Fiscal Note

Fiscal Services Division

HF 2317 – Income Tax Rate Reduction and Exemptions (LSB5798HV.1)
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Fiscal Note Version – As amended by S-5022 (strike after amendment)

Description

House File 2317 as amended by S-5022 (strike after amendment) reduces Iowa individual income tax rates, creates several new exemptions from the Iowa individual income tax, reduces corporate income tax rates, and makes changes to tax credits. Provisions of the Bill have various effective dates. **Figure 2** at the end of this ***Fiscal Note*** summarizes the fiscal impacts of the various Bill divisions.

Division I — Stock Capital Gains Income Tax Exemption

Description and Background

The Bill 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.

Assumptions/Fiscal Impact (Division I)

The Department of Revenue (Department) based the stock capital gains 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 projects that the stock capital gains income tax exemption will reduce tax liability and General Fund revenue by the following amounts:

- FY 2024 = $4.0 million
- FY 2025 = $7.6 million
- FY 2026 = $10.3 million
- FY 2027 = $9.0 million
- FY 2028 = $9.5 million

Fiscal impacts beyond FY 2028 are projected to continue, increasing each year at the rate of inflation. The Department's fiscal impact projection assumes the tax rates and retirement income exemption changes also included in this Bill. This means that if the stock capital gains provisions were estimated separately from the Bill's other provisions, the fiscal impact would be higher.

Division II — Farm Lease Income Tax Exemption

<u>Description and Background</u>

The Bill 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.

<u>Assumptions/Fiscal Impact (Division II)</u>

The Department based the farm lease income tax exemption 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 each year for the new exemption, with combined annual farm lease income of $37.8 million (an average of $29,157 per return).

The Department projects that the farm lease income tax exemption will reduce tax liability and General Fund revenue by the following amounts:

- FY 2024 = $2.1 million
- FY 2025 = $2.0 million
- FY 2026 = $1.8 million
- FY 2027 = $1.5 million
- FY 2028 = $1.6 million

Fiscal impacts beyond FY 2028 are projected to continue, increasing each year at the rate of inflation. The Department's fiscal impact projection assumes the tax rates and retirement income exemption changes also included in this Bill. This means that if the farm lease income tax exemption provisions were estimated separately from the Bill's other provisions, the fiscal impact would be higher.

Division III — Farm Capital Gains Income Tax Exemption

<u>Description and Background</u>

The Bill modifies the farm capital gains income exemption, which 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 Bill modifies the qualifying time frame for retired farmers to have materially participated in farm operations. The change to the exemption is effective beginning January 1, 2023, and applies to sales consummated on or after that date. The Bill specifies that sales consummated prior to January 1, 2023, shall be governed by the law as it existed prior to that date.

Assumptions/Fiscal Impact (Division III)

The Department utilized the following facts, sources, and assumptions to estimate the fiscal impact of the Division:

- 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). 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). The Department assumes that an additional 230 retired farmers will benefit from the capital gains exemption each year, with a total estimated annual exempted income amount of $25.7 million.
- The Bill specifies that sales consummated prior to January 1, 2023, are governed by law as it existed prior to that date. Prior to January 1, 2023, the capital gains exemption found in Iowa Code section 422.7(21) is more broad, encompassing the sale of farm and nonfarm businesses, livestock, breeding stock, timber, and qualified Iowa employee stock ownership plans.

The Department projects that the farm capital gains income tax exemption will reduce tax liability and General Fund revenue by the following amounts:

- FY 2024 = $7.2 million
- FY 2025 = $6.9 million
- FY 2026 = $6.1 million
- FY 2027 = $5.4 million
- FY 2028 = $5.7 million

Fiscal impacts beyond FY 2028 are projected to continue, increasing each year at the rate of inflation. The Department's fiscal impact projection assumes the tax rates and retirement income exemption changes also included in this Bill. This means that if the farm capital gains income tax exemption provisions were estimated separately from the Bill's other provisions, the fiscal impact would be higher.

Divisions IV, V, and VI — Income Tax Rate Reductions and Retirement Income Tax Exemption

Description and Background

The Bill reduces Iowa individual income tax rates annually for TY 2023 through TY 2025, and establishes a single tax bracket/rate for TY 2026 and after. Under existing law, Iowa's TY 2023 and after top individual income tax rate is 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 3.90% for TY 2026 and after. The number of brackets and the bracket income levels are also reduced over the 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 section 422.5(3) and section 422.5(3B).

Division IV (income tax rate reductions through TY 2025) takes effect January 1, 2023.

Division V (single bracket/rate) takes effect January 1, 2026.

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. 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.

Division VI exempts all income defined as retirement income from the State individual income tax for disabled taxpayers and taxpayers aged 55 years 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 described in the next paragraph. The change does not alter the full retirement pay exemption available to retired military personnel, which 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.

