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Fiscal Note

Fiscal Services Division

SF 551 – Full Expensing of Business Investments (LSB1575SV)
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Fiscal Note Version – New

Description

Senate File 551 decouples Iowa income tax laws from federal tax laws related to accelerated depreciation schedules (bonus depreciation) to allow Iowa business to continue to claim depreciation of eligible assets in the year the asset is placed in service (initial year) instead of over a number of tax years.

The change applies retroactively to January 1, 2022, and applies to tax years beginning on or after that date.

Background

For income tax purposes, assets purchased and used by a business are subject to expensing and/or depreciation. Property that is subject to depreciation must be used in a business or income-producing activity and must have a determinable useful life of more than one year. Expensing an asset allows a business to deduct the cost in the initial year, while depreciating an asset requires a business to deduct the cost of an asset over a period of years related to the expected useful life of the asset.

Federal law for tax year (TY) 2022 allows qualified assets to be 100.0% depreciated (expensed) for income tax purposes in the initial year. For TY 2023 through TY 2026, federal law decreases the percentage of depreciation that may be taken in the initial year by 20 percentage points each tax year. For TY 2027 and after, no additional depreciation beyond the normal depreciation schedule for the asset is allowed in the initial year. Iowa has been fully coupled with federal law on the issue of depreciation since TY 2021.

Allowing additional depreciation in the initial year of service lowers the taxable business income in the initial tax year. For businesses that maintain positive taxable income throughout the normal depreciation schedule of the asset, the fact that additional depreciation was claimed in the initial year increases the business's income tax in years beyond the initial year. If income tax rates remain the same across tax years and if the business is always sufficiently profitable for tax purposes, the total income tax owed by the business over the years is not reduced by the initial year depreciation, but it is delayed. However, if the business is not sufficiently profitable over the normal depreciable life of the asset, the tax benefit received in the initial year by the business will exceed the tax increase that is experienced over the normal depreciable life of the asset.

Iowa individual and corporate income tax rates, as well as the Iowa bank franchise tax rate, are each scheduled to be reduced under current law. Assets fully depreciated in the initial year at a higher tax rate will result in an overall tax reduction for the owner as the decrease in later year depreciation occurs at a lower effective income tax rate than the rate in place when the additional depreciation was taken.

Assumptions

The estimated fiscal impacts of the proposed business depreciation change were developed by the Department of Revenue (department) using the following procedures and assumptions.

- For individual income tax impacts, the department utilized the individual income tax micromodel developed for the 2023 Legislature combined with the following facts and assumptions:
  - The model is based on actual tax returns filed for TY 2021.
  - For TY 2021, 19,226 resident households claimed a total of $903.7 million in bonus depreciation on federal tax form 4562.
  - The income, deduction, and other TY 2021 taxpayer parameters are modified for each future tax year to account for expected or assumed changes in income and other tax items.
  - Annual adjustments for assumed changes in population (impacting the number of tax returns filed) are made.
  - Future tax years are adjusted for changes to federal and State tax rates that exist in current law.
  - The micromodel produces a projection for the amount of Iowa income tax owed for each tax year under current law and under the proposal. The difference between the two projections is the assumed fiscal impact by tax year.
  - The depreciation benefit will only be available to individual income taxpayers who file Iowa tax returns, since the depreciation benefit can only be realized through the filing of a return. Therefore, there is no impact on situations where tax is withheld from the paycheck of a taxpayer who does not file an Iowa income tax return (nonfilers).
  - In converting projected tax year impacts to projected impacts by fiscal year, the department utilized historical information concerning how individual income tax liability is met through the combination of withholding, estimate payments, payments when a tax return is filed, and tax refunds.
  - Law changes that reduce individual income tax liability also reduce the amount raised each year by the local option income surtax for schools. The statewide reduction in the surtax is assumed to equal 2.5% of the projected State income tax liability.
- For corporate income tax impacts, the department utilized electronic-filed corporate income tax returns through TY 2021 combined with the following facts and assumptions:
  - The income and deduction patterns shown on electronic returns are assumed to also apply to returns filed on paper.
  - The department estimates that limiting TY 2021 bonus depreciation to 80.0% of what was claimed by Iowa corporate income taxpayers would have increased corporate taxable income by $125.5 million. It is assumed that for tax years beyond TY 2021, the impact will be proportional to the TY 2021 impact.
  - The income, deduction, and other taxpayer parameters are modified for each future tax year to account for expected or assumed changes in income and other tax items.
  - Future tax years are adjusted for changes to federal and State tax rates that exist in current law.
  - The department produced a projection of the amount of Iowa corporate income tax owed for each tax year under current law and under the proposal. The difference between the two projections is the assumed fiscal impact on corporate income taxes.
  - In converting projected tax year impacts to projected impacts by fiscal year, the department utilized historical information concerning how corporate income tax liability is met through the combination of estimate payments, payments when a tax return is filed, and tax refunds.
- Based on the ratio of bank franchise tax net receipts to corporate income tax net receipts as projected by the March 2023 Revenue Estimating Conference, the department assumes that

the impact on bank franchise tax receipts will equal 11.0% of the projected impact on corporate income tax receipts.

Fiscal Impact

The change in the Bill to the amount of depreciation allowed in the year an asset is placed in service is projected to reduce individual income, corporate income, and bank franchise taxes owed to the State and, therefore, reduce State General Fund revenue. The projected amounts by fiscal year and tax type are as follows:

Projected State General Fund Revenue Change

In Millions

	Individual Income Tax	Corporate Income Tax	Bank Franchise Tax	Total
FY 2024	$ -7.6	$ -25.8	$ -2.8	$ -36.2
FY 2025	-12.2	-24.7	-2.7	-39.6
FY 2026	-14.5	-27.3	-3.0	-44.8
FY 2027	-14.5	-26.1	-2.9	-43.5
FY 2028	-16.5	-24.4	-2.7	-43.6
FY 2029	-16.0	-23.0	-2.6	-41.6

In years beyond FY 2029, the negative impact on taxes owed and tax revenue is expected to decline since depreciation taken in the initial years is not available as a business deduction in future years.

The projected reduction in individual income tax liability will also reduce the annual amount of revenue raised through the local option income surtax for schools by an estimated $0.2 million to $0.4 million per fiscal year, beginning in FY 2024.

Sources

Department of Revenue
Legislative Services Agency

/s/ Jennifer Acton

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