Iowa Department of
REVENUE

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May 2, 2018

Jeff Robinson
Legislative Services Agency
State Capitol
Des Moines, IA 50319

Dear Jeff:

This letter presents a fiscal estimate for HF 2489 under the proposed amendment that includes coupling with various federal tax provisions in 2018 and 2019, cuts to Iowa individual income tax rates in TY 2019, sales tax modernization provisions effective January 1, 2019, and multiple changes to income tax credits. In addition, the proposal includes a change to the corporation income tax that would become effective in TY 2021, and assuming revenue targets are met, additional reform to the individual income tax that would become effective in TY 2023.

Technical Corrections for Department of Revenue (Divisions I – III)

The following changes are included as technical corrections for administration of tax law by the Department of Revenue. The changes, listed briefly below, codify or clarify current practices, thus are estimated to have no fiscal impact.

- The interest accrual provisions standardize across tax types and conform with current practice the calculation of interest that accrues on refunds to be paid by the Department.

- The changes to sections 421.27 and 425.29 clarify that taxpayers are responsible for errors leading to overpayments by the Department or payments related to intentional refund or credit requests, regardless of whether the claim stems from a refund, credit, reimbursement, rebate, or other payment, and that penalties may be imposed on taxpayers who make false claims to obtain credits or reimbursements.

- Changes to section 421.19 clarify that the Department may provide information to law enforcement that indicates a taxpayer engaged in tax fraud or evasion.

- Modifications to section 423G.6 clarify that the Department will transfer funds to the water quality infrastructure fund and water quality financial assistance fund based on the amount reported. This will simplify the administration of these fund transfers and ensure that the funds are properly funded in accordance with the intent of the Legislature. The similar change to section 34A.7B relating to the 911 emergency communications fund reflects this same intent and brings the Code language into conformity with current Department practice.

- The income tax checkoff for contributions to the election campaign fund (political checkoff) was repealed for tax years beginning after December 31, 2016, meaning that contributions cannot be made to the fund for tax years beginning after that date. However, the Code sections creating the fund itself, and providing for its administration do not expire until July 1, 2018, meaning that the parties could still receive funds from the program up until that date. The Department estimates that it will cost significantly more to continue to administer this program through July 1, 2018 than the fiscal year filers still eligible to contribute to the fund could contribute. Because the political checkoff was really a designation of $1.50 of taxpayer's liability away from the General Fund and to a political party, directing any funds otherwise intended for the checkoff in the General Fund is appropriate.

- The proposal limits private causes of action against any taxpayer, retailer, marketplace provider, or referrer that may arise from or relate to overpayment of sales or use taxes that are remitted to the Department.

Income Tax Credits (Division IV)

The proposal would make changes to the following income tax credits; in addition, it has been indicated that the final proposal will include a one-year extension of the Targeted Jobs Withholding Tax Credit:

Innovation Fund Tax Credit (Section 32):
The proposal would extend the deadline for the certification of new innovation funds for which investments into the funds qualify for Innovation Fund Tax Credits. Under current law, the Iowa Economic Development Authority (IEDA) cannot certify any new innovation funds after June 30, 2018. This bill proposes extending the deadline to June 30, 2023.

Based on data from IEDA since the inception of the Innovation Fund Tax Credit only one innovation fund was approved in 2013 and more recently another fund has been conditionally approved. It is assumed that the conditional approval will be finalized under current law. Using this information, it is assumed that the extension of the deadline would result in an additional two innovation funds being approved. It is assumed that the first fund would be approved in 2020 and the second fund would be approved in 2022.

Research Activities Tax Credit (Sections 33-35, 38-40):
This automatic tax credit is currently linked to the federal definitions of research, providing tax credits for entities increasing research expenditures in Iowa claimed against individual and corporation income tax. The Department has realized a jump in claims during recent tax years, often on amended returns for tax years ending two and three years ago, made by contractors who purport to be conducting research. Often these taxpayers only make a claim to the refundable Iowa tax credit, finding much more benefit from that claim than to the similar federal tax credit that is nonrefundable.

The proposed language would restrict the industries of taxpayers considered eligible for the RAC and require that the taxpayer filed a federal research tax credit claim for the same tax year for which an Iowa claim was filed. These changes are effective for tax credits claimed for tax years beginning on or after January 1, 2017. The businesses, based on industry code, that would likely be excluded from eligibility under this proposal accounted for an average of 10% of RAC claims for tax years 2012 through 2015 filed to-date. It is assumed that this provision would reduce claims by 10% for claims filed for tax years 2017 and later.

In addition, the proposal clarifies that the Department's calculation of the tax credit as provided on the IA 128 accurately reflects that the Iowa Code matches the method used at the federal level. This change has no expected fiscal impact. The proposal would also couple the RAC with federal changes to the definition of research expenditures that, in several years, would be amortized rather than expensed. It is possible that these changes could result in increased Iowa tax liability of companies, but the impact is uncertain so has not been incorporated in the coupling estimates or the tax credit estimates.

School Tuition Organization Tax Credit (Sections 36-37):
Under current law, this awarded tax credit is equal to 65% of donations made to School Tuition Organizations (STOs). The credit is nonrefundable and capped at $12 million per year. The donations are used to fund tuition grants for Iowa students in households with income up to 300 percent of poverty to attend an accredited non-public school in Iowa.