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.

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/Fiscal Impact (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 previously enacted State and federal law changes, as well as 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 composed of filed 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. The individual income tax rate changes and retirement income exemption are projected to reduce net individual income tax liability and State General Fund revenue by the following amounts:

- FY 2023 = $216.7 million
- FY 2024 = $482.0 million
- FY 2025 = $666.8 million
- FY 2026 = $1,227.4 million
- FY 2027 = $1,651.2 million
- FY 2028 = $1,690.3 million

For years beyond FY 2029, the projected tax liability and State General Fund revenue reductions are expected to increase at the rate of growth in Iowa personal income.

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 individual income tax liability.

Division VII — Research Activities Tax Credit Changes

Description and Background

The Bill makes the following changes to the Research Activities Tax Credit:

- Requires the use of the alternative simplified method of credit calculation for State purposes if that method was used by the applicant for the federal tax credit.
- Disallows supplies and computer use expenses from being claimed as qualifying expenses as part of the credit calculation.
- Reduces tax credit refundability by ten percentage points each tax year through TY 2023. The first reduction would occur in TY 2023. This process will result in tax credit refundability equal to 50.0% for TY 2027 and after.

Assumptions/Fiscal Impact (Division VII)

The modifications of the Research Activities Tax Credit are expected to increase Iowa individual and corporate tax liability and increase State General Fund revenue. The Department utilized the following assumptions in estimating the fiscal impact of these provisions:

- Based on claims over the past three years, it is assumed that 75.0% of claims are from corporations and 25.0% are from individuals.
- Based on records for 2010 through 2019, it is assumed that 58.0% of credit claims will utilize the alternative simplified method and 42.0% will utilize the regular method.
- It is assumed that the disqualification of supplies and computer use expenses will decrease claims by 25.0%.

- It is assumed that tax credits that are not allowed for one tax year due to the reduced refundability provisions will not be allowed as carryforward claims the next tax year.
- The Department estimates that the changes to the Research Activities Tax Credit will increase individual and corporate income tax liability and State General Fund revenue by the following amounts:
  - FY 2024 = $13.1 million
  - FY 2025 = $23.7 million
  - FY 2026 = $30.0 million
  - FY 2027 = $36.6 million
  - FY 2028 = $44.8 million

Fiscal impacts beyond FY 2028 are projected to continue, increasing each year at the rate of inflation.

Division VIII — Other Tax Credit Changes

<u>Description and Background</u>

The Bill makes changes to several existing tax credit programs:

- **High-Quality Jobs Tax Credit** — Requires the Economic Development Authority to prioritize the Research Activities Tax Credit.
- **Geothermal Heat Pump Tax Credit** — Prohibits the issuance of new awards after December 31, 2022.
- **Endow Iowa Tax Credit** — Limits the maximum tax credit dollar amount a single taxpayer may receive in a year.
- **Tax Credit Refundability** — The Bill reduces the refundability (tax credits amounts in excess of taxpayer liability that are refunded to the taxpayer) of certain tax credits by five percentage points each year for five years. The first reduction would occur in TY 2023. This process will result in tax credit refundability of 75.0% for TY 2027 and after. The tax credits included are:
  - Assistive Device Tax Credit
  - Historic Preservation Tax Credit
  - Redevelopment Tax Credit
  - Research Activities Tax Credit (supplemental, included in Division VII)
  - Third-Party Developer Tax Credit

<u>Assumptions/Fiscal Impact (Division VIII)</u>

The changes to the High-Quality Jobs, Geothermal Heat Pump, and Endow Iowa Tax Credits are not projected to have an identifiable fiscal impact. The changes to tax credit refundability are projected to increase tax liability and General Fund revenue by the following amounts:

- FY 2024 = $0.4 million
- FY 2025 = $1.3 million
- FY 2026 = $2.5 million
- FY 2027 = $3.6 million
- FY 2028 = $4.9 million

Fiscal impacts beyond FY 2028 are projected to continue, increasing each year at the rate of inflation. The changes are effective January 1, 2023.

Divisions IX and X — Corporate Income Tax Rate Reduction

Description and Background

The Bill creates a process designed to reduce Iowa corporate income tax rates over a number of years. The process involves comparing the amount of net corporate income tax (gross corporate income tax receipts minus corporate income tax refunds issued) the State receives in a fiscal year to a base amount of $700.0 million. The process begins at the conclusion of FY 2022 and could first lower corporate income tax rates for TY 2023. If net corporate income tax received in a fiscal year exceeds $700.0 million, the Department is directed to calculate what top tax rate would have generated $700.0 million in the fiscal year that just concluded. The result of the calculation will yield a percentage by which the top tax rate for the upcoming tax year shall be lowered. This calculation will take place at the conclusion of each fiscal year until the Iowa corporate income tax rate is lowered to a single rate of 5.50%. Division IX is effective July 1, 2022, and Division X is effective on the first January 1 after the rate reduction process provided in Division IX results in a single corporate income tax rate of 5.50%.

