Fiscal Note

Fiscal Services Division

SF 2372 – Sales and Income Tax Changes (LSB6232SV)
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Fiscal Note Version – New

Description

Senate File 2372 relates to corporate and individual income tax, sales/use tax, automobile rental excise tax, bank franchise tax, and insurance premium tax. Provisions of the Bill have various effective dates. **Table 5** at the end of this ***Fiscal Note*** summarizes the General Fund fiscal impacts of the various Bill divisions.

Division I — Sales and Use Tax on Services and Exemptions

Description and Background

The Bill makes the following changes to the sales tax base, effective January 1, 2023:

- Replaces "software as a service" with "cloud computing" for purposes of imposing the sales tax.
- Makes web hosting and digital automated services subject to the sales tax.
- Exempts cloud computing, web hosting, and digital automated services purchased for use by commercial enterprises from the sales tax.
- Makes scooter rental services subject to the sales tax.
- Eliminates the sales/use tax exemption on the sales price from the sale or rental of computers or computer peripherals by an insurance company, financial institution, or commercial enterprise.
- Removes "professionals and occupations" from the definition of "commercial enterprise," making sales to professions and occupations related to prewritten software, specified digital services, and other services subject to the sales tax.
- Exempts from sales tax the purchase of specified digital products, prewritten computer software, and related services sold to public utilities.
- Exempts from sales tax the sale of period products.
- Exempts from sales tax the sale of child or adult diapers.
- Provides designated exempt entity status to a nonprofit facility licensed by the State built on or after January 1, 2022, that provides residential addiction recovery and emergency shelter services for children. This designation allows the entity to apply to the Department of Revenue for refund of sales/use tax on the sales price of all sales of building materials, supplies, equipment, or contractor services as applicable in Iowa Code section 423.4.
- Provides designated exempt entity status to a fair as defined in Iowa Code section 174.1. This designation allows the entity to apply to the Department of Revenue for refund of sales/use tax on the sales price of all sales of building materials, supplies, equipment, or contractor services as applicable in Iowa Code section 423.4. The change is effective upon enactment and applies retroactively to January 1, 2021. Due to the retroactive applicability, the Bill requires refund claims to be filed prior to October 1, 2022, and total refund claims cannot exceed $25,000.

Assumptions/Fiscal Impact (Division I)

- Replacing "software as a service" with "cloud computing" for purposes of imposing the sales tax, making web hosting and digital automated services subject to the sales tax, and making web hosting and digital automated services subject to the sales tax are expected to have no fiscal impact, because any increase in sales tax collections is offset by exempting from sales tax cloud computing, web hosting, and digital automated services purchased for use by commercial enterprises. It is assumed that the vast majority of identified services are purchased by commercial enterprises.
- The Department of Revenue estimates that sales/use tax revenue will increase 3.6% in FY 2023, 3.0% in FY 2024, 2.7% in FY 2025, 2.6% in FY 2026, 3.0% in FY 2027, and 3.0% in FY 2028. Those Department estimates are used for calculations of those fiscal years. The changes to items added to the base and the removal of exemptions are shown in **Table 1** and include impacts to the Secure an Advanced Vision for Education (SAVE) Fund.

Table 1 — Increase in Sales/Use Tax Collected

In Millions

	Exemption for Scooter Rentals	Exemption for Purchase of Digital Goods for Professions and Occupations	Exemption for Purchase of Digital Goods for Public Utilities	Removal of Exemption for Computers and Peripherals	Exemption for Purchase of Period Products	Exemption for Purchase of Adult & Child Diapers	Total Projected Increase to Sales/Use Tax Collected
FY 2023	$ 0.0	$ 1.4	$ -0.1	$ 34.6	$ -1.0	$ -4.7	$ 30.2
FY 2024	0.1	3.0	-0.2	69.9	-2.0	-9.5	61.2
FY 2025	0.1	3.1	-0.2	71.6	-2.0	-9.7	62.9
FY 2026	0.1	3.2	-0.2	72.2	-2.1	-9.9	63.3
FY 2027	0.1	3.4	-0.3	69.7	-2.1	-10.1	60.7
FY 2028	0.1	3.6	-0.3	66.2	-2.1	-10.3	57.2

The FY 2023 amount is for one-half of the fiscal year.
Totals may not add due to rounding.

