in which the costs are paid or incurred if the costs were incurred for a well which is located in the United States, the District of Columbia, and those continental shelf areas which are adjacent to United States territorial waters and over which the United States has exclusive rights with respect to the exploration and exploitation of natural resources as provided in Section 638 of the Internal Revenue Code.

In the case of intangible drilling and development costs which are incurred for oil or gas wells outside the United States, those costs must be recovered over a ten-year straight-line amortization period beginning in the year the costs are paid or incurred. However, in lieu of amortization of the costs, the taxpayer may elect to add these costs to the basis of the property for cost depletion purposes.

For tax years beginning on or after January 1, 1987, the intangible drilling costs, which are an addition to income subject to amortization, are the intangible drilling costs described in Section 57(a)(2) of the Internal Revenue Code. These intangible drilling costs are an item of tax preference for federal minimum tax purposes for tax years beginning after December 31, 1986.

This rule is intended to implement Iowa Code section 422.7.

701—40.30(422) Percentage depletion. For tax years beginning on or after January 1, 1986, but before January 1, 1987, add to net income the amount that percentage depletion of an oil, gas, or geothermal well computed under Section 613 of the Internal Revenue Code is in excess of cost depletion computed under Section 611 of the Internal Revenue Code.

For tax years beginning on or after January 1, 1987, the percentage depletion that is an addition to net income is the depletion described in Section 57(a)(1) of the Internal Revenue Code only to the extent the depletion applies to an oil, gas, or geothermal well. This depletion is an item of tax preference for federal minimum tax purposes for tax years beginning after December 31, 1986.

This rule is intended to implement Iowa Code section 422.7.

701—40.31(422) Away-from-home expenses of state legislators. For tax years beginning on or after January 1, 1981, but before January 1, 1987, state legislators may claim a deduction on the Iowa return of up to $50 per "legislative day" for away-from-home expenses incurred in performing the trade or business of a state legislator. For purposes of this deduction, a "legislative day" is any day during a tax year in which the legislature was in session (includes any day in which the legislature was not in session for a period of four consecutive days) or any day in which the legislature was not in session, but the legislator's physical presence was formally recorded at a committee meeting of the legislature. For federal income tax purposes, there is a requirement that in order for a state legislator to deduct away-from-home expenses, the state legislator's personal residence in the legislative district must be more than 50 miles from the state capitol. However, legislators may claim the deduction for away-from-home expenses on their state returns even in instances when their personal residences are less than 50 miles from the state capitol. State legislators whose away-from-home expenses such as expenses for food and lodging exceed $50 per legislative day may claim deductions for these expenses if they itemize these expenses when they file their state returns.

For tax years beginning on or after January 1, 1987, state legislators whose personal residences in their legislative districts are more than 50 miles from the state capitol may claim the same deductions for away-from-home expenses as are allowed on their federal income tax returns under Section 162(h)(1)(B) of the Internal Revenue Code. These individuals may claim a deduction for meals and lodging per "legislative day" the amount of per diem allowance for federal employees in effect for the tax year. The portion of this per diem allowance which is equal to the daily expense allowance authorized state legislators in Iowa Code section 2.10 may be claimed as an adjustment to income. The balance of the per diem allowance for federal employees must be allocated between lodging expenses and meal expenses and is deductible as a miscellaneous itemized deduction. However, only 80 percent of the amount attributable to meal expenses may be deducted.

State legislators whose personal residences in their legislative districts are 50 miles or less from the state capitol may claim a deduction for meals and lodging of $50 per "legislative day." However, in lieu of either of the deduction methods previously described in this rule, any state legislator may elect to itemize adjustments to income for amounts incurred for meals and lodging for the "legislative days" of the state legislator.

This rule is intended to implement Iowa Code section 422.7.

701—40.32(422) Interest and dividends from regulated investment companies which are exempt from federal income tax. For tax years beginning on or after January 1, 1987, interest and dividends from regulated investment companies which are exempt from federal income tax under the Internal Revenue Code are subject to Iowa income tax. See rule 701—40.52(422) for a discussion of the Iowa income tax exemption of some interest and dividends from regulated investment companies that invest in certain obligations of the state of Iowa and its political subdivisions the interest from which is exempt from Iowa income tax. To the extent that a loss on the sale or exchange of stock in a regulated investment company was disallowed on an individual's federal income tax return pursuant to Section 852(b)(4)(B) of the Internal Revenue Code because the taxpayer held the stock six months or less and because the regulated investment company had invested in federal tax-exempt securities, the loss is allowed for purposes of computation of net income.

This rule is intended to implement Iowa Code section 422.7.

701—40.33(422) Partial exclusion of pensions and annuities for retired and disabled public employees. Effective for tax years beginning in the 1989 and 1990 calendar years only, there is a partial exclusion of pensions and annuities for disabled public employees, retired public employees who are aged 55 or older, and survivors of public employees who would have qualified for the exclusion on the basis of age or disability. The exclusion applies to all pensions and annuities which are paid for service as a federal employee or officer, including military service. The exclusion also applies to pensions and annuities received from the peace officers' retirement system under Iowa Code chapter 97A, the Iowa public employees' retirement system under Iowa Code chapter 97B, the Iowa police officers' and firefighters' retirement system under Iowa Code chapter 411, and the judicial retirement system under Iowa Code chapter 602. The exclusion is up to $5,000 of pension or annuity benefits received for married taxpayers who file joint state returns and up to $2,500 of pension or annuity benefits received by taxpayers who file other than a joint state return. In the case of married taxpayers who file separate state returns or separately on the combined return form, each spouse may exclude up to $2,500 of pension and annuity benefits received, if both spouses have received one or more public pensions described previously in this rule. The exclusion of pension and annuity benefits applies to the portion of pension and annuity benefits which is taxable for federal income tax purposes and not to total pension and annuity benefits received by the individuals who are eligible for the exclusion. Disability pensions for public employees which are totally exempt for federal income tax purposes such as disability pensions for workers' compensation for work-related illnesses or injuries are totally exempt for state income tax purposes. Rule 40.4(422) describes the exemptions of public pensions which were applicable for tax years beginning prior to January 1, 1989.

In the case of pensions and annuities received in the 1990 calendar year by persons who are aged 55 or older, disabled or survivors of public employees who would have qualified for the exclusion on the basis of age or disability, the partial pension exemptions described above apply also to individuals who receive pension and annuity benefits under the disabled and retired firefighters' and police officers' system under Iowa Code chapter 410 and pension and annuity benefits under the pension and annuity retirement system for public school teachers under Iowa Code chapter 294.

This rule is intended to implement Iowa Code section 422.7.

701—40.34(422) Exemption of restitution payments for persons of Japanese ancestry. For tax years beginning on or after January 1, 1988, restitution payments authorized by P.L. 100-383 to individuals of Japanese ancestry who were interned during World War II are exempt from Iowa income tax to the extent the payments are included in federal adjusted gross income. P.L. 100-383 provides for a payment of $20,000 for each qualifying individual who was alive on August 10, 1988. In cases where the qualifying individuals have died prior to the time that the restitution payments were received, the restitution payments received by the survivors of the interned individuals are also exempt from Iowa income tax.

This rule is intended to implement Iowa Code section 422.7.

701—40.35(422) Exemption of Agent Orange settlement proceeds received by disabled veterans or beneficiaries of disabled veterans. For tax years beginning on or after January 1, 1989, proceeds from settlement of a lawsuit against the manufacturer or distributor of a Vietnam herbicide received by a disabled veteran or the beneficiary of a disabled veteran for damages from exposure to the herbicide are exempt from Iowa income tax to the extent the proceeds are included in federal adjusted gross income. For purposes of this rule, Vietnam herbicide means a herbicide, defoliant, or other causative agent containing a dioxin, including, but not limited to, Agent Orange used in the Vietnam conflict beginning December 22, 1961, and ending May 7, 1975.

This rule is intended to implement Iowa Code section 422.7.

701—40.36(422) Exemption of interest earned on bonds issued to finance beginning farmer loan program. Interest earned on or after July 1, 1989, from bonds or notes issued by the agricultural development authority to finance the beginning farmer loan program is exempt from the state income tax.

This rule is intended to implement Iowa Code sections 175.17 and 422.7.

701—40.37(422) Exemption of interest from bonds issued by the Iowa comprehensive petroleum underground storage tank fund board. Interest received from bonds issued by the Iowa comprehensive petroleum underground storage tank fund board is exempt from state individual income tax. This is effective for interest received from these bonds on or after May 5, 1989, but before July 1, 2009.

This rule is intended to implement Iowa Code section 455G.6.

