Fiscal Note

Fiscal Services Division

HF 2317 – Income Tax Rate Reduction and Exemptions (LSB5798HV)
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Fiscal Note Version – New

Description

House File 2317 reduces Iowa individual income tax rates and also creates several new exemptions from the Iowa income tax. By Division, the Bill does the following:

- **Division I** — Exempts capital gains earned through the sale or exchange of capital stock in a qualified corporation. The exemption is available to taxpayers defined under the Bill as employee-owners and applies to stock in a qualified company that was acquired while employed by and on account of employment with the qualified company. The Bill grants one irrevocable lifetime election to exclude such capital gains income and the exemption is phased in over three calendar years. The change is effective beginning with calendar year (CY) 2023, and 33.0% of any qualified capital gains will be exempt for that year while 66.0% will be exempt for CY 2024. Beginning with CY 2025, qualified sales will be fully exempt from Iowa individual income tax.
- **Division II** — Exempts total net income received by a retired farmer pursuant to a farm tenancy agreement covering real property if the retired farmer held the property for 10 years or more and materially participated in a farming business for 10 years or more. To be eligible, a retired farmer must be 55 years of age or older and must no longer materially participate in farming. The exemption is effective beginning January 1, 2023.
- **Division III** — Expands the farm capital gains income exemption that is available beginning tax year (TY) 2023 on the sale of real property used in a farming business and the sale of cattle, horses, and breeding livestock. The changes expand the qualifying time frame for retired farmers to have materially participated in farm operations. The exemption is effective beginning January 1, 2023, and applies to sales consummated on or after that date.
- **Divisions IV and V** — Reduces Iowa individual income tax rates for TY 2023, TY 2024, and TY 2025 and establishes a single tax rate of 4.00% beginning with TY 2026. Under existing law, Iowa's TY 2023 top individual income tax rate is equal to 6.50%. The Bill reduces the top tax rate to 6.00% for TY 2023, 5.70% for TY 2024, 4.82% for TY 2025, and 4.00% for TY 2026 and after. The number of brackets and the top bracket income levels are also reduced over the four years. Corresponding reductions are made in the alternate tax rate that may apply in situations related to a taxpayer's qualification for Iowa's universal and age-based low-income exemptions from the individual income tax (Iowa Code sections 422.5(3) 422.5(3B)). Division IV takes effect January 1, 2023. Division V takes effect January 1, 2026.
- **Division VI** — Exempts all income defined as retirement income from the State individual income tax for disabled taxpayers and taxpayers age 55 or older. The exemption also applies to a deceased person's retirement income that is received by a surviving spouse or a person with an insurable interest in the deceased person. The change replaces the current exemption, which is limited to $6,000 for individual taxpayers and $12,000 jointly for married taxpayers, but does not alter the full retirement pay exemption available to retired military personnel that is not based on age or disability. The Bill also excludes retirement income from the calculation of Iowa's universal and age-based low-income full exemptions from individual income tax. The changes are effective beginning TY 2023.

- **Division VII** — Schedules transfers totaling $829.0 million from the [Taxpayer Relief Fund] to the State General Fund over six fiscal years. Division VII takes effect July 1, 2022. The transfer amounts are as follows:
  - FY 2023 = $113.0 million
  - FY 2024 = $159.1 million
  - FY 2025 = $92.3 million
  - FY 2026 = $259.4 million
  - FY 2027 = $195.6 million
  - FY 2028 = $9.6 million

Background

Individual Income Tax Rates and Brackets — Iowa's TY 2022 top individual income tax rate is 8.53%, and that rate applies to taxable income over $78,435. Under provisions enacted in 2018 Iowa Acts, chapter 1161, Iowa's current-law income tax rates and brackets will change starting TY 2023. Under this impending change, Iowa's top tax rate will be 6.50% and will apply to taxable income exceeding $150,000 for married couples filing joint returns and $75,000 for all other filing categories. This Bill strikes the current-law TY 2023 rates and replaces them with lower tax rates and lower tax brackets.