- The changes to items added to the base and the removal of exemptions will increase Local Option Sales Tax (LOST) revenue by the following amounts:
  - FY 2023 — $4.8 million (for one-half of the fiscal year)
  - FY 2024 — $9.7 million
  - FY 2025 — $10.0 million
  - FY 2026 — $10.0 million
  - FY 2027 — $9.6 million
  - FY 2028 — $9.1 million
- The information is not available at this time to determine a fiscal impact for changes in the Bill regarding designated exempt entity status for nonprofit facilities licensed by the State built on or after January 1, 2022, that provides residential addiction recovery and emergency shelter services for children.
- The Department of Revenue estimates that annual taxable purchases for construction materials and services by county fairs are estimated to be $10.9 million and will increase 5.0% in 2022 and 2.0% annually thereafter through 2028. The fiscal impact of refund claims for FY 2021 and FY 2022 is assumed to fall in FY 2023. The tax decrease associated with providing designated exempt entity status to county fairs is shown in **Table 2** and includes impacts to the SAVE Fund.

Table 2 — Fiscal Impact of Exemption for County Fair Purchases of Construction Services and Materials

In Millions

	General Fund Including SAVE		LOST	
FY 2023	$	-1.7	$	-0.3
FY 2024		-0.7		-0.1
FY 2025		-0.7		-0.1
FY 2026		-0.7		-0.1
FY 2027		-0.8		-0.1
FY 2028		-0.8		-0.1

Division II — Automobile Rental Excise Tax

Description and Background

The Bill removes an exemption for platform car rentals where an individual registered owner of an automobile makes the automobile available for sharing through a peer-to-peer automobile sharing marketplace. The change is effective January 1, 2023.

From a recent survey, there were fewer than 100 cars listed for this kind of rental throughout the State. This Division is estimated to have little fiscal impact.

Division III — Manufactured Food Sales Tax Exemption

Description and Background

The Bill expands the exemption of items and services used by a manufacturer to produce marketable food products for human consumption to also include an exemption for a manufacturer of food ingredients. The change is effective upon enactment and applies retroactively to January 1, 2019. Due to the retroactive applicability, the Bill requires refund claims to be filed prior to October 1, 2022, and total refund claims cannot exceed $100,000 for any calendar year.

Iowa Code section 423.3(49) provides an exemption for items or services purchased in the production of food. Those items and services are considered taxable if used in the production of food ingredients or other products that could be eaten as food but are not marketable food products for human consumption.

Items, services, equipment, materials, and facilities used in the production of food are often the same as those used in the production of food ingredients or other food products that are not marketable for human consumption. It can be difficult to distinguish an item or service that is used in the production of food products for human consumption from one that is used for some other purpose, which can complicate compliance with the provisions of current law. The difficulty to distinguish has been the source of a number of tax appeals in recent years.

Assumptions/Fiscal Impact (Division III)

- The cost of items and services associated with the manufacture of both food and food ingredients is estimated to have been $445.1 million in 2020, and 80.0% of these costs will fall under the new exemption. Because of current noncompliance, the fiscal impact of the change will be 20.0% of the expanded exemption.

- Growth trends in future fiscal years are based on consumer price index (CPI) and will increase 5.0% in 2021 and 2.0% annually thereafter through 2028.
- The full $100,000 of refund claims per year starting with FY 2019 and continuing through FY 2022 will be utilized, increasing the FY 2023 fiscal impact estimate by $400,000 to account for four years of refund claims being filed.

The tax decrease associated with the expanded exemption is shown in **Table 3** and includes impacts to the SAVE Fund.

Table 3 — Fiscal Impact of Exemption for Manufacturers of Food Ingredients
In Millions

	General Fund Including SAVE		LOST	
FY 2023	$	-5.0	$	-0.8
FY 2024		-4.7		-0.8
FY 2025		-4.8		-0.8
FY 2026		-4.9		-0.8
FY 2027		-5.0		-0.8
FY 2028		-5.1		-0.8

Division IV — National Guard Pay Income Tax Exemption

Description and Background

This Division exempts from the individual income tax up to $20,000 in annual military pay received under 32 U.S.C. §502 (National Guard drills and field exercises). The new exemption is effective retroactively to January 1, 2022.

Under current law, pay received from the federal government for military service performed by members of the armed forces, armed forces military reserve, and the National Guard in an active duty status, as defined in U.S.C. Title 10, is exempt from the Iowa individual income tax.