701—40.38(422) Capital gains deduction for limited amounts of certain types of net capital gains. Effective for tax years beginning on or after January 1, 1990, a deduction is allowed in computing net income for 45 percent of the net capital gains described in subrules 40.38(1) to 40.38(4). However, the aggregate net capital gains from the four subrules which are to be considered for the tax year for the capital gain deduction cannot exceed $17,500 for all individual taxpayers except married taxpayers filing separate state returns. In the case of married taxpayers filing separate returns, the aggregate net capital gains to be considered for the deduction cannot exceed $8,750 per spouse. Married taxpayers filing separately on the combined return form shall prorate the $17,500 capital gain deduction limitation between the spouses in the ratio of each spouse's net capital gains from subrules 40.38(1) to 40.38(4) to the total net capital gains of both spouses from subrules 40.38(1) to 40.38(4). The capital gain deduction authorized in this rule does not apply to estates or trusts. Effective for tax years beginning on or after January 1, 1994, the capital gain deduction is not allowed for purposes of computation of a net operating loss for the tax year and for purposes of computing the income for a tax year to which a net operating loss is carried. Subrule 40.38(5) includes information on how the capital gain deduction is treated in a tax year with a net operating loss and in a tax year with the capital gain deduction where a net operating loss deduction is carried.

40.38(1) Net capital gains from sales or exchanges of real property, tangible personal property, or other assets of a business owned by the taxpayer for a minimum of ten years and in which the taxpayer has materially participated for a minimum of ten years. Net capital gains from the sales or exchanges of real property, tangible personal property, or other assets from a business the taxpayer has owned for ten years and in which the taxpayer materially participated as defined in Section 469(h) of the Internal Revenue Code for ten years qualify for the capital gain deduction on limited amounts of capital gains provided in subrule 40.38(2). In the case of installment sales of real property, tangible personal property, or other assets of a business, where the selling price of the business assets is paid to the seller in one or more years after the year in which the sales transaction occurred, all installments received on or after January l, 1990, qualify for the capital gains deduction described in subrule 40.38(2), assuming the taxpayers had met the ownership and material participation requirements at the time the sales transactions occurred. *Herbert Clausen and Sylvia Clausen v. the Iowa Department of Revenue and Finance*, Law No. 32313, Crawford County District Court, May 24, 1995. For example, if a taxpayer received an installment payment in 1996 from the sale of the taxpayer's farmland in 1988, the installment received in 1996 would qualify for the 45 percent capital gain deduction provided in subrule 40.38(2) if the taxpayer had owned the farmland at least ten years at the time of the sale and the taxpayer had materially participated in the farm business for a minimum of ten years at the time of the sale. The following terms and definitions clarify which sales and exchanges of assets of a business qualify for the capital gain deduction authorized in rule 701—40.38(422).

a. Business. A business includes any activity engaged in by a person with the object of gain, benefit, or advantage, either direct or indirect. In addition, a business for purposes of the capital gains deduction in rule 40.38(422) must have been owned by the taxpayer for at least ten years and the taxpayer must have materially participated in the business for at least ten years.

b. Assets of a business. Those assets of a business which may qualify for capital gain treatment under rule 40.38(422) if the assets are sold or exchanged under the conditions described in this rule are real property, tangible personal property, or other assets of a business which were held by the business more than one year at the time the assets were sold or exchanged. However, for purposes of this subrule, tangible personal property of a business does not include cattle or horses described in subrule 40.38(2), other livestock described in subrule 40.38(3), or timber which is described in subrule 40.38(4).

c. Material participation in a business if the taxpayer has been involved in the operation of the business on a regular, continuous, and substantial basis for ten or more years at the time assets of the business are sold or exchanged. If the taxpayer has involvement in a business which meets the criteria for material participation in an activity under Section 469(h) of the Internal Revenue Code and the Treasury rules for material participation in §1.469-5 and §1.469-5T, for ten years or more immediately before the sale or exchange of the assets of a business, the taxpayer shall be considered to have satisfied the material participation requirement for this subrule. In determining whether or not a particular taxpayer has material participation in a business, participation of the taxpayer's spouse in a business must also be taken into account. The spouse's participation in the business must be taken into account even if the spouse does not file a joint state return with the taxpayer, or if the spouse has no ownership interest in the business. A taxpayer is most likely to have material participation in a business if that business is the taxpayer's principal business. However, it is possible for a taxpayer to have had material participation in more than one business in a tax year for purposes of this subrule.

A highly relevant factor in material participation in a business is how regularly the taxpayer is present at the place where the principal operations of a business are carried on. In addition, a taxpayer is likely to have material participation in a business if the taxpayer performs all functions of the business.

The fact that the taxpayer utilizes employees or contracts services to perform daily functions in a business will not prevent the taxpayer from qualifying as materially participating in the business.

Generally, an individual will be considered as materially participating in a tax year if the taxpayer satisfies or meets any of the following tests:

1. The individual participates in the business for more than 500 hours in the taxable year.

EXAMPLE. Joe and Sam Smith are brothers who formed a computer software business in 1981 in Altoona, Iowa. In 1991, Joe spent approximately 550 hours selling software for the business and Sam spent about 600 hours developing new software programs for the business. Both Joe and Sam would be considered to have materially participated in the computer software business in 1991.

2. The individuals' participation in the business constitutes substantially all of the participation in the business for the tax year.

EXAMPLE. Roger McKee is a teacher in a small town in southwest Iowa. He owns a truck with a snowplow blade. He contracts with some of his neighbors to plow driveways. He maintains and drives the truck. In the winter of 1991, there was little snow so Mr. McKee spent only 20 hours in 1991 in clearing driveways. Roger McKee is deemed to have materially participated in the snowplowing business in 1991.

3. The individual participates in the business for more than 100 hours in the tax year and no other individual spends more time in the business activity than the taxpayer.

4. The individual participates in two or more businesses, excluding rental businesses, in the tax year and participates for more than 500 hours in all of the businesses and more than 100 hours in each of the businesses. Thus, the taxpayer is regarded as materially participating in each of the business activities.

EXAMPLE. Frank Evans is a full-time CPA. He owns a restaurant and a record store. In 1992, Mr. Evans spent 400 hours in working at the restaurant and 150 hours at the record store. Mr. Evans is treated as a material participant in each of the businesses in 1992.

5. An individual who has materially participated (by meeting any of the tests in numbered paragraphs "1" through "4" above) in a business for five of the past ten years will be deemed a material participant in the current year.

EXAMPLE. Joe Bernard is the co-owner of a plumbing business. He retired in 1988 after 35 years in the business. Since Joe's retirement, he has retained his interest in the business. Joe is considered to be materially participating in the business for the years through 1993 or for the five years after the year of retirement. Thus, if the plumbing business is sold before the end of 1993, the sale will qualify for the Iowa capital gain on Joe's 1993 Iowa return because he was considered to be a material participant in the business according to the federal rules for material participation.

6. An individual who has materially participated in a personal service activity for at least three years will be treated as a material participant for life. A personal service activity involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting or any other trade or business in which capital is not a material income-producing factor.

EXAMPLE. Gerald Williams is a retired attorney, but retains an interest in the law firm he was involved in for over 40 years. Because the law firm is a personal services activity, Mr. Williams is considered to be a material participant in the law firm even after his retirement from the firm.

7. An individual who participates in the business activity for more than 100 hours may be treated as materially participating in the activity if, based on all the facts and circumstances, the individual participates on a regular, continuous, and substantial basis. The following paragraphs provide clarification regarding the facts and circumstances test:

- A retired or disabled farmer is treated as materially participating in a farming activity for the current year if the farmer materially participated in the activity for five of the last eight years before the farmer's retirement or disability. That is, the farmer must have been subject to self-employment tax in five of the eight years before retirement or disability and had to have been either actively farming so the income was reported on Schedule F or materially participating in a crop-share activity for five of those eight last years prior to retirement or disability.

EXAMPLE. Fred Smith was 80 years old in 1991 when he sold 200 acres of farmland he had owned since 1951. Mr. Smith retired in 1981. In the last eight years before retirement, Mr. Smith was paying self-employment tax on his farm income which was reported on Schedule F for each of those eight years. In the years before he sold the farmland, Mr. Smith was leasing the farmland on a cash-rent basis, whereby Mr. Smith would not be considered to be materially participating in the farming activity. Because Mr. Smith had material participation in the farmland in the eight years before retirement, Mr. Smith was considered to have met the material participation requirement, so the capital gain qualified for the Iowa capital gain deduction.

- A surviving spouse of a farmer is treated as materially participating in the farming activity for the current tax year if the farmer met the material participation requirements at the time of death and the spouse actively participates in the farming business activity. That is, the spouse participates in the making of management decisions relating to the farming activity or arranges for others to provide services (such as repairs, plowing, and planting).
- Management activities of a taxpayer are not considered for purposes of determining if there was material participation if either of the following apply: Anybody other than the taxpayer is compensated for management services; or somebody provides more hours of management services than the taxpayer.

