



[HF 352](#) – Pass-Through Business Entity Tax and Deduction (LSB1209HV.2)
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Fiscal Note Version – Final Action

Description

[House File 352](#) creates a new voluntary pass-through entity income tax (PTE tax) to be paid by partnerships and Subchapter S Corporations (S Corporations) business pass-through entities.

The Bill also creates a new income tax credit to be passed through to the individual owners of a partnership or S Corporation that has elected to pay the PTE tax. The credit flows to the PTE owners to reflect and adjust for the fact that the PTE tax was paid at the business entity level, and the credit is distributed to an entity's owners in the same proportion that the income of an entity is distributed to its owners. The credit, to be used by an entity's owners and not the entity itself, is refundable to the individual taxpayer through the filing of individual income tax returns.

The Bill is effective upon enactment, and the new PTE tax and tax credit apply retroactively to tax year (TY) 2022.

Background

Note: For this **Fiscal Note**, partnership and S Corporation pass-through entities are referred to as "PTE businesses," and the owners of the PTE businesses are referred to as "owners" and "taxpayers."

Pass-through entities such as partnerships and S Corporations are generally not subject to federal or State income tax. Instead, the income generated by the entities is passed through to the owners of the entities, where it becomes income to the entities' owners.

Federal legislation enacted in 2017 increased the standard deduction and also limited the amount of State and local taxes (property tax and either income or sales tax) a taxpayer may deduct from the taxpayer's income for federal individual income tax purposes.

The increased standard deduction changed a significant percentage of federal taxpayers from itemized deduction filers to standard deduction filers. For standard deduction filers, the amount of State and local taxes paid does not enter into the calculation of federal individual income taxes. For itemized deduction filers, any amount of State and local taxes above \$10,000 (\$5,000 for married taxpayers filing separate returns) does not enter into the calculation of federal individual income taxes. The portion of the 2017 federal tax legislation that created the State and local tax (SALT) limit expires at the end of calendar year 2025.

This Bill is a SALT limit workaround that would allow certain individual income taxpayers (owners of partnerships and S Corporations who make a voluntary election) to pay an Iowa income tax through their pass-through partnerships and S Corporation businesses. That State PTE tax would be treated as a business expense, which would lower the taxable income that flows out of the pass-through entity to the individual tax returns of the owners of the pass-through entities. The Bill also provides a State income tax credit that will compensate the entity owners for the PTE tax that was paid, and that tax credit is split between the owners of

the pass-through entity to be used when filing individual income tax returns. In this manner, the entity owners are allowed to deduct State taxes at the entity level that would be useless to them for federal income tax purposes if the taxes were paid at the individual income tax level.

Assumptions

- The federal SALT deduction limitation workaround created in this Bill will lower the income distributed by PTE businesses for federal tax purposes (if the PTE makes the voluntary election), and this will lower the federal individual income taxes owed by the PTE taxpayers.
- Since distributed PTE business income for federal tax purposes is also used as income for Iowa income tax calculations, the Bill will also lower the taxpayers' Iowa income tax.
- In addition to the lowered income for State tax purposes, the taxpayers will also receive a tax credit equal to a percentage of the PTE tax paid by the PTE business to be used on the individual income tax returns of the PTE's owners (taxpayers). The PTE tax credit percentage each tax year is equal to 100.0% minus the top individual income tax rate for the applicable tax year, with the result multiplied by the amount of the PTE tax. Reducing the PTE tax amount by the top individual income tax rate adjusts for the fact that the PTE tax paid at the entity level reduced not only the federal taxable income distributed by the entity, but also State taxable income.
- For Iowa taxpayers living within a school district that has in place a local option income surtax for schools, tax items that lower Iowa individual income tax liability (with the exception of refundable tax credits) also lower the income surtax owed by the taxpayer.
- The local option income surtax for schools does not apply to the PTE taxes paid by PTE businesses.

Fiscal Impact

The creation of the new PTE tax will result in decreased PTE income passed through to PTE owners, thereby lowering State taxable income and State individual income tax. The revenue generated by the PTE tax will increase State tax revenue, while the new PTE tax credit will return the PTE tax paid at the entity level to the PTE owners. The PTE credit is designed to return the PTE tax to the owners while also adjusting for the fact that paying PTE tax lowered the amount of pass-through income that is subject to State income tax.

It is projected that the State General Fund revenue benefit due to the new PTE tax will be fully offset when the new refundable PTE tax credit is redeemed through the filing of individual income tax returns by the PTE owners.

Since the PTE tax credit is refundable, the redemption of the credit will not impact the calculation of the local option income surtax for schools. However, the fact that PTE tax paid at the entity level reduces reported individual income for the entity owners will result in some reduction in the amount of local option income surtax for schools. The cumulative surtax reduction over four tax years (TY 2022 through TY 2025) is projected to be \$0.1 million statewide.

The creation of a new tax and new tax credit, along with the potential for a significant number of amended returns filed for TY 2022, will increase administrative expenses incurred by the Department of Revenue. The Department was not able to provide an estimate for the expense increase.

Sources

Department of Revenue
Legislative Services Agency analysis

/s/ Jennifer Acton

May 16, 2023

Doc ID 1374179

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.

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