

JAN 25 1995

WAYS & MEANS CALENDAR

HOUSE FILE 75
BY COMMITTEE ON WAYS AND MEANS

(SUCCESSOR TO HSB 5)

Passed House, Date _____ Passed Senate, Date _____
Vote: Ayes _____ Nays _____ Vote: Ayes _____ Nays _____
Approved _____

A BILL FOR

1 An Act relating to the taxation of shareholders of corporations
2 whose income is taxed to the shareholders and providing an
3 effective and applicability date provision.

4 BE IT ENACTED BY THE GENERAL ASSEMBLY OF THE STATE OF IOWA:

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HF 75

1 Section 1. Section 422.5, subsection 1, paragraph j, Code
2 1995, is amended by adding the following new unnumbered
3 paragraph:

4 NEW UNNUMBERED PARAGRAPH. The tax imposed upon the taxable
5 income of a resident shareholder in a corporation which has in
6 effect for the tax year an election under subchapter S of the
7 Internal Revenue Code and carries on business within and
8 without the state may be computed by reducing the amount
9 determined pursuant to paragraphs "a" through "i" by the
10 amounts of nonrefundable credits under this division and by
11 multiplying this resulting amount by a fraction of which the
12 resident's net income allocated to Iowa, as determined in
13 section 422.8, subsection 2, paragraph "b", is the numerator
14 and the resident's total net income computed under section
15 422.7 is the denominator. This paragraph also applies to
16 individuals who are residents of Iowa for less than the entire
17 tax year.

18 Sec. 2. Section 422.5, subsection 1, paragraph k,
19 unnumbered paragraph 4, Code 1995, is amended to read as
20 follows:

21 In the case of a resident, including a resident estate or
22 trust, the state's apportioned share of the state alternative
23 minimum tax is one hundred percent of the state alternative
24 minimum tax computed in this subsection. In the case of a
25 resident or part year resident shareholder in a corporation
26 which has in effect for the tax year an election under
27 subchapter S of the Internal Revenue Code and carries on
28 business within and without the state, nonresident, including
29 a nonresident estate or trust, or an individual, estate, or
30 trust that is domiciled in the state for less than the entire
31 tax year, the state's apportioned share of the state
32 alternative minimum tax is the amount of tax computed under
33 this subsection, reduced by the applicable credits in sections
34 422.10 through 422.12 and this result multiplied by a fraction
35 with a numerator of the sum of state net income allocated to

1 Iowa as determined in section 422.8, subsection 2, paragraph
2 "a" or "b" as applicable, plus tax preference items,
3 adjustments, and losses under subparagraph (1) attributable to
4 Iowa and with a denominator of the sum of total net income
5 computed under section 422.7 plus all tax preference items,
6 adjustments, and losses under subparagraph (1). In computing
7 this fraction, those items excludable under subparagraph (1)
8 shall not be used in computing the tax preference items.
9 Married taxpayers electing to file separate returns or
10 separately on a combined return must allocate the minimum tax
11 computed in this subsection in the proportion that each
12 spouse's respective preference items, adjustments, and losses
13 under subparagraph (1) bear to the combined preference items,
14 adjustments, and losses under subparagraph (1) of both
15 spouses.

16 Sec. 3. Section 422.7, Code 1995, is amended by adding the
17 following new subsection:

18 NEW SUBSECTION. 32. Resident shareholders of a
19 corporation which has an election in effect under subchapter S
20 of the Internal Revenue Code shall add their proportionate
21 share of a deemed distribution of current year income, upon
22 which Iowa income tax has not been paid as determined under
23 rules of the director, to the extent that the salaries, wages,
24 or other compensation for services performed by all
25 shareholders does not equal ten percent of net income of the
26 corporation computed in accordance with section 422.35 and
27 considering items of income and expense which pass directly to
28 the shareholders under provisions of the Internal Revenue Code
29 before deduction of shareholders' salaries, wages, or other
30 compensation for services performed. In addition there shall
31 be added any cash or the value of any property distributions
32 made to the extent they are made from income upon which Iowa
33 income tax has not been paid as determined under rules of the
34 director.

35 Sec. 4. Section 422.8, subsection 2, Code 1995, is amended

1 to read as follows:

2 2. a. Nonresident's net income allocated to Iowa is the
3 net income, or portion thereof, which is derived from a
4 business, trade, profession, or occupation carried on within
5 this state or income from any property, trust, estate, or
6 other source within Iowa. However, income derived from a
7 business, trade, profession, or occupation carried on within
8 this state and income from any property, trust, estate, or
9 other source within Iowa shall not include distributions from
10 pensions, including defined benefit or defined contribution
11 plans, annuities, individual retirement accounts, and deferred
12 compensation plans or any earnings attributable thereto so
13 long as the distribution is directly related to an
14 individual's documented retirement and received while the
15 individual is a nonresident of this state. If a business,
16 trade, profession, or occupation is carried on partly within
17 and partly without the state, only the portion of the net
18 income which is fairly and equitably attributable to that part
19 of the business, trade, profession, or occupation carried on
20 within the state is allocated to Iowa for purposes of section
21 422.5, subsection 1, paragraph "j", and section 422.13 and
22 income from any property, trust, estate, or other source
23 partly within and partly without the state is allocated to
24 Iowa in the same manner, except that annuities, interest on
25 bank deposits and interest-bearing obligations, and dividends
26 are allocated to Iowa only to the extent to which they are
27 derived from a business, trade, profession, or occupation
28 carried on within the state.