Material participation by individuals in specific types of activities. The following are individuals in specific types of activities that may have unique problems or circumstances related to material participation in a business:

1. Limited partners of a limited partnership. The limited partners will not be treated as materially participating in any activity of a limited partnership except in a situation where the limited partner would be treated as materially participating under the material participation tests in paragraphs "1," "5" and "6" above as if the taxpayer were not a limited partner for the tax year.

2. Work not customarily done by owners. Work done in connection with an activity shall not be treated as participation in the activity if both of the following apply:

Such work is not of a type that is customarily done by an owner of such activity; and

One of the principal purposes for the performance of such work is to avoid the disallowance of any loss or credit from such activity.

3. Participation in a business by an investor. Work done by an individual in the individual's capacity as an investor in an activity is not considered to be material participation in the business or activity unless the investor is directly involved in the day-to-day management or operations of the activity or business.

4. Cash farm lease. A farmer who rents farmland on a cash basis will not generally be considered to be materially participating in the farming activity. The burden is on the landlord to show there was material participation in the cash-rent farm activity.

5. Farm landlord involved in crop-share arrangement. A farm landlord is subject to self-employment tax on net income from a crop-share arrangement with a tenant. The landlord is considered to be materially participating with the tenant in the crop-share activity if the landlord meets one of the four following tests:

TEST 1. The landlord does any three of the following: (1) Pay or be obligated to pay for at least half the direct costs of producing the crop; (2) Furnish at least half the tools, equipment, and livestock used in producing the crop; (3) Consult with the tenant; and (4) Inspect the production activities periodically.

TEST 2. The landlord regularly and frequently makes, or takes part in making, management decisions substantially contributing to or affecting the success of the enterprise.

TEST 3. The landlord worked 100 hours or more spread over a period of five weeks or more in activities connected with crop production.

TEST 4. The landlord has done tasks or performed duties which, considered in their total effect, show that the landlord was materially and significantly involved in the production of the farm commodities.

6. Conservation reserve payments. Farmers entering into long-term contracts providing for less intensive use of highly erodible or other specified cropland can receive compensation for conversion of such land in the form of an "annualized rental payment." Although the CRP payments are referred to as "rental payments," the payments are considered to be receipts from farm operations and not rental payments from real estate.

If an individual is receiving CRP payments and is not considered to be retired from farming, the CRP payments are subject to self-employment tax. If individuals actively manage farmland placed in the CRP program by directly participating in seeding, mowing, and planting the farmland or by overseeing these activities, the owner will be considered to have had material participation in the farming activity.

7. Rental activities or businesses. For purposes of this subrule 40.38(1), the general rule is that a taxpayer who actively participates in a rental activity or business which would be considered to have been material participation in another business or activity would not be deemed to have had material participation in the rental activity unless covered by a specific exception in this subrule. Rental activity or rental business is as the term is used in Section 469(c) of the Internal Revenue Code.

40.38(2) Net capital gains from sales of cattle or horses used for certain purposes which were held for 24 months by taxpayers who received more than one-half of their gross incomes from farming or ranching. Net capital gains from the sales of cattle or horses held 24 months or more for breeding, dairy, or sporting purposes qualify for the capital gains deduction on limited capital gains provided in rule 40.38(422) if more than 50 percent of the taxpayer's gross income in the tax year is from farming or ranching operations. Proper records should be kept showing purchase and birth dates of cattle and horses. The absence of records may make it impossible for the owner to show that the owner has held a particular animal for the necessary holding period. Whether cattle or horses are held for draft, breeding, sporting, or dairy purposes depends on all the facts and circumstances of each case.

Whether or not cattle or horses sold by the taxpayer after the taxpayer has held them 24 months or more were held for draft, breeding, dairy, or sporting purposes may be determined from federal court cases on such sales and the standards and examples included in Treasury Regulations §1.1231-2.

A taxpayer's gross income from farming or ranching includes amounts the individual has received in the tax year from cultivating the soil or raising or harvesting any agricultural commodities. This includes the income from the operation of a stock, dairy, poultry, fish, bee, fruit, or truck farm, plantation, ranch, nursery, range, orchard, or oyster bed, as well as income in the form of crop shares received from the use of the taxpayer's land. It also includes total gains from sales of draft, breeding, dairy, or sporting livestock. In the case of individual income tax returns for the 1988 tax year gross income from farming includes the total of the amounts from line 12 or line 52 of Schedule F and line 8 of Form 4835, (Farm Rental Income and Expenses), plus the share of partnership income from farming, the share of distributable net taxable income from farming of an estate or trust, and total gains from the sale of livestock held for draft, breeding, sport, or dairy purposes, as shown on Form 4797 (Sale of Business Property). In the case of an individual's returns for tax years beginning after 1988, equivalent lines from returns and supplementary forms would be used to determine a taxpayer's gross income from farming or ranching for those years.

To make the calculation as to whether more than half of the taxpayer's gross income in the tax year is from farming or ranching operations, the gross income from farming or ranching as determined in the previous paragraph is divided by the taxpayer's total gross income. If the resulting percentage is greater than 50 percent, the taxpayer's capital gains from sales of cattle and horses described previously in this subrule will be considered for the capital gain deduction provided in rule 40.38(422).

In instances where married taxpayers file a joint return, the gross income from farming or ranching of both spouses will be considered for the purpose of determining whether or not the taxpayers received more than half of their gross income from farming or ranching.

However, in situations where married taxpayers file separate Iowa returns or separately on the combined return form, each spouse must separately determine whether or not that spouse has more than 50 percent of gross income from farming or ranching operations.

40.38(3) Net capital gains from sale of breeding livestock, other than cattle or horses, held 12 or more months by taxpayers who received more than one-half of gross incomes from farming or ranching. Net capital gains from the sale of breeding livestock, other than cattle or horses, held 12 or more months from the date of acquisition qualify for the capital gain deduction in rule 40.38(422), if more than one-half of the taxpayer's gross income is from farming or ranching. For the purposes of this subrule, "livestock" has a broad meaning and includes hogs, mules, donkeys, sheep, goats, fur-bearing mammals, and other mammals. Livestock does not include poultry, chickens, turkeys, pigeons, geese, other birds, fish, frogs, reptiles, etc. If livestock other than cattle or horses is considered to have been held for breeding purposes under the criteria established in Treasury Regulation §1.1231-2, the livestock will also be deemed to have been breeding livestock for this subrule. In addition, for the purposes of this subrule livestock does not include cattle and horses held for 24 or more months for draft, breeding, dairy, or sporting purposes which were described in subrule 40.38(2).

The procedure in subrule 40.38(2) for determining whether or not more than 50 percent of a taxpayer's gross income is from farming or ranching operations is also applicable for this subrule.

40.38(4) Net capital gains from sales of timber held by the taxpayer more than one year. Effective for tax years beginning on or after January 1, 1990, capital gains from qualifying sales of timber held by the taxpayer for more than one year are eligible for the capital gains deduction described in rule 40.38(422). In all of the following examples of circumstances where gains from sales of timber qualify for capital gains treatment, it is assumed that the timber sold was held by the owner for more than one year at the time the timber was sold. The owner of the timber can be the owner of the land on which the timber was cut or the holder of a contract to cut the timber. In the case where a taxpayer sells standing timber the taxpayer held for investment, any gain from the sale is a capital gain. Timber includes standing trees usable for lumber, pulpwood, veneer, poles, pilings, crossties, and other wood products. It does not apply to sales of pulpwood cut by a contractor from the tops and limbs of felled trees. Under the general rule, the cutting of timber results in no gain or loss, and it is not until the sale or exchange that gain or loss is realized. But if a taxpayer owned, or had a contractual right to cut timber, the taxpayer may make an election to treat the cutting of timber as a sale or exchange in the year the timber is cut. Gain or loss on the cutting of the timber is determined by subtracting the adjusted basis for depletion of the timber from the fair market value of the timber on the first day of the tax year in which the timber is cut. For example, the gain on this type of transaction is computed as follows:

Fair market value of timber on January 1, 1990	$400,000
Minus: Adjusted basis for depletion	100,000
Capital gain on cutting of timber	$300,000

The fair market value shown above of $400,000 is the basis of the timber. A later sale of the cut timber, including treetops and stumps would result in ordinary income for the taxpayer and not a capital gain.

Evergreen trees, such as those used as Christmas trees, that are more than six years old at the time they are severed from their roots and sold for ornamental purposes, are included in the definition of timber for purposes of this subrule. The term "evergreen trees" is used in its commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees. Where customers of the taxpayer cut down the Christmas tree of their choice on the taxpayer's farm, there is no sale until the tree is cut. However, "evergreen trees" sold in a live state do not qualify for capital gain treatment.

Capital gains or losses also are received from sales of timber by a taxpayer who has a contract which gives the taxpayer an economic interest in the timber. The date of disposal of the timber shall be the day the timber is cut, unless payment for the timber is received before the timber is cut. Under this circumstance, the taxpayer may treat the date of the payment as the date of disposal of the timber.

