

Iowa Franchise Tax Credit

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Outline

- ▶ **Iowa Franchise Tax Credit**
 - An administrative tax credit
- ▶ **Iowa Franchise Tax**
 - A tax on financial institutions in Iowa
- ▶ **How other states tax financial institutions**
- ▶ **Characteristics of Iowa Franchise Tax Credit claimants**
- ▶ **Potential administrative changes**

Iowa Franchise Tax Credit

- ▶ **Claimed by shareholders of financial institutions organized as S corporations**
- ▶ **Income of S–corporation financial institutions:**
 - at entity level: subject to Iowa franchise tax
 - at shareholder level: passed through to shareholders and subject to Iowa individual income tax
- ▶ **Created to avoid double taxation**
- ▶ **Cannot exceed shareholder’s portion of franchise tax paid**
- ▶ **Considered an administrative tax credit because not intended to alter taxpayers’ behavior**

Franchise Tax Credit Key Features

- ▶ **Credit equals smaller of:**
 - Shareholder's individual income tax calculated on income passed through from the financial institution
 - Shareholder's *pro rata* share of the Iowa franchise tax paid by the financial institution
- ▶ **Calculated on the IA 147 Franchise Tax Credit Form**
- ▶ **Nonrefundable and cannot be carried forward**
 - Unused credit expires
- ▶ **Nontransferable**
- ▶ **Claimed against individual, fiduciary, and corporation income tax**

Iowa Franchise Tax

- ▶ **Tax levied on financial institutions for the privilege of doing business in Iowa (IA Code Chapter 422, Division V)**
 - Financial institutions mainly include:
 - State chartered banks
 - National banking associations
 - Federally chartered savings and loan associations
 - Financial institutions do not include credit unions
- ▶ **Administered by the Iowa Department of Revenue**
 - Annual returns and quarterly estimate payments required to meet tax liability
- ▶ **Net revenue accounted for 0.5% of State net revenue in FY 2015 and 0.7% in FY 2016**

Calculation of Iowa Franchise Tax

1. Determine net income

- Net income measured similarly to corporation income tax
- Also includes earnings on U.S. securities (*Federal law prohibits states from taxing federal securities or interest paid on those securities with an exception for nondiscriminatory state franchise taxes*)

2. Apportion net income to Iowa

3. Larger of regular tax (5% of income) or Iowa alternative minimum tax (3% of broader income)

4. Subtract income tax credits (earned or purchased)

- Iowa Alternative Minimum Tax Credit, Endow Iowa, Historic Preservation, Fund of Funds, Investment, Innovation Fund, Renewable Energy, Solar Energy System, Venture Capital – Qualifying Business, Wind Energy Production, and Workforce Housing

Taxes on Financial Institutions in Other States

- ▶ Majority of states subject financial institutions to corporation income tax
- ▶ 21 states (including Iowa) impose a tax on financial institutions separate from general corporations with four general scenarios:
 - 1) S corporations are exempt from this tax (4 states)
 - 2) S corporations are taxed at lower tax rates (2 states)
 - 3) Tax is imposed regardless of entity type with no tax credit for shareholders (11 states)
 - 4) S corporations are taxed and shareholders are allowed a tax credit to avoid double taxation (4 states)

Profile of Franchise Tax Taxpayers, Tax Year 2014

- ▶ 444 unique institutions filed a franchise tax return
- ▶ Top 5 institutions with highest tax payments paid over 25% of total franchise tax receipts
- ▶ The 10 largest banks in the United States (by assets) paid less than 10% of Iowa franchise tax
- ▶ Over 90% franchise tax receipts are paid by smaller banks
- ▶ Approximately 220 institutions are S corporations with tax payments comprising over half (58.5%) of total franchise tax receipts
 - The vast majority of S corporation financial institutions specialize in agricultural financing

Distribution History of Iowa Franchise Tax

- ▶ **Prior to 1970, financial institutions taxed on the value of their capital stock and all surplus profits**
 - Revenue divided among the State, cities, and counties based on location of bank
- ▶ **Franchise tax effective in 1970: Revenue divided among the State, cities, and counties**
 - Franchise tax divided among State (55%), cities (27%), and counties (18%) on a percentage basis
 - Starting FY 1997, first \$8.8 million directed to cities (60%) and counties (40%) and remaining revenues went to the General Fund
- ▶ **Starting FY 2005, all revenues went to the General Fund except for**
 - \$7 million dedicated to Community Attraction and Tourism Fund annually
- ▶ **Starting FY 2013, all revenues remain in the General Fund**

History of Iowa Franchise Tax Credit

- ▶ Federal law change allowing financial institutions to be organized as S corporations in 1997
- ▶ Iowa Legislature: S corporations still subject to franchise tax to maintain revenue for cities and counties
- ▶ Effective in 1997, Franchise Tax Credit was created to avoid double taxation
- ▶ Expanded to LLCs in FY 2005

Franchise Tax Revenues vs Tax Credit Claims

FY	Net Franchise Tax Revenues (Million \$)	TY	Franchise Tax Credit Claims (Million \$)	Percent of Revenues Claimed as Credits
2007	\$31.9	2006	\$11.5	35.9%
2008	\$33.7	2007	\$12.4	36.8%
2009	\$28.2	2008	\$11.9	42.2%
2010	\$26.9	2009	\$12.4	45.9%
2011	\$31.5	2010	\$16.0	50.9%
2012	\$31.5	2011	\$16.9	53.6%
2013	\$29.7	2012	\$20.8	70.1%
2014	\$37.5	2013	\$17.4	46.3%
2015	\$32.2	2014*	\$20.3	63.1%
Average	\$31.5		\$15.5	49.3%