Assumptions/Fiscal Impact (Division IV)

The fiscal impact estimate was developed by the Department of Revenue using the following sources and procedures:

- Data regarding 2021 pay, rank, and time in service was obtained from the Iowa Army National Guard manning roster. The information includes estimates of taxable income and the number of personnel at each pay grade.
- Pay schedules beyond 2021 were estimated using the Employment Cost Index (ECI) for military personnel. Projections of the ECI for each year through 2028 are based on consensus forecasts from Moody's Analytics.
- Personnel numbers for each pay grade through 2028 are assumed to remain unchanged.
- It is assumed that 5.0% of income is earned while the taxpayer is deployed on active duty and thus is exempt under current law.
- State tax liability is estimated on a single taxpayer example basis for each pay grade, with the result multiplied by the total personnel number at that pay grade and then summed across all pay grades.
- Based on the number of Army National Guard and Air National Guard personnel, the Army National Guard amount is multiplied by 27.4% to account for Air National Guard personnel.

- The preceding assumptions concerning the proposed $20,000 income exemption result in a projected annual reduction in taxable income of $86.0 million.
- Tax year (TY) 2022 impacts are assumed to fall in FY 2023. For tax years after 2022, 48.0% of the impact is assumed to fall in the fiscal year in which the tax year starts and 52.0% in the next fiscal year.

Tax exemptions lower the statewide yield received through the local option income surtax for schools. The surtax reduction is assumed to equal 2.6% of the projected amount of the State income tax reduction.

The proposed exemption of up to $20,000 in annual National Guard drill and field exercise pay is projected to decrease tax liability and State General Fund revenue by the following amounts:

- FY 2023 — $8.1 million
- FY 2024 — $5.6 million
- FY 2025 — $5.7 million
- FY 2026 — $5.8 million
- FY 2027 — $5.9 million
- FY 2028 — $6.1 million

The reductions are projected to increase in years beyond FY 2028 by the annual rate of increase in the ECI.

Division V — Net Operating Loss Income Tax Deduction

Description and Background

The Division changes the definition of "net income" for Iowa corporate income tax purposes for TY 2023 and after. The change moves the basis of the Iowa corporate income tax calculation from line 30 (taxable income) of the federal Form 1120, to line 28 (taxable income before net operating loss deduction and special deductions).

The Division also allows a net operating loss (NOL) generated by a taxpayer in a year prior to TY 2023 to be carried forward to future tax years and used to reduce positive tax liability in those future tax years. The carryforward period is limited to no more than 20 tax years. The Division also allows NOL amounts from TY 2023 and after to be carried forward for an unlimited number of tax years. A carryforward NOL from TY 2023 and after is limited to no more than 80.0% of taxable income for any single tax year.

Assumptions/Fiscal Impact (Division V)

The Department estimated the tax liability and General Fund impacts of Division V using a tax liability model based on TY 1990 through TY 2019 corporate income tax returns and the corporate income tax rates that are projected to be in place for future years under the contingent tax rate reduction procedure established in HF 2317 (2022 Income Tax Rate Reduction and Exemptions Act).

For business entities that are not C corporations, the Department assumed that entities that pay a franchise tax (banks) will collectively experience an impact that is 11.0% of the projected C corporation impact, and entities that are organized so that the income from the business passes through to an individual income tax return will collectively experience an impact that is 65.0% of the projected C corporation impact.

The Department's analysis determined that the changes to the definition of "net income," coupled with the NOL changes, will result in a tax increase compared to current law and the increase will be spread across corporate income tax, individual income tax, and bank franchise tax. As described in Division VII of this ***Fiscal Note***, changes to bank franchise tax liability alter the use of the Franchise Tax Credit, with each $1.00 of increased bank franchise tax liability resulting in a $0.35 increase in Franchise Tax Credit redemptions. **Table 4** provides the fiscal impact of the NOL provisions by tax item.

Table 4
Projected Increase (Decrease) in Tax Liability and General Fund Revenue Due to Net Operating Loss Changes
In Millions

Tax Item	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028
Corporate Income Tax	$ 18.4	$ 19.2	$ 19.9	$ 20.6	$ 21.3
Individual Income Tax	12.0	12.5	12.9	13.4	13.9
Bank Franchise Tax	2.0	2.1	2.2	2.3	2.3
Franchise Tax Credit	-0.7	-0.7	-0.8	-0.8	-0.8
Total Change	$ 32.4	$ 33.8	$ 35.0	$ 36.3	$ 37.5

Division VI — Stock Capital Gains Income Tax Exemption

Description and Background

The Bill expands a capital gains individual income tax exemption available for the sale or exchange of certain stock that was enacted in Division I of HF 2317 (2022 Income Tax Rate Reduction and Exemptions Act). That Act allows a taxpayer defined under the Act as an employee-owner to exclude capital gains that result from the sale or exchange of stock that was acquired by the taxpayer while employed by and on account of employment with a qualified company. A taxpayer is allowed a single, lifetime, irrevocable exemption under the Act. The full exemption is phased in over three calendar years, with capital gains fully exempt starting with sales or exchanges made in 2025.