Additional information about gains and losses from the sale of timber is included under Treasury Regulations §1.631-1 and §1.631-2.

40.38(5) Treatment of capital gain deduction for tax years with net operating losses and for tax years to which net operating losses are carried. The following paragraphs describe the tax treatment of the capital gain deduction in a tax year with a net operating loss and the tax treatment of a capital gain deduction in a tax year to which a net operating loss was carried:

a. For tax years beginning on or after January 1, 1994, the capital gain deduction otherwise allowable on a return is not allowed for purposes of computing a net operating loss from the return which can be carried to another tax year and applied against the income for the other tax year.

EXAMPLE. Joe Jones filed a 1994 return showing a net loss of $12,000. On this return Mr. Jones claimed a capital gain deduction of $3,000 from sale of breeding stock, other than cattle or horses, held 12 months or more which was considered in computing the loss of $12,000. However, the $3,000 capital gain deduction is not allowed in the computation of the net operating loss deduction for 1994 for purposes of carrying the net operating loss deduction to another tax year. Thus, the net operating loss deduction for 1994 is $9,000.

b. In the case of net operating losses for tax years beginning on or after January 1, 1994, which are carried back to a tax year prior to 1994 where the taxpayer has claimed the capital gains deduction described above, the capital gains deduction is not allowed for purposes of computing the income to which the net operating loss deduction is applied.

EXAMPLE. John Brown had a net operating loss of $20,000 on the Iowa return he filed for 1994. Mr. Brown elected to carry back the net operating loss to his 1991 Iowa return. The 1991 return showed a taxable income of $27,000 which included a capital gain deduction of $3,000. For purposes of computing the income in the carryback year to which the net operating loss would be applied, the income was increased by $3,000 to disallow the capital gain deduction properly allowed in computing taxable income for the carryback year. Therefore, the net operating loss deduction from 1994 was applied to an income of $30,000 for the carryback year.

This rule is intended to implement Iowa Code Supplement section 422.7 as amended by 1994 Iowa Acts, Senate File 2057.

701—40.39(422) Exemption of interest from bonds or notes issued to fund the E911 emergency telephone system. Interest received on or after May 4, 1990, from bonds or notes issued by the Iowa finance authority to fund the E911 emergency telephone system is exempt from the state income tax.

This rule is intended to implement Iowa Code sections 422.7 and 477B.20.

701—40.40(422) Exemption of active-duty military pay of national guard personnel and armed forces reserve personnel received for services related to operation desert shield. For tax years ending on or after August 2, 1990, military pay received by persons in the national guard and persons in the armed forces military reserve is exempt from state income tax to the extent the military pay is not otherwise excluded from taxation and the military pay is for active-duty military service on or after August 2, 1990, pursuant to military orders related to Operation Desert Shield. The exemption applies to individuals called to active duty in Iowa to replace other persons who were in military units who were called to serve on active duty outside Iowa provided the military orders specify that the active duty assignment in Iowa pertains to Operation Desert Shield.

Persons filing original returns or amended returns on Form IA 1040X for tax years where the exempt income was received should print the notation, "Operation Desert Shield" at the top of the original return form or amended return form. A copy of the military orders showing the person was called to active duty and was called in support of Operation Desert Shield should be attached to the original return form or amended return form to support the exemption of the active duty military pay.

This rule is intended to implement Iowa Code section 422.7.

701—40.41(422) Disallowance of private club expenses.

40.41(1) Expenses incurred on or after July 1, 1991, through December 31, 1993, with respect to expenditures made at, or payments to, a club which restricts membership or the use of its services or facilities on the basis of age, sex, marital status, race, religion, color, ancestry, or national origin are disallowed as a deduction and, therefore, must be added to federal adjusted gross income. For the purposes of this rule, restricting membership or use of services or facilities due to a legal age requirement is not considered to be discrimination.

40.41(2) Definitions for the purposes of this rule.

a. The term *"expenses"* means those expenses otherwise deductible under Section 162(a) of the Internal Revenue Code and includes, but is not limited to, club membership dues and assessments, food and beverage expenses, expenses for services furnished by the club, and reimbursements or salary adjustments to officers or employees for any of the preceding expenses.

b. The term *"club"* means any nonprofit corporation or association of individuals which is the owner, lessee, or occupant of a permanent building or part of a building, membership in which entails the prepayment of regular dues, and which is not operated for a profit other than profits which would accrue to the entire membership including, but not limited to, any chapter, aerie, parlor, lodge, or other local unit of an American national fraternal organization.

A club described in this rule holding an alcoholic beverage license pursuant to Iowa Code chapter 123 must provide on each receipt furnished to a taxpayer a printed statement as follows: "The expenditures covered by this receipt are nondeductible for state income tax purposes."

This rule is intended to implement Iowa Code Supplement section 422.7 as amended by 1994 Iowa Acts, Senate File 2215.

701—40.42(422) Depreciation of speculative shell buildings.

40.42(1) For tax years beginning on or after January 1, 1992, speculative shell buildings constructed or reconstructed after that date may be depreciated as 15-year property under the accelerated cost recovery system of the Internal Revenue Code. If the taxpayer has deducted depreciation on the speculative shell building on the taxpayer's federal income tax return, that amount of depreciation must be added to the federal adjusted gross income in order to deduct depreciation computed under this rule.

40.42(2) On sale or other disposition of the speculative building, the taxpayer must report on the taxpayer's Iowa individual income tax return the same gain or loss as is reported on the taxpayer's federal individual income tax return. If, while owned by the taxpayer, the building is converted from a speculative shell building to another use, the taxpayer must deduct the same amount of depreciation on the taxpayer's Iowa tax return as is deducted on the taxpayer's federal tax return.

40.42(3) For the purposes of this rule, the term "speculative shell building" means a building as defined in Iowa Code subsection 427.1(4).

This rule is intended to implement Iowa Code section 422.7.

701—40.43(422) Retroactive exemption for payments received for providing unskilled in-home health care services to a relative. Retroactive to January 1, 1988, for tax years beginning on or after that date, supplemental assistance payments authorized under Iowa Code section 249.3(2)*"a"*(2) which are received by an individual providing unskilled in-home health care services to a member of the caregiver's family are exempt from state income tax to the extent that the individual caregiver is not a licensed health care professional designated in Iowa Code section 147.13, subsections 1 to 10.

For purposes of this exemption, a member of the caregiver's family includes a spouse, parent, stepparent, child, stepchild, brother, stepbrother, sister, stepsister, lineal ancestor such as grandparent and great-grandparent, and lineal descendant such as grandchild and great-grandchild, and those previously described relatives that are related by marriage or adoption. Those licensed health care professionals that are not eligible for this exemption include medical doctors, doctors of osteopathy, physician assistants, psychologists, podiatrists, chiropractors, physical therapists, occupational therapists, nurses, dentists, dental hygienists, optometrists, speech pathologists, and audiologists.

Taxpayers who paid state income tax on the supplemental assistance payments on individual income tax returns for tax years beginning in the 1988 calendar year and who are eligible for the exemption may claim refunds of state income tax paid on the assistance payments, if the refund claims are filed with the department of revenue and finance on or before April 30, 1993.

This rule is intended to implement Iowa Code section 422.7.

701—40.44(422,541A) Individual development accounts. Individual development accounts are authorized for low-income taxpayers for tax years beginning on or after January 1, 1994. Additions to the accounts are described in the following subrule:

40.44(1) *Exemption of additions to individual development accounts.* The following additions to individual development accounts are exempt from the state income tax of the owners of the accounts to the extent the additions were subject to federal income tax:

a. The amount of contributions made in the tax year to an account by persons and entities other than the owner of the account.

b. The amount of any savings refund made in the tax year to an account as authorized for contributions made to the accounts by the owner of the account.

c. Earnings on the account in the tax year or interest earned on the account.

40.44(2) *Additions to net income for withdrawals from individual development accounts.* Rescinded IAB 9/11/96, effective 10/16/96.

This rule is intended to implement Iowa Code sections 422.7, 541A.2 and 541A.3 as amended by 1996 Iowa Acts, Senate File 2324.

701—40.45(422) Exemption for distributions from pensions, annuities, individual retirement accounts, and deferred compensation plans received by nonresidents of Iowa. For tax years beginning on or after January 1, 1994, a distribution from a pension plan, annuity, individual retirement account, and deferred compensation plan which is received by a nonresident of Iowa is exempt from Iowa income tax to the extent the distribution is directly related to the documented retirement of the pensioner, annuitant, owner of individual retirement account, or participant in a deferred compensation arrangement. In a situation where the pensioner, annuitant, owner of the individual retirement account, or participant of a deferred compensation arrangement dies before the date of documented retirement, any distribution from the pension, annuity, individual retirement account, or deferred compensation arrangement will not be taxable to the beneficiary receiving the distributions, if the beneficiary is a nonresident of Iowa. If the pensioner, annuitant, owner of the individual retirement account, or participant of a deferred compensation arrangement dies after the date of documented retirement, any distributions from the pension, annuity, individual retirement account, or deferred compensation arrangement will not be taxable to a beneficiary receiving distributions if the beneficiary is a nonresident of Iowa.