Assumptions/Fiscal Impact (Divisions IX and X)

The Department uses an income tax model that is based on Iowa corporate income tax returns filed for tax years 1990 through 2019 for law change projections. Tax liability for each return is forecasted for future years using tax rates and economic growth projections for corporate income, adjustments, and tax credits. The growth factors used in the model are primarily based on data provided by Moody's Analytics. The model provides two projections for each return. One projection is based on current law and one on the law as proposed in the Bill. The fiscal impact is the tax liability difference between the two estimates. Fiscal impacts are reported on a net basis (gross corporate receipts adjusted for corporate income tax refunds issued).

The fiscal impact projections for Divisions IX and X were produced by the Department using their model and a current-law FY 2022 net corporate income tax revenue estimate provided by the LSA of $780.0 million for FY 2022 and growth for each succeeding fiscal year of 3.5%.

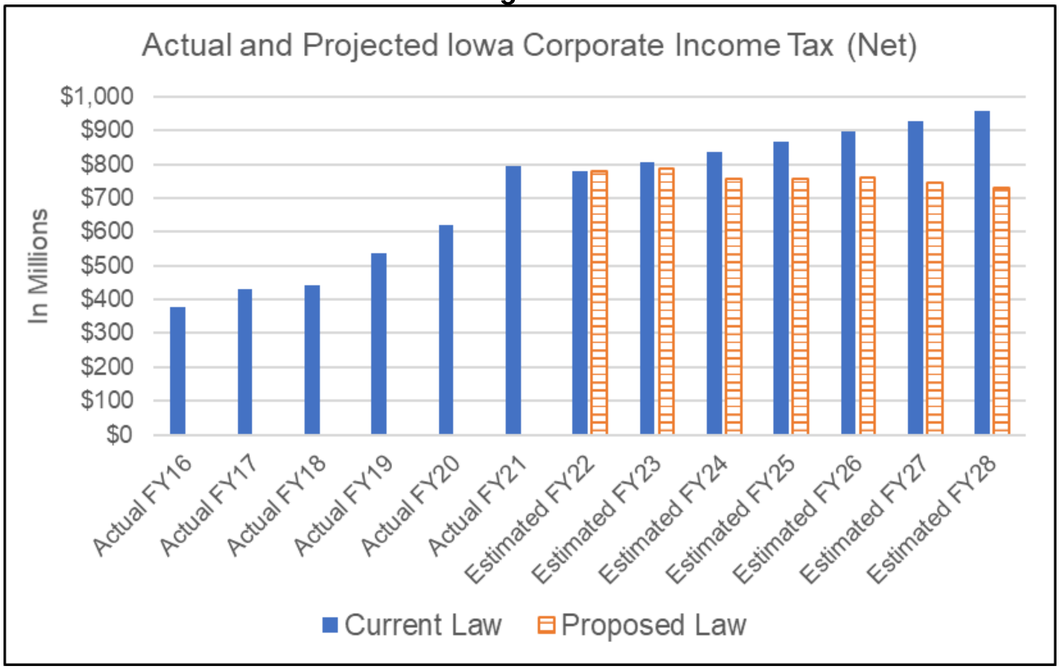
Net corporate income tax receipts for FY 2021 totaled $793.7 million and the FY 2022 projection of $780.0 million represents a decrease of $13.7 million (-1.7%) from the FY 2022 level. Through February 21, 2022, net corporate income tax deposits to the General Fund have increased 5.5% compared to the same date in FY 2021.

The corporate income tax rate changes in the Bill are projected to reduce net corporate income tax liability and State General Fund revenue by the following amounts:

- FY 2023 = $19.6 million
- FY 2024 = $79.6 million
- FY 2025 = $109.8 million
- FY 2026 = $135.3 million
- FY 2027 = $182.1 million
- FY 2028 = $229.4 million

Actual net corporate income tax receipts for FY 2016 through FY 2021, as well as projected receipts under current law and under the proposal, are shown in **Figure 1**.

Figure 1



For years beyond FY 2028, the Bill's process to lower the corporate income tax to a single tax rate of 5.50% over time will result in a fiscal impact for Divisions IX and X that is projected to increase whenever the trigger mechanism put in place activates a rate reduction the next tax year.

Division XI — Tax Expenditure Committee Repeal

Description and Background

This Division repeals the Legislative Tax Expenditure Committee of the Legislative Council. The duty to submit tax expenditure reports to the Council is transferred from the Committee to the various departments that are responsible for oversight of the tax expenditures. The change is effective July 1, 2022, and is not projected to have an identifiable fiscal impact.