Retirement Income — Current Iowa law allows for a retirement income exemption of up to $6,000 for single filers or $12,000 for married filers. This exemption is available to disabled taxpayers and taxpayers age 55 and older. Military retirement income received from the federal government and Social Security income are also fully excluded from Iowa income tax under current law.

Low-Income Filing Thresholds — Iowa law contains two separate net income thresholds below which low-income taxpayers are not subject to the Iowa income tax. The first threshold applies to all potential taxpayers and is generally equal to $9,000 of net income for single taxpayers and $13,500 for married taxpayers, heads of households, and surviving spouses. This universal low-income threshold generally does not apply to dependents. In determining whether the taxpayer qualifies for the low-income threshold and is therefore fully exempt from Iowa income tax, net income includes sources of income that are not subject to Iowa income tax.

The second threshold is based on higher amounts that apply only to taxpayers who are age 65 or older. The threshold is generally equal to $24,000 of net income for single taxpayers and $32,000 for married taxpayers, heads of households, and surviving spouses. Like the universal low-income threshold, this age-based threshold generally does not apply to dependents. The age-based low-income threshold is available to both spouses as long as one spouse is age 65 or older.

The changes in the Bill to the calculation of the two full-exemption thresholds will allow taxpayers to benefit from the low-income exemptions without regard to the amount of the taxpayers' retirement income.

Assumptions

Capital Gains from Qualified Stock Exemption (Division I) — The Department of Revenue (Department) based the Division I fiscal impact projection on a similar provision of Nebraska tax law that has been in place for a number of years. The Department extrapolated the Iowa estimate from available estimates of the Nebraska law's impact on that state's tax revenue, with adjustment factors for differences in the proposal, state tax rates, and size of the two states' corporate sectors.

The Department's fiscal impact projection for Division I assumes the tax rates and retirement income exemption changes also included in this Bill. This means that if Division I were estimated separately from the other provisions of the Bill, the fiscal impact would be higher.

Retired Farmer Lease Income Exemption (Division II) — The Department based the Division II fiscal impact projection on federal Internal Revenue Service (IRS) data covering taxpayers who filed electronically and met all of the following three criteria:

- Reported net farm rental income.
- Filed IRS schedule F for the past 10 years.
- One or both taxpayers on the return were age 55 or older.

In addition, the Department further adjusted numbers and amounts to account for retired farmers identified who are currently utilizing the Beginning Farmer Tax Credit since the Bill prohibits utilizing both that credit and this new exemption. The Department analysis concluded that 1,295 returns will qualify for the new exemption, with a combined annual farm lease income of $37.8 million (an average of $29,157 per return).

The Department's fiscal impact projection for Division II assumes the tax rates and retirement income exemption changes also included in this Bill. This means that if Division II were estimated separately from the other provisions of the Bill, the fiscal impact would be higher.

Retired Farmer Capital Gains Exemption (Division III) — The Department utilized the following facts, sources, and assumptions to estimate the fiscal impact of Division III:

- The Bill requires that a taxpayer choose between the lease income exemption contained in Division II and the capital gains exemption. It is assumed that taxpayers with this choice will choose the ongoing lease income exemption instead of the capital gains exemption.
- The Bill prohibits taxpayers from benefiting from this new tax exemption during a tax year in which they claim the Beginning Farmer Tax Credit. The Department's estimate adjusts for this interaction.
- Current Iowa law allows a farmer to exempt from taxable income certain capital gains from the sale of real property used in a farm business (reported on Form IA 100B). This Bill expands the narrow area of farm capital gains exemptions available under current law. The Department assumes that an additional 948 retired farmers will benefit from the capital gains exemption each year, with a total exempted annual income amount of $113.1 million.
- Current Iowa law allows a farmer to exempt from taxable income the certain capital gains from the sale of cattle, horses, and breeding livestock (reported on Form IA 100A). This Bill expands the narrow area of capital gains exemptions available under current law. The Department assumes that an additional 230 retired farmers will benefit from the capital gains exemption each year, with a total annual exempted income amount of $25.7 million.