For purposes of this rule, the distributions from the pensions, annuities and deferred compensation arrangements were from pensions, annuities, and deferred compensation earned entirely or at least partially from employment or self-employment in Iowa. For purposes of this rule, distributions from individual retirement arrangements were from individual retirement arrangements that were funded by contributions from the arrangements that were deductible or partially deductible on the Iowa income tax return of the owner of the individual retirement accounts.

The following subrules include definitions and examples which clarify when distributions from pensions, annuities, individual retirement accounts, and deferred compensation arrangements are exempt from Iowa income tax, when the distributions are received by nonresidents of Iowa:

40.45(1) *Definitions.*

a. The word "beneficiary" means an individual who receives a distribution from a pension or annuity plan, individual retirement arrangement, or deferred compensation plan as a result of either the death or divorce of the pensioner, annuitant, participant of a deferred compensation arrangement, or owner of an individual retirement account.

b. The term "individual's documented retirement" means any evidence that the individual can provide to the department of revenue and finance which would establish that the individual or the individual's beneficiary is receiving distributions from the pension, annuity, individual retirement account, or the deferred compensation arrangement due to the retirement of the individual.

Examples of documents that would establish an individual's retirement may include: copies of birth certificates or driver's licenses to establish an individual's age; copies of excerpts from an employer's personnel manual or letter from employer to establish retirement or early retirement policies; a copy of a statement from a physician to establish an individual's disability which could have contributed to a person's retirement.

c. The term "nonresident" applies only to individuals and includes all individuals other than those individuals domiciled in Iowa and those individuals who maintain a permanent place of abode in Iowa. See 701—subrule 38.1(9) for the definition of domicile.

40.45(2) *Examples:*

a. John Jones had worked for the same Iowa employer for 32 years when he retired at age 62 and moved to Arkansas in March of 1994. Mr. Jones started receiving distributions from the pension plan from his former employer starting in May 1994. Because Mr. Jones was able to establish that he was receiving the distributions from the pension plan due to his retirement from his employment, Mr. Jones was not subject to Iowa income tax on the distributions from the pension plan. Note that Mr. Jones had sold his Iowa residence in March and established his domicile in Arkansas at the time of his move to Arkansas.

b. Wanda Smith was the daughter of John Smith who died in February 1994 after 25 years of employment with a company in Urbandale, Iowa. Wanda Smith was the sole beneficiary of John and started receiving distributions from John's pension in April 1994. Wanda Smith was a bona fide resident of Oakland, California, when she received distributions from her father's pension. Wanda was not subject to Iowa income tax on the distributions since she was a nonresident of Iowa at the time the distributions were received.

c. Martha Graham was 55 years old when she quit her job with a firm in Des Moines to take a similar position with a firm in Dallas, Texas. Ms. Graham had worked for the Des Moines business for 22 years before she resigned from the job in May 1994. Starting in July 1994, Ms. Graham received monthly distributions from the pension from her former Iowa employer. Although Ms. Graham was a nonresident of Iowa, she was subject to Iowa income tax on the pension distribution since the taxpayer didn't have a documented retirement.

d. William Moore was 58 years old when he quit his job with a bank in Mason City in February 1994 after 30 years of employment with the bank. By the time Mr. Moore started receiving pension payments from his employment with the bank, he had moved permanently to New Mexico. Shortly after he arrived in New Mexico, Mr. Moore secured part-time employment. The pension payments were not taxable to Iowa as Mr. Moore was retired notwithstanding his part-time employment in New Mexico.

e. Joe Brown had worked for an Iowa employer for 25 years when he retired in June 1992 at the age of 65. Mr. Brown started receiving monthly pension payments in July 1992. Mr. Brown resided in Iowa until August 1994, when he moved permanently to Nevada to be near his daughter. Mr. Brown was not taxable to Iowa on the pension payments he received after his move to Nevada. Mr. Brown's retirement occurred in June 1992 when he resigned from full-time employment.

This rule is intended to implement Iowa Code section 422.8.

701—40.46(422) Taxation of compensation of nonresident members of professional athletic teams. Effective for tax years beginning on or after January 1, 1995, the Iowa source income of a nonresident individual who is a member of a professional athletic team includes the portion of the individual's total compensation for services provided for the athletic team that is in the ratio that the number of duty days spent in Iowa rendering services for the team during the tax year bears to the total number of duty days spent both within and without Iowa in the tax year. Thus, if a nonresident member of a professional athletic team has $50,000 in total compensation from the team in 1995 and the athlete has 20 Iowa duty days and 180 total duty days for the team in 1995, $5,556 of the compensation would be taxable to Iowa ($50,000 × 20/180 = $5,556).

The following subrules include definitions, examples, and other information which clarify Iowa's taxation of nonresident members of professional athletic teams:

40.46(1) *Definitions.*

a. The term "professional athletic team" includes, but is not limited to, any professional baseball, basketball, football, soccer, or hockey team.

b. The term "member of a professional athletic team" includes those employees who are active players, players on the disabled list, and any other persons required to travel and who travel with and perform services on behalf of a professional athletic team on a regular basis. This includes, but is not limited to, coaches, managers, and trainers.

c. The term "total compensation for services rendered as a member of a professional athletic team" means the total compensation received during the taxable year for services rendered. "Total compensation" includes, but is not limited to, salaries, wages, bonuses (as described in subparagraph (1) of this paragraph), and any other type of compensation paid during the taxable year to a member of a professional athletic team for services performed in that year. Such compensation does not include strike benefits, severance pay, termination pay, contract or option year buy-out payments, expansion or relocation payments, and any other payments not related to services rendered for the team.

For purposes of this paragraph, "bonuses" included in "total compensation for services rendered as a member of a professional athletic team" subject to the allocation described in this rule are:

(1) Bonuses earned as a result of play (i.e., performance bonuses) during the season, including bonuses paid for championship, playoff, or "bowl" games played by a team, or for the member's selection to all-star, league, or other honorary positions; and

(2) Bonuses paid for signing a contract, unless all of the following conditions are met:

1. The payment of the signing bonus is not conditional upon the signee playing any games for the team, or performing any subsequent services for the team, or even making the team;
2. The signing bonus is payable separately from the salary and any other compensation; and
3. The signing bonus is nonrefundable.

d. Except as provided in subparagraphs (4) and (5) of this paragraph, the term "duty days" means all days during the taxable year from the beginning of the professional athletic team's official preseason training period through the last game in which the team competes or is scheduled to compete. Duty days are included in the allocation described in this rule for the tax year in which they occur, including where a team's official preseason training period through the last game in which the team competes, or is scheduled to compete, occurs during more than one tax year.

(1) Duty days also includes days on which a member of a professional athletic team renders a service for a team on a date which does not fall within the previously mentioned period (e.g., participation in instructional leagues, the "Pro Bowl" or promotional "caravans"). Rendering a service includes conducting training and rehabilitation activities, but only if conducted at the facilities of the team.

(2) Included within duty days are game days, practice days, days spent at team meetings, promotional caravans and preseason training camps, and days served with the team through all postseason games in which the team competes or is scheduled to compete.

(3) Duty days for any person who joins a team during the period from the beginning of the professional athletic team's official preseason training period through the last game in which the team competes, or is scheduled to compete, begins on the day the person joins the team. Conversely, duty days for any person who leaves a team during such period ends on the day the person leaves the team. When a person switches teams during a taxable year, separate duty day calculations are to be made for the period the person was with each team.

(4) Days for which a member of a professional athletic team is not compensated and is not rendering services for the team in any manner, including days when the member of a professional athletic team has been suspended without pay and prohibited from performing any services for the team, are not to be treated as duty days.

(5) Days for which a member of a professional athletic team is on the disabled list and does not conduct rehabilitation activities at facilities of the team and is not otherwise rendering services for the team in Iowa, are not to be considered duty days spent in Iowa. However, all days on the disability list are considered to be included in total duty days spent both within and outside the state of Iowa.

(6) Total duty days for members of a professional athletic team that are not professional athletes are the number of days in the year that the members are employed by the professional athletic team. Thus, in the case of a coach of a professional athletic team who was coach for the entire year of 1995, the coach's total duty days for 1995 would be 365.

(7) Travel days in Iowa by a team member that do not involve a game, practice, team meeting, all-star game, or other personal service for the team are not considered to be duty days in Iowa. However, to the extent these days fall within the period from the team's preseason training period through the team's final game, these Iowa travel days will be considered in the total duty days spent within and outside Iowa, for team members who are professional athletes.

(8) Duty days in Iowa do not include days a team member performs personal services for the professional athletic team in Iowa on those days that the team member is a bona fide resident of a state with which Iowa has a reciprocal tax agreement. See rule 701—38.13(422).