Division XII — Taxpayer Relief Fund Transfers

Description and Background

The Bill creates a procedure to automatically transfer all or a portion of the balance in the Taxpayer Relief Fund to the State General Fund if both of the following conditions are met:

- The actual ending balance of the State General Fund is less than 1.0% of the adjusted revenue estimate for the fiscal year.
- State General Fund revenues plus the transfer to the State General Fund from the Economic Emergency Fund as authorized in Iowa Code section 8.55(2)(b) for the fiscal year is less than 103.5% of State General Fund actual receipts for the previous fiscal year.

If both requirements are met, the amount transferred for a fiscal year is limited to the smaller of the following three calculated amounts:

- An amount sufficient to make the total of State General Fund revenues, plus any transfer from the Economic Emergency Fund, plus the transfer from the Taxpayer Relief Fund equal to but not more than 103.5% of the amount of State General Fund revenues for the previous fiscal year.

- An amount sufficient to make the ending balance for the fiscal year equal to but not more than 1.0% of the adjusted revenue estimate for the fiscal year.
- The balance of the Taxpayer Relief Fund.

The new contingent transfer is effective beginning with FY 2024. The full amount of any budgeted transfer from the Taxpayer Relief Fund to the State General Fund is added to the State General Fund expenditure limitation for the fiscal year. The transfer and expenditure limitation increase process is repealed at the conclusion of any fiscal year in which the full balance of the Taxpayer Relief Fund was transferred to the State General Fund through this process.

The Taxpayer Trust Fund currently has a balance of more than $1.0 billion and the balance is projected to increase to almost $2.0 billion by the end of FY 2023. Under current law, the balance in the Fund may only be used pursuant to appropriations or transfers made by the General Assembly for tax relief. The Bill adds this automatic transfer procedure to the allowable uses of the Fund balance.

Assumptions/Fiscal Impact (Division XII)

The automatic Taxpayer Relief Fund transfer procedure created in the Bill will not be activated unless a specific State General Fund financial situation occurs in the future. The specific financial conditions required to trigger a transfer are not predictable. The most likely outcome under current law and under the language of Division XII is that the balance in the Taxpayer Trust Fund will remain until utilized by the Legislature at a future date.

Fiscal Impact

The Bill as amended by S-5022, is projected to reduce individual income tax liability and State General Fund revenue by the amounts in **Figure 2**.

Figure 2

Projected Change in 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	$ -9.0	$ -9.5
II	Farm Lease Income Exemption	0.0	-2.1	-2.0	-1.8	-1.5	-1.6
III	Farm Capital Gains Exemption	0.0	-7.2	-6.9	-6.1	-5.4	-5.7
IV and V	Tax Rate Reduction	-37.3	-135.7	-352.1	-948.2	-1,397.1	-1,413.4
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	80.6	109.8	99.5
	Individual Income Tax Total	$ -216.7	$ -495.3	$ -683.3	$ -1,245.6	$ -1,667.1	$ -1,707.1
IX and X	Corporate Income Tax Rate Reduction	$ -19.6	$ -79.6	$ -109.8	$ -135.3	$ -182.1	$ -229.4
VII	Research Activities Tax Credit	$ 0.0	$ 13.1	$ 23.7	$ 30.0	$ 36.6	$ 44.8
VIII	Assistive Device Tax Credit	0.0	0.0	0.0	0.0	0.0	0.0
VIII	Historic Preservation Tax Credit	0.0	0.3	1.2	2.3	3.3	4.4
VIII	Redevelopment Tax Credit	0.0	0.0	0.0	0.0	0.0	0.1
VII	Research Activities Tax Credit (Supplemental)	0.0	0.0	0.0	0.1	0.1	0.2
VIII	Third-Party Developer Tax Credit	0.0	0.1	0.1	0.1	0.2	0.2
	Tax Credits Total	$ 0.0	$ 13.5	$ 25.0	$ 32.5	$ 40.2	$ 49.7
	Total Projected Change Compared to Current Law	$ -236.3	$ -561.4	$ -768.1	$ -1,348.4	$ -1,809.0	$ -1,886.8

* 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.

For fiscal years beyond FY 2028, the individual income tax portion is projected to increase at a rate similar to the rate of growth in Iowa personal income. Since the process set in place to lower the corporate income tax to a single tax rate of 5.50% is projected to continue after FY 2028, that portion of the Bill's fiscal impact is expected to continue to result in larger reductions in corporate income tax revenue when compared to what would be expected under current law.

The decrease in tax liability is projected to also decrease the statewide yield of the local option income surtax for schools by $5.2 million in FY 2023, increasing to $41.0 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.

Sources

Department of Revenue
Legislative Services Agency analysis

/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.