29 b. A resident's income allocable to Iowa is the income
30 determined under section 422.7 reduced by the net income or
31 loss of a corporation which is fairly and equitably
32 attributable without the state under section 422.33. For the
33 purposes of this paragraph, "corporation" means a corporation
34 which has in effect for the tax year an election under
35 subchapter S of the Internal Revenue Code and carries on

1 business partly within and partly without the state. This
2 paragraph also applies to individuals who are residents of
3 Iowa for less than the entire tax year.

4 Sec. 5. Section 422.8, Code 1995, is amended by adding the
5 following new subsection:

6 NEW SUBSECTION. 6. If the resident or part year resident
7 is a shareholder of a corporation which has in effect an
8 election under subchapter S of the Internal Revenue Code,
9 subsections 1 and 3 do not apply to any income taxes paid to
10 another state or foreign country on the income from the
11 corporation which has in effect an election under subchapter S
12 of the Internal Revenue Code.

13 Sec. 6. This Act takes effect upon enactment and applies
14 retroactively to January 1, 1995, for tax years beginning on
15 or after that date.

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EXPLANATION

17 Under current statutory provisions, a nonresident
18 shareholder of a subchapter S corporation computes an amount
19 of Iowa individual income tax on the nonresident's total
20 income earned everywhere and then that amount of tax is
21 prorated to Iowa in the ratio of gross income from Iowa
22 sources to total gross income.

23 The bill taxes the income from a subchapter S corporation
24 for a resident shareholder the same way as the income is taxed
25 for a nonresident. An amount of Iowa individual income tax is
26 computed on the total resident shareholder's total income
27 everywhere and then the amount of tax is prorated to Iowa in
28 the ratio of gross income everywhere reduced by the non-Iowa
29 income of the subchapter S corporation to total income
30 everywhere. The resident shareholder may still take an out-
31 of-state tax credit on income other than income from the
32 subchapter S corporation for taxes paid to another state.

33 The bill applies retroactively to January 1, 1995, for tax
34 years beginning on or after that date.

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**HOUSE FILE 75
FISCAL NOTE**

A fiscal note for **House File 75** is hereby submitted pursuant to Joint Rule 17. Data used in developing this fiscal note is available from the Legislative Fiscal Bureau to members of the Legislature upon request.

House File 75 would tax resident shareholders of Subchapter S corporations the same way that nonresident shareholders are taxed. Under current law, a nonresident shareholder apportions income based on the corporations sales in Iowa. An amount of Iowa individual income tax would be computed on the total resident shareholder's income everywhere, and then the amount of tax would be apportioned to Iowa in the ratio of gross income everywhere reduced by the non-Iowa income of the Subchapter S corporation, to total income everywhere.

Under House File 75 affected individuals would pay individual income tax on the greater of the following amounts:

1. 10.0% of the resident shareholder's share of total distributions, including retained earnings.
2. The resident shareholder's actual distribution.
3. The resident shareholder's share of the apportioned income.

ASSUMPTIONS

1. The estimates of House File 75 are based on an analysis completed by the Department of Revenue and Finance of data reported on S corporation 1992 returns. Approximately 550 1992 IA 1120NT returns were sampled.
2. The estimate is extrapolated to 18,278 S corporations.
3. Approximately 84.2% of S corporation returns include at least one Iowa resident shareholder. Of these, approximately 65.6% are estimated to have income greater than zero.
4. Approximately 25.0% of S corporations are expected to apportion income.
5. The amount of the out-of-State tax credit used by resident shareholders is approximately \$400,000.
6. Approximately \$120.0 million in taxable income will be apportioned outside the State.

FISCAL IMPACT

House File 75 is expected to result in a decrease in General Fund revenues of at least \$8.0 million in FY 1996 and subsequent years. This amount could be increased to the extent that earnings are retained at a higher rate than under

current law; to the extent that the average marginal tax rate for the affected individuals exceeds 7.0%; and to the extent that more Subchapter S corporations are created.

SOURCES

Department of Revenue and Finance

(LSB 1066hv, JAM)

FILED FEBRUARY 6, 1995

BY DENNIS PROUTY, FISCAL DIRECTOR

Larson, Chr.
Lamberti
Brammer

HSB 5

WAYS AND MEANS

SF By _____
HOUSE FILE _____

BY (PROPOSED COMMITTEE ON WAYS
AND MEANS BILL BY CHAIR-
PERSON HALVORSON)

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