40.46(2) *Filing composite Iowa returns for nonresident members of professional athletic teams.* Professional athletic teams may file composite Iowa returns on behalf of team members who are nonresidents of Iowa and who have compensation that is taxable to Iowa from duty days in Iowa for the athletic team. However, the athletic team may include on the composite return only those team members who are nonresidents of Iowa and who have no Iowa source incomes other than the incomes from duty days in Iowa for the team. The athletic team may exclude from the composite return any team member who is a nonresident of Iowa and whose income from duty days in Iowa is less than $1,000. See rule 701—48.1(422) about filing Iowa composite returns.

40.46(3) *Examples of taxation of nonresident members of professional athletic teams.*

a. Player A, a member of a professional athletic team, is a nonresident of Iowa. Player A's contract for the team requires A to report to such team's training camp and to participate in all exhibition, regular season, and playoff games. Player A has a contract which covers seasons that occur during year 1/year 2 and year 2/year 3. Player A's contract provides that A is to receive $500,000 for the year 1/year 2 season and $600,000 for the year 2/year 3 season. Assuming player A receives $550,000 from the contract during taxable year 2 ($250,000 for one-half the year 1/year 2 season and $300,000 for one-half the year 2/year 3 season), the portion of compensation received by player A for taxable year 2, attributable to Iowa, is determined by multiplying the compensation player A receives during the taxable year ($550,000) by a fraction, the numerator of which is the total number of duty days player A spends rendering services for the team in Iowa during taxable year 2 (attributable to both the year 1/year 2 season and the year 2/year 3 season) and the denominator of which is the total number of player A's duty days spent both within and outside Iowa for the entire taxable year.

b. Player B, a member of a professional athletic team, is a nonresident of Iowa. During the season, B is injured and is unable to render services for B's team. While B is undergoing medical treatment at a clinic, which is not a facility of the team, but is located in Iowa, B's team travels to Iowa for a game. The number of days B's team spends in Iowa for practice, games, meetings, for example, while B is present at the clinic, are not to be considered duty days spent in Iowa for player B for that taxable year for purposes of this rule, but these days are considered to be included within total duty days spent both within and outside Iowa.

c. Player C, a member of a professional athletic team, is a nonresident of Iowa. During the season, C is injured and is unable to render services for C's team. C performs rehabilitation exercises at the facilities of C's team in Iowa as well as at personal facilities in Iowa. The days C performs rehabilitation exercise in the facilities of C's team are considered duty days spent in Iowa for player C for that taxable year for purposes of this rule. However, days player C spends at personal facilities in Iowa are not to be considered duty days spent in Iowa for player C for that taxable year for purposes of this rule, but the days are considered to be included within total duty days spent both within and outside Iowa.

d. Player D, a member of a professional athletic team, is a nonresident of Iowa. During the season, D travels to Iowa to participate in the annual all-star game as a representative of D's team. The number of days D spends in Iowa for practice, the game, meetings, for example, are considered to be duty days spent in Iowa for player D for that taxable year for purposes of this rule, as well as included within total duty days spent both within and outside Iowa.

e. Assume the same facts as given in paragraph *"d,"* except that player D is not participating in the all-star game and is not rendering services for D's team in any manner. Player D is instead traveling to and attending this game solely as a spectator. The number of days player D spends in Iowa for the game is not to be considered to be duty days spent in Iowa for purposes of this rule. However, the days are considered to be included within total duty days spent both within and outside Iowa.

40.46(4) *Use of an alternative method to compute taxable portion of a nonresident's compensation as a member of a professional athletic team.* If a nonresident member of a professional athletic team believes that the method provided in this rule for allocation of the member's compensation to Iowa is not equitable, the nonresident member may propose the use of an alternative method for the allocation of the compensation to Iowa. The request for an alternative method for allocation must be filed no later than 60 days before the due date of the return, considering that the due date may be extended for up to 6 months after the original due date if at least 90 percent of the tax liability was paid by the original due date (April 30 for taxpayers filing on a calendar-year basis).

The request for an alternative method should be filed with the Policy Section, Compliance Division, P.O. Box 10457, Des Moines, Iowa 50306. The request must set forth the alternative method for allocation to Iowa of the compensation of the nonresident professional team member. In addition, the request must specify, in detail, why the method for allocation of the compensation set forth in this rule is not equitable, as well as why the alternative method for allocation of the compensation is more equitable than the method provided in this rule. The burden of proof is on the nonresident professional team member to show that the alternative method is more equitable than the method provided in the rule.

If the department determines that the alternative method is more reasonable for allocation of the taxable portion of the team member's compensation than the method provided in this rule, the team member can use the alternative method on the current return and on subsequent returns.

If the department rejects the team member's use of the alternative method, the team member may file a protest within 60 days of the date of the department's letter of rejection. The nonresident team member's protest of the department's rejection of the alternate formula must be made in accordance with rule 701—7.8(17A) and must state, in detail, why the method provided in this rule is not equitable, as well as why the alternative method for allocation of the compensation is more equitable than the method set forth in this rule.

This rule is intended to implement Iowa Code sections 422.3, 422.7, and 422.8.

701—40.47(422) Partial exclusion of pensions and other retirement benefits for disabled individuals, individuals who are 55 years of age or older, surviving spouses, and survivors. For tax years beginning on or after January 1, 1995, an individual who is disabled, is 55 years of age or older, is a surviving spouse, or is a survivor with an insurable interest in an individual who would have qualified for the exclusion is eligible for a partial exclusion of retirement benefits received in the tax year.

"Insurable interest" is a term used in life insurance which also applies to this rule and is defined to be "such an interest in the life of the person insured, arising from the relations of the party obtaining the insurance, either as credit of or surety for the assured, or from the ties of blood or marriage to him, as would justify a reasonable expectation of advantage or benefit from the continuance of his life." *Warnock v. Davis,* 104 U.S. 775, 779, 26 L.Ed. 924; *Connecticut Mut. Life Ins. Co. v. Luchs,* 2 S.Ct. 949, 952, 108 U.S. 498, 27 L.Ed. 800; Appeal of Corson, 6 A. 213, 215, 113 Pa. 438, 57 Am. Rep. 479; *Adams' Adm'r v. Reed,* Ky., 36 S.W. 568, 570; *Trinity College v. Travelers' Co.,* 18 S.E. 175, 176, 113 N.C. 244, 22 L.R.A. 291; *Opitz v. Karel,* 95 N.W. 948, 951, 118 Wis. 527, 62 L.R.A. 982. It is not necessary that the expectation of advantage or profit should always be capable of pecuniary estimation, for a parent has an insurable interest in the life of his child, and a child in the life of his parent, a husband in the life of his wife, and a wife in the life of her husband. The natural affection in cases of this kind is considered as more powerful, as operating the more efficaciously, to protect the life of the insured than any other consideration, but in all cases there must be a reasonable ground, founded on relations to each other, either pecuniary or of blood or affinity, to expect some benefit or advantage from the continuance of the life of the assured. *Warnock v. Davis,* 104 U.S. 775, 26 L.Ed. 924; Appeal of Corson, 6 A. 213, 215, 113 Pa. 438, 57 Am. Rep. 479; *Connecticut Mut. Life Ins. Co. v. Luchs,* 2 S.Ct. 949, 952, 108 U.S. 498, 27 L.Ed. 800.

For purposes of this rule, the term "insurable interest" will be considered to apply to a beneficiary receiving retirement benefits due to the death of a pensioner or annuitant under the same circumstances as if the beneficiary were receiving life insurance benefits as a result of the death of the pensioner or annuitant.

For purposes of this rule, the term "survivor" is a person other than the surviving spouse of an annuitant or pensioner who is receiving the annuity or pension benefits because the person was a beneficiary of the pensioner or annuitant at the time of death of the pensioner or annuitant. In addition, in order for this person to qualify for the partial exclusion of pensions or retirement benefits, this survivor must have had an insurable interest in the pensioner or annuitant at the time of death of the annuitant or pensioner.

A survivor other than the surviving spouse will be considered to have an insurable interest in the pensioner or annuitant if the survivor is a son, daughter, mother, or father of the annuitant or pensioner. The relationship of these individuals to the pensioner or annuitant is considered to be so close that no separate pecuniary or monetary interest between the pensioner or annuitant and any of these relatives must be established.

A survivor may include relatives of the pensioner or annuitant other than those relatives that were mentioned above. However, before any of these relatives can be considered to be a survivor for purposes of this rule, the relative must have had some pecuniary interest in the continuation of the life of the pensioner or annuitant. That is, the relative must establish a relationship with the pensioner or annuitant that shows there was a reasonable expectation of an advantage or benefit which the person would have received with the continuance of the life of the pensioner or annuitant.

