Fiscal Note

Fiscal Services Division

[SF 2367](#) – Department of Revenue, Sales Tax (LSB5284SV.1)

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Fiscal Note Version – Final Action

Description

Senate File 2367 makes technical and operational adjustments to Iowa Department of Revenue (IDR) tax programs and administrative functions. The Bill also relates to sales/use tax, bank franchise tax, and personal income tax. Provisions of the Bill have various effective dates. **Table 4** at the end of this ***Fiscal Note*** summarizes the General Fund fiscal impacts of the various Bill divisions.

Background — Divisions with Minimal or No Projected Fiscal Impact

- **Division III —** Distributions of revenue to local governments and school districts.
- **Division IV —** Liability of sellers using certified service provider.
- **Division V —** IDR authority to cancel various permits issued by the Department.
- **Division VI —** Iowa Economic Development Authority (IEDA) sales/use tax refund incentives.
- **Division IX —** Motor fuel reporting requirement penalty.

Division I — Sales, Use, and Excise Tax — Returns Due

Description and Background

The Bill provides for administrative changes, technical updates, and other changes affecting the tax code and program administration. The Bill also exempts from sales tax the purchase of specified digital products (SDP), prewritten computer software, and related services sold to public utilities.

Assumptions/Fiscal Impact (Division I)

- The IDR 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 IDR estimates are used for fiscal impact calculations. The changes to items added to the sales tax base and the removal of exemptions are shown in **Table 1** and include impacts to the Secure an Advanced Vision for Education (SAVE) Fund distributions.

Table 1 — Fiscal Impact of Exemption for Purchase of Digital Goods for Public Utilities
In Millions

	Total Projected Change to Gross Sales/Use Tax Collected	Change in SAVE Transfers	Net General Fund Impact
FY 2023	$ -0.1	$ 0.0	$ -0.1
FY 2024	-0.2	0.0	-0.2
FY 2025	-0.2	0.0	-0.2
FY 2026	-0.2	0.0	-0.2
FY 2027	-0.3	-0.1	-0.2
FY 2028	-0.3	-0.1	-0.2

The FY 2023 amount is for one half of the fiscal year.

- The change to the exemption will decrease Local Option Sales Tax (LOST) revenue by a minimal amount.

Division II — Sales and Use Tax Exemptions

<u>Description and Background</u>

The Bill makes the following changes to the sales tax base. All changes are effective January 1, 2023, except for the removal of exemption for computers and peripherals, which is effective January 1, 2024.

- 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.
- Exempts from sales tax the purchase of SDP, prewritten computer software, and related services sold to public utilities.
- Exempts from the sales tax the sale of feminine hygiene products.
- Exempts from sales tax the sale of child and adult diapers.

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

- The IDR 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 fiscal impact calculations. The changes to items added to the sales tax base and the removal of exemptions are shown in **Table 2** and include impacts to the SAVE Fund distributions.

Table 2 — Increase in Sales/Use Tax Collected
In Millions

	Removal of Exemption for Computers and Peripherals	Exemption for Purchase of Feminine Hygiene Products	Exemption for Purchase of Adult & Child Diapers	Total Projected Change to Gross Sales/Use Tax Collected	Change in SAVE Transfers	Net General Fund Impact
FY 2023	$ 0.0	$ -1.0	$ -4.7	$ -5.7	$ -1.0	$ -4.7
FY 2024	34.9	-2.0	-9.5	23.4	3.9	19.5
FY 2025	71.6	-2.0	-9.7	59.9	10.0	49.9
FY 2026	72.2	-2.1	-9.9	60.2	10.0	50.2
FY 2027	69.7	-2.1	-10.1	57.5	9.6	47.9
FY 2028	66.2	-2.1	-10.3	53.8	9.0	44.8

The FY 2023 amount is for one half of the fiscal year.

- The changes to exemptions will impact LOST revenue by the following amounts:
  - FY 2023 — Decrease $0.9 million (for one half of the fiscal year)
  - FY 2024 — Increase $3.8 million
  - FY 2025 — Increase $9.7 million
  - FY 2026 — Increase $9.7 million
  - FY 2027 — Increase $9.3 million
  - FY 2028 — Increase $8.7 million

Division VII — Bank Franchise Tax

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 4.7% for tax year (TY) 2023 and is reduced over the next four years until the rate is fixed at 3.5% 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 Bank Franchise Tax Credit that is the result of a decrease in the franchise tax rate. The Bank Franchise Tax Credit is a mechanism used to avoid the double taxation of financial institution profits. Double taxation occurs if the profits of an institution are taxed first at the entity (corporate) level, and the owners are then taxed on the profits as income. The credit adjusts an owner's income to account for the fact that franchise tax was paid on the profits at the entity level. The Bank Franchise Tax Credit is a nonrefundable credit.

Assumptions/Fiscal Impact (Division VII)

The IDR uses a bank profit projection process for the franchise tax projection 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 projected tax liability results using the current tax rate to the results using the proposed tax rates.
- 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 IDR's projections for future years.

Based on 2007 through 2021 historical averages of franchise tax payments and Bank Franchise Tax Credits, the IDR estimates that for each $1.00 of reduced franchise tax, the corresponding reduction in Bank 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 Bank Franchise Tax Credit. The annual amounts of the two fiscal impacts combine to produce the following projected net tax liability and State General Fund revenue reductions:

- FY 2023 — $1.9 million
- FY 2024 — $4.2 million
- FY 2025 — $5.5 million
- FY 2026 — $8.4 million
- FY 2027 — $11.4 million
- FY 2028 — $13.4 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 — 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 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 VIII)

- 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 trend projections for future fiscal years are based on the consumer price index (CPI) and will increase 5.0% in 2021 and 2.0% annually thereafter through 2028.
- SAVE refunds are 1.0% of sales/use tax collected. LOST distributions are estimated to be 0.97% of sales/use tax collected.
- 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 distributions.