This Bill expands the new exemption by changing the definition of "qualified company" to include not only affiliates that are included in the consolidated tax return of a qualified company, but also companies that are eligible to be included in the consolidated return of a qualified company but are not actually included in the consolidated tax return. The change is effective January 1, 2023.

Assumptions/Fiscal Impact (Division VI)

The Department determined that based on corporate income tax returns filed for TY 2011 through TY 2020, expanding the universe of corporations that are defined as qualified corporations for the new capital gains tax exemption available to their employee-owners will increase the revenue reduction associated with Division I of HF 2317 by 5.6%. Applying that percentage to the ***Fiscal Note*** for HF 2317 results in the following additional projected reductions in income tax liability and General Fund revenue:

- FY 2024 — $0.2 million
- FY 2025 — $0.4 million
- FY 2026 — $0.6 million
- FY 2027 — $0.5 million
- FY 2028 — $0.5 million

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

Division VII — Bank Franchise Tax Rate Reduction

Description and Background

The Bill reduces Iowa's current bank franchise tax rate of 5.0% of net income over five tax years. The tax rate is first reduced to 4.8% for TY 2023 and is reduced over the next four years until the rate is fixed at 3.9% for TY 2027 and after.

The Iowa franchise tax applies to the net income of financial institutions that is apportioned to Iowa. The term "financial institution" refers to banks but also includes several other corporate structures. The term does not include credit unions.

The fiscal impact for a change in the franchise tax consists of two parts:

- Calculating the reduction in the franchise tax.
- Calculating the reduction in the use of the individual income tax Franchise Tax Credit that is the result of a decrease in the franchise tax rate. The Franchise Tax Credit is a mechanism used to avoid the double taxation of financial institution profits. Double taxation would occur if the profits of an institution were taxed first at the entity (corporate) level, and the owners were then taxed on the profits that flow to the owners and are included as income on the owners' Iowa individual income tax return. The Franchise Tax Credit adjusts an owner's income to account for the fact that franchise tax was paid on the profits at the entity level. The Franchise Tax Credit is a nonrefundable credit.

Assumptions/Fiscal Impact (Division VII)

The Department uses a bank profit projection process for the franchise tax that:

- Begins with a projection of net income at the entity (national) level using data from returns filed for tax years 2018 through 2020.
- Apportions each entity's net income to Iowa.
- Applies the current 5.0% tax rate and the proposed tax rate reductions.
- Subtracts tax credits.
- Compares the results using the current tax rate to the results using the proposed tax rate. This process determined that the revenue reduction at each step of the phased-in rate reduction is estimated to be:
  - TY 2023 — 4.5%
  - TY 2024 — 9.0%
  - TY 2025 — 13.5%
  - TY 2026 — 18.0%
  - TY 2027 and after — 23.13%
- Applies the projected reduction percentages to current law projections for gross franchise tax collections based on the most recent Revenue Estimating Conference projections for FY 2023 and the Department's projections for future years.

Based on 2007 through 2021 historical averages of franchise tax payments and Franchise Tax Credits, the Department estimates that for each $1.00 of reduced franchise tax, the corresponding reduction in Franchise Tax Credit usage on Iowa individual income tax returns will increase individual income tax by $0.35.

The franchise tax rate reductions are projected to reduce bank franchise tax liability and decrease the use of the Franchise Tax Credit. The amounts of the net tax liability and State General Fund revenue reductions are projected as follows:

- FY 2023 — $0.7 million
- FY 2024 — $2.7 million
- FY 2025 — $4.6 million
- FY 2026 — $6.9 million

- FY 2027 — $8.8 million
- FY 2028 — $10.4 million

For years beyond FY 2028, the projected tax liability and State General Fund revenue reductions are expected to increase at the rate of net income growth for banks doing business in Iowa.

Division VIII — Insurance Premium Tax Rate Reduction

Description and Background

The Bill reduces Iowa's current insurance premium tax rate of 1.00% of gross premiums in two increments. The rate is lowered to 0.95% for premiums collected in calendar year (CY) 2023 and to 0.90% for premiums collected in CY 2024 and after.

Under existing law, insurance companies that are not domiciled in Iowa may be subject to a higher tax rate if the insurance premium tax of their state of domicile is higher than the Iowa rate.