The Department's fiscal impact projection for Division III assumes the tax rates and retirement income exemption changes also included in this Bill. This means that if Division III were estimated separate from the other provisions of the Bill, the fiscal impact would be higher.

Tax Rate Reduction and Retirement Income Exemption (Divisions IV, V, and VI) — The tax reduction estimate was completed by the Department using the individual income tax micromodel developed by the Department. The micromodel is based on income tax returns filed for TY 2020 and is time-adjusted for other enacted State and federal law changes, as well as for personal income and population changes that are projected to occur after the 2020 base tax year.

The model results are adjusted to account for persons who pay Iowa income tax through income tax withholding or other means but do not file Iowa income tax returns. Since the micromodel is based on people who file income tax returns, it does not account for people who make individual income tax payments but then do not file an Iowa income tax return. While not the only example of payments the State might receive from people who do not file income tax returns, most of the payments likely arrive in the form of income tax withholding. When the State lowers income tax rates and/or withholding tables, these nonfilers also receive an income tax reduction. To account for this and other types of nonfiler income tax payments, the micromodel results are adjusted based on the Department's estimate of the amount of nonfiler income tax revenue the State will receive under current law and under the proposed law.

The micromodel produces tax year basis results. The Department converts tax year results to fiscal year estimates using historical relationships between income tax withholding, estimate payments, tax refunds, and payments with filed tax returns.

Income Surtax for Schools — The income surtax for schools is a local option tax that is based on a taxpayer's Iowa income tax liability. Law changes that lower Iowa income tax liability also lower the amount of surtax owed by any taxpayer subject to the surtax. For this projection, the surtax is assumed to equal 2.6% of State income tax liability.

Fiscal Impact

The Bill is projected to reduce individual income tax liability and State General Fund revenue by the amounts in the following table. For fiscal years beyond FY 2028, the impact is projected to increase at a rate similar to future Iowa personal income growth.

Projected Change in Income Tax Liability and State General Fund Revenue
In Millions

Division	Item	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028
I	Qualified Stock Exemption	$ 0.0	$ -4.0	$ -7.6	$ -10.3	$ -9.3	$ -9.8
II	Farm Lease Income Exemption	0.0	-2.1	-2.0	-1.8	-1.6	-1.7
III	Farm Capital Gains Exemption	0.0	-7.2	-6.9	-6.1	-5.5	-5.8
IV and V	Tax Rate Reduction	-37.3	-135.7	-352.1	-905.7	-1,304.9	-1,321.4
VI	Retirement Income Exemption	-179.6	-353.3	-340.6	-359.8	-363.9	-376.4
IV, V, and VI *	Rate Reduction and Exemption Interaction	0.2	7.0	25.9	75.0	81.9	91.4
	Total	$ -216.7	$ -495.3	$ -683.3	$ -1,208.7	$ -1,603.3	$ -1,623.7
VII	Transfers from Taxpayer Relief Fund	$ 113.0	$ 159.1	$ 92.3	$ 259.4	$ 195.6	$ 9.6
	Net General Fund Revenue Change	$ -103.7	$ -336.2	$ -591.0	$ -949.3	$ -1,407.7	$ -1,614.1

* The tax reduction and retirement income components were estimated separately and in combination. This table presents the fiscal impacts separately, and the final line of the table adjusts for the interaction of the two tax reductions.

The decrease in tax liability is projected to also decrease the statewide yield of the local option income surtax for schools by $5.6 million in FY 2023, increasing to $42.2 million by FY 2028. To adjust for the reduction in surtax revenue, local school districts that have the surtax in place may raise the surtax percentage in order to reduce the level of revenue reduction.

The new qualified stock, farm lease, and farm capital gains exemptions are expected to increase the administrative and enforcement costs experienced by the Department of Revenue. No estimate of the annual increase in costs is available at this time.

Source
Department of Revenue

/s/ Holly M. Lyons

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