Table 3 — Fiscal Impact of Exemption for Manufacturers of Food Ingredients In Millions			
	Total Projected Change to Gross Sales/Use Tax Collected	Change in SAVE Transfers	Net General Fund Impact
FY 2023	$ -5.0	$ -0.8	$ -4.2
FY 2024	-4.7	-0.8	-3.9
FY 2025	-4.8	-0.8	-4.0
FY 2026	-4.9	-0.8	-4.1
FY 2027	-5.0	-0.8	-4.2
FY 2028	-5.1	-0.9	-4.2

The FY 2023 amount includes $400,000 for refund claims being filed.

The changes to exemptions will decrease LOST revenue by the following amounts:

- FY 2023 — $0.8 million
- FY 2024 — $0.8 million
- FY 2025 — $0.8 million
- FY 2026 — $0.8 million
- FY 2027 — $0.8 million
- FY 2028 — $0.8 million

Division X — Solar Energy System Tax Credit

Description and Background

The Bill allows taxpayers with residential solar energy system installations that were completed during calendar year (CY) 2021 or are on the wait list to receive the Solar Energy System Tax Credit. The Bill makes inapplicable the current May 1, 2022, deadline for credit applications to be filed for CY 2021 installations and instead requires application by June 30, 2022. The residential installations that are approved for the tax credit under the provisions of the Bill are not to be counted as part of the annual $5.0 million aggregate tax credit cap for all solar energy system installations. The changes are effective upon enactment and apply retroactively to tax year 2022.

The Solar Energy System Tax Credit has been available since January 1, 2012. The Iowa tax credit is equal to a percentage of the federal tax credit that was available for the same purpose. For installations completed on or after January 1, 2016, the Iowa credit is equal to the 50.0% of the federal credit.

The federal tax credit ended for residential installations completed after December 31, 2021. Iowa law limits the total aggregate amount of tax credits approved under the program in a calendar year to $5.0 million. The full CY 2021 allocation has been awarded, and a wait list exists for projects that qualify for the credit but will not receive an award under current law because of the annual cap.

The tax credits are not transferable or refundable, but unused tax credits may carry forward for up to 10 fiscal years.

Assumptions/Fiscal Impact (Division X)
Based on tax credit applications from residential projects completed during CY 2018 through CY 2020, the IDR estimates that a total of $5.6 million in applications will be approved under the provisions of the Bill.

The Legislative Services Agency estimates that awarded tax credits will be redeemed over eight fiscal years as follows:

- FY 2023 — 45.0%
- FY 2024 — 20.0%
- FY 2025 — 10.0%
- FY 2026 through FY 2030 — 5.0% each fiscal year

The redemption of Solar Energy System Tax Credits that are assumed to be issued under the provisions of the Bill are projected to reduce individual income tax liability and General Fund revenue by the following amounts:

- FY 2023 — $2.5 million
- FY 2024 — $1.1 million
- FY 2025 — $0.5 million
- FY 2026 through FY 2030 — $0.3 million each fiscal year

There is no projected fiscal impact beyond FY 2030.

Division XI — Individual Income Tax Exclusion — Certain Premium Pay and Bonuses

Description and Background

The Bill provides for State individual income tax exemptions for bonus payments specified in the Bill. The State individual income tax exemption applies retroactively to tax years beginning on or after January 1, 2022, but before January 1, 2023.

Fiscal Impact (Division XI)

The fiscal impact is estimated to be a General Fund reduction of $2.8 million in FY 2023 compared to what would have been collected if the identified bonuses would have been subject to State individual income tax.

Summary of Fiscal Impact

State General Fund — Table 4 summarizes the Bill's projected General Fund fiscal impacts.

Table 4 — Projected Net 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	Sales/Use Tax — Public Utilities Exemption SDP	$ -0.1	$ -0.2	$ -0.2	$ -0.2	$ -0.2	$ -0.2
II	Sales/Use Tax — Change to Computers Exemption	0.0	29.1	59.7	60.3	58.1	55.2
II	Sales/Use Tax — Fem. Hygiene Products Exemption	-0.8	-1.7	-1.7	-1.8	-1.8	-1.8
II	Sales/Use Tax — Diapers Exemption	-3.9	-7.9	-8.1	-8.3	-8.4	-8.6
VII	Bank Franchise Tax Rate Reduction	-2.9	-6.4	-8.4	-12.8	-17.5	-20.6
VII	Bank Franchise Tax Credit	1.0	2.2	2.9	4.4	6.1	7.2
VIII	Sales/Use Tax — Manufactured Food	-3.8	-3.9	-4.0	-4.1	-4.2	-4.2
VIII	Sales/Use Tax — Manufactured Food Refunds	-0.4	0.0	0.0	0.0	0.0	0.0
X	Solar Energy Tax Credit	-2.5	-1.1	-0.5	-0.3	-0.3	-0.3
XI	Premium Pay Individual Income Tax Exemption	-2.8	0.0	0.0	0.0	0.0	0.0
	Total Projected Change Compared to Current Law	$ -16.2	$ 10.1	$ 39.7	$ 37.2	$ 31.8	$ 26.7

SDP = Specified digital products

Sources

Department of Revenue
LSA calculations

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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.