Source: I3 Accounting System Receipts and IA 148
Tax Credit Schedule * Incomplete tax year

Franchise Tax Credits Available, Claimed, and Expired by Tax Year

Tax Year	Tax Credit Available	Tax Credit Claimed		Tax Credits Expired		Share of Expired in Total Available Amount
	Total Amount (Million \$)	Number of Taxpayers	Total Amount (Million \$)	Number of Taxpayers	Total Amount (Million \$)	
2006	\$12.9	2,022	\$11.5	401	\$1.4	11.0%
2007	\$13.9	2,281	\$12.4	465	\$1.5	10.6%
2008	\$14.3	2,329	\$11.9	550	\$2.4	16.6%
2009	\$14.0	2,326	\$12.4	541	\$1.6	11.7%
2010	\$17.4	2,347	\$16.0	487	\$1.4	8.1%
2011	\$18.6	2,362	\$16.9	525	\$1.8	9.6%
2012	\$22.1	2,491	\$20.9	390	\$1.3	5.7%
2013	\$18.8	2,614	\$17.4	519	\$1.4	7.5%
2014*	\$20.9	1,962	\$20.3	228	\$0.5	2.4%
Average	\$17.0	2,304	\$15.5	456	\$1.5	8.7%

Source: IA 148 Tax Credits Schedule *Incomplete tax year
 Number of taxpayers is based on individual claimants. A married couple filing separately and both claiming the tax credit are counted as two taxpayers.

Unused tax credit expires. Taxpayers are found to have a tendency to underreport expired credits

Tax Credit Claims by Residence Status

Tax Year	Residents			Nonresidents		
	Number of Taxpayers	Share of Claim Dollars	Share of Expired in Total Available Amount	Number of Taxpayers	Share of Claim Dollars	Share of Expired in Total Available Amount
2006	1,611	76.2%	4.0%	387	23.8%	25.1%
2007	1,823	77.5%	8.3%	434	22.5%	17.0%
2008	1,896	78.1%	7.4%	420	21.9%	25.3%
2009	1,915	78.5%	6.2%	393	21.5%	23.8%
2010	1,888	78.2%	3.0%	434	21.8%	17.2%
2011	1,889	80.8%	5.3%	439	19.2%	20.0%
2012	1,693	78.3%	3.9%	448	21.7%	11.3%
2013	2,099	80.6%	3.4%	478	19.4%	18.9%
2014*	1,531	77.7%	0.7%	392	22.3%	8.2%
Average	1,816	78.4%	4.7%	425	21.6%	18.5%

Source: IA 148 Tax Credits Schedule and Iowa individual tax returns * Incomplete tax year
 Data exclude claims made on fiduciary and corporation returns

Tax Credit Claims by Income Group, Tax Year 2013

Iowa Adjusted Gross Income for Individual Taxpayers	Franchise Tax Credit Claimants					All Taxpayers in Iowa	
	Number of Claimants	Distribution of Number of Claimants	Total Claim Amount (Million \$)	Distribution of Total Claims	Average Claim (\$)	Number of All Taxpayers	Distribution of Number of Individual Taxpayers
Less than \$50,000	513	19.9%	\$0.2	1.3%	\$411	2,567,417	83.0%
\$50,001 to \$100,000	591	22.9%	\$0.6	3.4%	\$949	381,932	12.3%
\$100,001 to \$150,000	339	13.1%	\$0.6	3.9%	\$1,880	70,676	2.3%
\$150,001 to \$200,000	238	9.2%	\$0.6	3.9%	\$2,711	24,948	0.8%
\$200,001 to \$250,000	157	6.1%	\$0.6	3.6%	\$3,777	12,721	0.4%
\$250,001 to \$500,000	373	14.5%	\$2.4	14.4%	\$6,366	21,205	0.7%
\$500,001 to \$1,000,000	205	8.0%	\$3.1	18.5%	\$14,929	8,402	0.3%
\$1,000,001 or over	162	6.3%	\$8.4	51.0%	\$51,981	6,747	0.2%
Total	2,578	100.0%	\$16.5	100.0%	\$6,402	3,094,048	100.0%

Source: IA 148 Tax Credits Schedule and Iowa individual income tax returns

Data exclude claims made on fiduciary and corporation returns

Potential Administrative Changes to Eliminate the Franchise Tax Credit

- ▶ **Exempt S corporations from Iowa franchise tax and eliminate Franchise Tax Credit**
 - Estimated fiscal impact: annually \$1.5 million reduction in General Fund (equal to the averaged expired tax credit amount TY 2006–2014)
 - 50% reduction in franchise tax returns processing and compliance
 - Elimination of Franchise Tax Credit compliance
- ▶ **Eliminate franchise tax and Franchise Tax Credit and subject C corporation financial institutions to corporation income tax**
 - Estimated fiscal impact: annually \$1.9 million revenue loss (upper bond) with exemption of earnings on U.S. securities
 - Allows C corporation financial institutions to electronically file income tax returns

Questions?