Assumptions/Fiscal Impact (Division VIII)

The Department used insurance premium tax returns filed for tax years 2018 through 2020 as the model for the proposed rate reduction by using each company's tax liability under existing law to compute the company's liability under the lower tax rates proposed in the Bill. The Department determined that the rate reductions will decrease tax liability by 5.4% for CY 2023 and 10.6% for CY 2024 and after. The projected reduction percentages were then applied to current-law projections for gross insurance premium tax collections based on the most recent Revenue Estimating Conference projections for FY 2023 and Department projections for future years.

The tax rate reductions in Division VIII are projected to reduce insurance premium tax liability and State General Fund revenue by the following amounts:

- FY 2023 — $4.7 million
- FY 2024 — $13.0 million
- FY 2025 — $17.0 million
- FY 2026 — $17.3 million
- FY 2027 — $17.7 million
- FY 2028 — $18.0 million

For years beyond FY 2028, the projected tax liability and State General Fund revenue reductions are expected to increase at the rate of Iowa insurance premium growth.

Summary of Fiscal Impact

State General Fund — Table 5 summarizes the Bill's projected General Fund fiscal impacts.

Table 5 — Projected Increase (Decrease) 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	Sales/Use Tax — Scooter Rentals	$ 0.0	$ 0.1	$ 0.1	$ 0.1	$ 0.1	$ 0.1
I	Sales/Use Tax — Change to SDP Exemption	1.4	3.0	3.1	3.2	3.4	3.6
I	Sales/Use Tax — Public Utilities Exemption SDP	-0.1	-0.2	-0.2	-0.2	-0.3	-0.3
I	Sales/Use Tax — Change to Computers Exemption	34.6	69.9	71.6	72.2	69.7	66.2
I	Sales/Use Tax — Period Products Exemption	-1.0	-2.0	-2.0	-2.1	-2.1	-2.1
I	Sales/Use Tax — Diapers Exemption	-4.7	-9.5	-9.7	-9.9	-10.1	-10.3
I	Sales/Use Tax — County Fair Purchase Exemption	-1.7	-0.7	-0.7	-0.7	-0.8	-0.8
II	Automobile Rental Tax	0.0	0.0	0.0	0.0	0.0	0.0
III	Sales/Use Tax — Manufactured Food	-4.6	-4.7	-4.8	-4.9	-5.0	-5.1
III	Sales/Use Tax — Refunds	-0.4	0.0	0.0	0.0	0.0	0.0
IV	National Guard Ind. Income Exemption	-8.1	-5.6	-5.7	-5.8	-5.9	-6.1
V	Net Operating Loss — Corporate Income Tax	0.0	18.4	19.2	19.9	20.6	21.3
V	Net Operating Loss — Individual Income Tax	0.0	12.0	12.5	12.9	13.4	13.9
V	Net Operating Loss — Bank Franchise Tax	0.0	2.0	2.1	2.2	2.3	2.3
V	Net Operating Loss — Franchise Tax Credit	0.0	-0.7	-0.7	-0.8	-0.8	-0.8
VI	Qualified Stock — Ind. Income Tax Exemption	0.0	-0.2	-0.4	-0.6	-0.5	-0.5
VII	Bank Franchise Tax Rate Reduction	-1.1	-4.1	-7.1	-10.5	-13.5	-15.9
VII	Bank Franchise Tax Credit	0.4	1.4	2.5	3.6	4.7	5.5
VIII	Insurance Premium Tax Rate Reduction	-4.7	-13.0	-17.0	-17.3	-17.7	-18.0
	Total Projected Change Compared to Current Law	$ 10.1	$ 66.0	$ 62.8	$ 61.3	$ 57.5	$ 53.0

SPD = Specified digital products

Under provisions of the corporate income tax reduction enacted this year in HF 2317, any corporate income tax net revenue for a fiscal year that is in excess of $700.0 million results in a permanent reduction in the corporate income tax rate beginning with the tax year that starts after the end of the fiscal year. Since the NOL changes are projected to increase annual corporate income tax net revenue beginning with FY 2024, the increased revenue, if realized in a year when corporate income tax net revenue exceeds $700.0 million, will result in a permanent decrease in the corporate income tax rate. All other provisions of the Bill are projected to be fully phased in by the conclusion of FY 2028.

Income Surtax for Schools — The income surtax for schools is a local option tax that is based on a taxpayer's Iowa individual income tax liability. Law changes that lower Iowa individual income tax liability also lower the amount of surtax owed by any taxpayer subject to the surtax. The combined impact of the various individual income tax provisions on surtax receipts is projected to be an increase of $0.2 million per fiscal year, beginning FY 2024.

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.