The fact that a niece of the pensioner or annuitant was named beneficiary of an uncle's pension where the uncle had no closer relatives does not in itself establish that the niece had an insurable interest in the pension benefits, if the niece was not receiving monetary benefits or the niece did not have some special relationship to the uncle at the time of the uncle's death.

If a grandson was receiving college tuition regularly from his grandfather and received the grandfather's pension as a beneficiary of the grandfather after the grandfather's death, the grandson would be deemed to have an insurable interest in the benefits and would be eligible for the partial retirement benefit exclusion.

A person who is not related to the pensioner or annuitant, such as a partner in a business or a creditor, may have an insurable interest in the pensioner or annuitant. However, the burden of proof is on a nonrelated person to show that the person had an insurable interest in the pensioner or the annuitant at the time of death of the pensioner or annuitant.

There are numerous court cases which deal with whether a person had established an insurable interest in the life of an individual that was insured. These cases may be used as a guideline to determine whether or not a person receiving a pension or annuity due to the death of an annuitant or pensioner had an insurable interest in the annuitant or pensioner at the time of death of the pensioner or annuitant. Thus, if a person would have met criteria for an insurable interest for purposes of an interest in a person's life insurance policy, the person would also be considered to be qualified for an insurable interest in a pensioner or annuitant.

An eligible individual filing a separate state return can exclude up to a maximum of $3,000 in retirement benefits. A husband and wife who file a joint state return can exclude up to a maximum of $6,000 in retirement benefits. Retirement benefits subject to the exclusion include, but are not limited to: benefits from defined benefit or defined contribution pension and annuity plans, benefits from annuities, incomes from individual retirement accounts, benefits from pension or annuity plans contributed by an employer or maintained or contributed by a self-employed person and benefits and earnings from deferred compensation plans. However, the exclusion does not apply to social security benefits. A surviving spouse who is not disabled or is not 55 years of age or older can only exclude retirement benefits received as a result of the death of the other spouse and on the basis that the deceased spouse would have been eligible for the exclusion in the tax year. In order for a survivor other than the surviving spouse to qualify for the partial exclusion of retirement benefits, the survivor must have received the retirement benefits as a result of the death of a pensioner or annuitant who would have qualified for the exclusion in the tax year on the basis of age or disability. In addition, the survivor other than the surviving spouse would have had to have an insurable interest in the pensioner or annuitant at the time of the death of the pensioner or annuitant.

For purposes of this rule, a disabled individual is a person who is receiving benefits as a result of retirement from employment or self-employment due to disability. In addition, a person is considered to be a disabled individual if the individual is determined to be disabled in accordance with criteria established by the Social Security Administration or other federal or state governmental agency.

Note that the pension or other retirement benefits that are excluded from taxation for certain individuals are to be considered as a part of net income for purposes of determining whether or not a particular individual's income is low enough to exempt that taxpayer from tax. In addition, the pension or other retirement benefits that are excluded from taxation for certain individuals are to be considered as a part of net income for the alternative tax computation, which is available to all taxpayers except those taxpayers filing as single individuals.

Finally, the pension or other retirement benefits are to be considered as a part of net income for individuals using the single filing status whose tax liabilities are limited so the liabilities cannot reduce the person's net income plus exempt benefits below $9,000.

This rule is intended to implement Iowa Code sections 422.5 and 422.7.

701—40.48(422) Health insurance premiums deduction. For tax years beginning on or after January 1, 1996, the amounts paid by a taxpayer for health insurance for the taxpayer, the taxpayer's spouse, and the taxpayer's dependents are deductible in computing net income on the Iowa return to the extent the amounts paid were not otherwise deductible in computing adjusted gross income. However, amounts paid by a taxpayer for health insurance on a pretax basis whereby the portion of the wages of the taxpayer used to pay health insurance premiums is not included in the taxpayer's gross wages for income tax or social security tax purposes are not deductible on the Iowa return.

In situations where married taxpayers pay health insurance premiums from a joint checking or other joint account and the taxpayers are filing separate state returns or separately on the combined return form, the taxpayers must allocate the deduction between the spouses on the basis of the net income of each spouse to the combined net income unless one spouse can show that only that spouse's income was deposited to the joint account.

In circumstances where a taxpayer is self-employed and takes a deduction on the 1996 federal return for 30 percent of the premiums paid for health insurance on the federal return, the taxpayer would be allowed a deduction on the Iowa return for the portion of the health insurance premiums that was not deducted on the taxpayer's federal return, including any health insurance premiums deducted as an itemized medical deduction under Section 213 of the Internal Revenue Code.

For purposes of the state deduction for health insurance premiums, the same premiums for the same health insurance or medical insurance coverage qualify for this deduction as would qualify for the federal medical expense deduction. Thus, premiums paid for contact lens insurance qualify for the health insurance deduction. Also eligible for the deduction for tax years beginning in the 1996 calendar year are premiums paid by a taxpayer before the age of 65 for medical care insurance effective after the age of 65, if the premiums are payable (on a level payment basis) for a period of ten years or more or until the year the taxpayer attains the age of 65 (but in no case for a period of less than five years). For tax years beginning on or after January 1, 1997, premiums for long-term health insurance for nursing home coverage are eligible for this deduction to the extent the premiums for long-term health care services are eligible for the federal itemized deduction for medical and dental expenses.

Amounts paid under an insurance contract for other than medical care (such as payment for loss of limb or life or sight) are not deductible, unless the medical charge is stated separately in the contract or provided in a separate statement.

This rule is intended to implement Iowa Code section 422.7 as amended by 1997 Iowa Acts, Senate File 129.

701—40.49(422) Employer social security credit for tips. Employers in the food and beverage industry are allowed a credit under Section 45B of the Internal Revenue Code for a portion of the social security taxes paid or incurred after 1993 on employee tips. The credit is equal to the employer's FICA obligation attributable to tips received which exceed tips treated as wages for purposes of satisfying minimum wage standards of the Fair Labor Standards Act. The credit is allowed only for tips received by an employee in the course of employment from customers on the premises of a business for which the tipping of employees serving food or beverages is customary. To the extent that an employer takes the credit for a portion of the social security taxes paid or incurred, the employer's deduction for the social security tax is reduced accordingly. For Iowa income tax purposes, the full deduction for the social security tax paid or incurred is allowed for tax years beginning on or after January 1, 1994.

This rule is intended to implement Iowa Code Supplement section 422.7.

701—40.50(422) Computing state taxable amounts of pension benefits from state pension plans. For tax years beginning on or after January 1, 1995, a retired member of a state pension plan, or a beneficiary of a member, who receives benefits from the plan where there was a greater contribution to the plan for the member for state income tax purposes than for federal income tax purposes can report less taxable income from the benefits on the Iowa individual income tax return than was reported on the federal return for the same tax year. This rule applies only to a member of a state pension plan, or the beneficiary of a member, who received benefits from the plan sometime after January 1, 1995, and only in circumstances where the member received wages from public employment in 1995 or in later years so the member had greater contributions to the state pension plan for state income tax purposes than for federal income tax purposes.

For example, in the case of a state employee who was covered by IPERS and had wages from covered public employment of $41,000 or more in l995, that person would have made posttax contributions to IPERS of $1,517 for state income tax purposes for 1995 and zero posttax contributions to IPERS for federal income tax purposes for 1995. The $1,517 in contributions to IPERS for federal income tax purposes was made on a pretax basis and was considered to have been made by the employee's employer or the state of Iowa and not the employee. At the time this employee receives retirement benefits from IPERS, the retired employee will be subject to federal income tax on the portion of the benefits that is attributable to the $1,517 IPERS contribution made in 1995. However, this employee will not be subject to state income tax on the portion of the IPERS benefits received which is attributable to the $1,517 contribution to IPERS for 1995.

This rule does not apply to members or beneficiaries of members who elect to take a lump sum distribution of benefits from a state pension plan in lieu of receiving monthly payments of benefits from the plan.

The following subrules further clarify how the portion of certain state pension benefits that is taxable for state individual income tax purposes for tax years beginning on or after January 1, 1995, is determined.

40.50(1) *Definitions related to state taxation of benefits from state pension plan.* The following definitions clarify those terms and phrases that have a bearing on the state's taxation of certain individuals who receive retirement benefits from state pension plans:

a. For purposes of this rule, the terms "state pension," "state pensions," and "state pension plans" mean only those pensions and those pension plans authorized in Iowa Code chapter 97A for public safety peace officers, chapter 97B for Iowa public employees (IPERS), chapter 294 for certain teachers, and chapter 411 for police officers and firefighters. There are other pension plans available for some public employees in the state which may be described as "state pensions" or "state pension plans" in other contexts or situations, but these pension plans are not covered by this rule. An example of a pension plan that is not a "state pension plan" for purposes of this rule is the judicial retirement system for state judges authorized in Iowa Code section 602.9101.

b. For purposes of this rule, "member" is an individual who was employed in public service covered by a state pension plan and is either receiving or was receiving benefits from the pension plan.

c. For purposes of this rule, "beneficiary" is a person who has received or is receiving benefits from a state pension plan due to the death of an individual or member who earned benefits in a state pension plan.

d. For purposes of this rule, the term "IPERS" means the Iowa public employees retirement system.

e. For purposes of this rule, the term "pretax," when the term is applied to a contribution made to a state pension plan during a year from a public employee's compensation, means a contribution to a state pension plan that is not taxed on the employee's income tax return for the tax year in which the contribution is made. The contribution is considered to have been made by the state or the employee's employer and not by the employee so this contribution is not part of the employee's basis in the pension that is not taxed when the pension is received.

f. For purposes of this rule, the term "posttax," when the term is applied to a contribution made to a state pension plan during a year from a public employee's compensation, means the contribution is included in the employee's taxable income for the tax year of the contribution and the contribution is considered to have been made by the employee. That is, the contribution is part of the employee's basis in the pension which is not taxed at the time the pension is received.

40.50(2) *Computation of the taxable amount of the state pension for federal income tax purposes.* An individual who receives benefits in the tax year from one of the state pension plans is not subject to federal income tax on the benefits to the extent of the pensioner's or member's recovery of posttax contribution to the pension plan. The individual receiving benefits in the year from a state pension plan should get a Form 1099-R showing the total benefits received in the tax year from the pension plan. The individual can determine the federal taxable amount of the benefits by using the general rule or the simplified general rule which is described in federal publication 17 or federal publication 575. Note that members who first receive pension benefits after November 18, 1996, must compute the federal taxable amount of their pension benefits by using the simplified general rule shown in the federal tax publications. Note also that individuals receiving benefits in the tax year from IPERS who started receiving benefits in 1993 or in later years will receive information with the 1099-R form which shows the amount of gross benefits received in the tax year that is taxable for federal income tax purposes.

40.50(3) *Computing the taxable amount of state pension benefits for state individual income tax purposes.* An individual receiving state pension benefits in the tax year must have a number of facts about the state pension in order to be able to compute the taxable amount of the pension for Iowa income tax purposes. The individual must know the gross pension benefits received in the tax year, the taxable amount of the pension for federal income tax purposes, the employee's contribution to the pension for federal income tax purposes, and the employee's contribution to the pension for state income tax purposes. In situations where the employee's contribution for state income tax purposes is equal to the contribution for federal income tax purposes, the same amount of the pension will be taxable on the state income tax return as is taxable on the federal return.

In cases when all of an individual's employment covered by a state pension plan occurred on or after January 1, 1995, so that all the contributions to the pension plan (other than posttax service purchases) for the employee were made on a pretax basis for federal income tax purposes, all of the benefits received from the pension would be taxed on the federal income tax return. In this situation, the state taxable amount of the pension would be computed using the general rule or the simplified general rule shown in federal publication 17 or federal publication 575. The employee's state contribution or state basis would be entered on line 2 of the worksheet in the federal publication that is usually used to compute the taxable amount of the pension for the federal income tax return.

To compute the state taxable amount of the state pension in situations where the employee had a contribution to the pension for federal tax purposes, the federal taxable amount for the year is first subtracted from the gross pension benefit received in the year which leaves the amount of the pension received in the year which was not taxable on the federal return. Next, the member's posttax contribution or basis in the pension for federal tax purposes is divided by the member's posttax contribution or basis in the pension for state income tax purposes which provides the ratio of the member's federal basis or contribution to the member's state contribution or basis. Next, the amount of the state pension received in the year that is not taxed on the federal return is divided by the ratio or percentage that was determined in the previous step, which provides the exempt amount of the pension for state tax purposes. Finally, the state exempt amount determined in the previous step is subtracted from the gross amount received in the year, which leaves the taxable amount for state income tax purposes. Note that individuals who retired in 1993 and in years after 1993 and are receiving benefits from IPERS will receive information from IPERS which will advise them of the taxable amount of the pension for state income tax purposes. The examples in subrule 40.50(4) are provided to illustrate how the state taxable amounts of state pension benefits received in the tax year are computed in different factual situations.

40.50(4) *Examples.*

a. A state employee retired in April 1996 and started receiving IPERS benefits in April 1996. The retired state employee received $1,794.45 in gross benefits from IPERS in 1996. The federal taxable amount of the benefits was $1,690.36. The employee's federal posttax contribution or basis in the pension was $4,907 and the state posttax contribution or basis was $7,194. The nontaxable amount of the IPERS benefits for federal income tax was $104.09 which was calculated by subtracting the federal taxable amount of $1,690.36 from the gross amount of the benefits of $1,794.45. The ratio of the employee's posttax contribution to the pension for federal income tax purposes was 68.21 percent of the employee's contribution to the pension for state income tax purposes. This was determined by dividing $4,907 by $7,194. The nontaxable amount of the IPERS benefit for federal income tax purposes of $104.09 was then divided by 68.21 percent, which is the ratio determined in the previous step, and which results in a total of $152.60. This was the nontaxable amount of the pension for state income tax purposes. When $152.60 is subtracted from the gross benefits of $1,794.45 paid in the year, the remaining amount is $1,641.85 which is the taxable amount of the pension that should be reported on the individual's Iowa individual income tax return for the 1996 tax year.

b. A state employee retired in July 1995. The retired employee received $1,881.88 in IPERS benefits in 1996 and $1,790.60 of the benefits was taxable on the individual's federal return for 1996. The person's federal posttax contribution to the IPERS pension was $3,130 and the posttax contribution for state income tax purposes was $3,821. The amount of benefits not taxable for federal income tax purposes was $91.28 which was computed by subtracting the amount of pension benefits of $1,790.60 that was taxable on the federal income tax return from the gross benefits of $1,881.88 received in 1996. The retiree's federal posttax contribution of $3,130 to IPERS was divided by the retiree's posttax contribution of $3,821 to IPERS for state income tax purposes which resulted in a ratio of 81.91 percent. The amount of IPERS benefits of $91.28 exempt for federal income tax purposes is divided by the 81.91 percent computed in the previous step which results in an amount of $111.44 which is the amount of IPERS benefits received in 1996 which is not taxable on the Iowa return. $111.44 is subtracted from the gross benefits of $1,881.88 received in 1996 which leaves the state taxable amount for 1996 of $1,770.44.

This rule is intended to implement Iowa Code section 422.7.

701—40.51(422) Exemption of active-duty military pay of national guard personnel and armed forces military reserve personnel for overseas services pursuant to military orders for peacekeeping in the Bosnia-Herzegovina area. For active duty military pay received on or after November 21, 1995, by national guard personnel and by armed forces military reserve personnel, the pay is exempt from state income tax to the extent the military pay was earned overseas for services performed pursuant to military orders related to peacekeeping in the Bosnia-Herzegovina area. In order for the active duty pay to qualify for exemption from tax, the military service had to have been performed outside the United States, but not necessarily in the Bosnia-Herzegovina area.

This rule is intended to implement Iowa Code section 422.7 as amended by 1997 Iowa Acts, House File 355.

701—40.52(422) Mutual funds. Iowa does not tax dividend or interest income from regulated investment companies to the extent that such income is derived from interest on United States Government obligations or obligations of this state and its political subdivisions. The exemption is also applicable to income from regulated investment companies which is derived from interest on government-sponsored enterprises and agencies where federal law specifically precludes state taxation of such interest. Income derived from interest on securities which are merely guaranteed by the federal government or from repurchase agreements collateralized by the United States Government obligations is not excluded and is subject to Iowa income tax. There is no distinction between Iowa's tax treatment of interest received by a direct investor as compared with a mutual fund shareholder. The interest retains its same character when it "flows-through" the mutual fund and is subject to taxation accordingly.

Taxpayers may subtract from federal adjusted gross income, income received from any of the obligations listed in 701—subrule 40.2(1) and rule 701—40.3(422) above, even if the obligations are owned indirectly through owning shares in a mutual fund:

1. If the fund invests exclusively in these state tax-exempt obligations, the entire amount of the distribution (income) from the fund may be subtracted.
2. If the fund invests in both exempt and nonexempt obligations, the amount represented by the percentage of the distribution that the mutual fund identifies as exempt may be subtracted.
3. If the mutual fund does not identify an exempt amount or percentage, taxpayers may figure the amount to be subtracted by multiplying the distribution by the following fraction: as the numerator, the amount invested by the fund in state-exempt United States obligations; as the denominator, the fund's total investment. Use the year-end amounts to figure the fraction if the percentage ratio has remained constant throughout the year. If the percentage ratio has not remained constant, take the average of the ratios from the fund's quarterly financial reports.

Therefore, if the federal adjusted gross income of an individual, taxable by Iowa, includes dividends or interest of this type, an adjustment must be made deducting the amount of the dividend or interest.

This rule is intended to implement Iowa Code section 422.7.

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