The Department's recent evaluation study showed that the existence of this tax credit program results in a positive fiscal impact for the State. The costs savings reflect the reduction in public school spending as some tuition grant recipients are able to move from public school to private school. It is estimated that those cost savings have exceeded the tax credits awarded under the program each year. However, given that the number of tuition grants was largely unchanged with the last increase in the cap, rather the average tuition grant increased, it is reasonable to assume that the number of students shifting from public to private was also unchanged. It is assumed that the number of students shifting from public schools would also not be increased by the proposed increase in the cap to $13 million, thus savings to the State are not increased. Also, the expansion of eligibility to higher income families could result in a reduction of the average tuition grant that might cause some lower income students to return to public school. Therefore, the increase in the cap is modeled as a cost to the State equal to the expected increase in tax credit claims resulting from the higher amount awarded each year beginning in 2019. The cap has been fully utilized in recent years. The fiscal impact does not reflect any assumed change in Iowa itemized deductions claimed by donors, where donations eligible for the tax credit cannot be itemized. It is expected that much of the additional $1.54 million in donations would be new contributions (potentially higher-income taxpayers attempting to get around the federal SALT cap) rather than a substitution for other charitable contributions.

Geothermal Heat Pump Tax Credit and Geothermal Tax Credit (Sections 42 and 49):
These two automatic tax credits offer mutually exclusive incentives for installing a geothermal heat pump on the residence of the taxpayer where the former is linked to a similar federal tax credit while the latter is a stand-alone Iowa tax credit. Under current law, the federal credits for geothermal property expired December 31, 2016 but were retroactively extended through December 31, 2021 in the Bipartisan Budget Act of 2018. Under current law, Iowa is not coupled with that federal tax legislation, so the Geothermal Heat Pump Tax Credit is unavailable, but taxpayers can claim the Geothermal Tax Credit. Under the bill, Iowa would couple with that extension effective January 1, 2019, making the Geothermal Heat Pump Tax Credit available for installations on or after that date. However, the proposal would also eliminate the tax credit from the Code along with the Geothermal Tax Credit that can currently be claimed for 10% of the installation costs effective for installations on or after January 1, 2019. It is assumed that the 10-year carryforward for installations prior to January 1, 2019 available for both tax credits would be allowed.

Solar Energy System Tax Credit (Sections 43 and 48):
This awarded tax credit, administered by the Iowa Department of Revenue, offers a tax credit equal to 50% of the similar federal tax credit covering 30% of the installation costs of a solar

energy system installed on a home or business in Iowa. Credits awarded for residential installations are capped at $5,000 while credits awarded for business installations are capped at $20,000. Under current law, the program is capped at $5 million in awards each year. Under current law, the federal tax credit is set to expire January 1, 2022; thus, the Iowa credit would not be available after that date.

The proposal would eliminate the Solar Energy System Tax Credit effective July 1, 2018 for any solar energy systems installations occurring on or after that date. The 2017 cap was met with installations completed in August 2017. An additional $5.0 million of applications are pending award for the remainder of 2017 installations and for early 2018 installations. For installations completed in the first seven months of 2017, $2.9 million of applications were filed; it is assumed a similar number will be completed in the first six months of this year. Subtracting out the $0.6 million of 2018 included above suggests $2.3 million in additional applications. Therefore, it is assumed that the full 2018 cap would be met along with $2.3 million awarded in FY 2019 under this proposal. The timing of claims to previously awarded credits and future award is based on historical claim information.

Targeted Jobs Withholding (TJC) Tax Credit:
The TJC Tax Credit Program, administered by EDA, allows five pilot project cities to award withholding tax credits to businesses locating or expanding in the cities located on the Iowa border. Businesses are eligible to claim a credit against withholding tax equal to 3 percent of the gross wages paid to new or retained jobs for up to 10 years, although many recent contracts have been limited to 5 years. Under current law, no new awards can be made after June 30, 2018. Under current law, less than $2 million in contracts were signed in FY 2016 and FY 2017, and at this point only one contract is close to completion for FY 2018.

The proposal would extend the ending date of the TJC program until June 30, 2019. The fiscal impact assumes an additional $2 million in awards will be signed during FY 2019 with claims made over the following five to 10 years.

The estimated fiscal impact for each of these changes is presented in Table 1.

Expenditure Limitation and Taxpayer Trust Fund (Division V)

The proposal would implement a spending limitation and eliminate the Taxpayers Trust Fund Tax Credit. Because no future Taxpayers Trust Fund Tax Credit claims were considered for REC forecasts, these provisions are estimated to have no impact on future tax revenues.

Individual Income Tax (Divisions VI – IX)

The proposal would introduce limited coupling in TY 2018 and additional coupling provisions in TY 2019, cutting income tax rates between 5.0% and 8.3% in TY 2019, then move to federal taxable income with additional changes in tax rates and brackets in TY 2023, assuming revenue targets are met. The tax brackets and rates under this proposal are summarized in Table A.

Table A. Current and Proposed Individual Income Tax Brackets and Rates

	Iowa Current Law*			Under the Proposal					
							TY 2023 and after**		
	Over	But Not Over	Tax Rates	TY 2018	TY 2019 - 2022		Over	But Not Over	Tax Rates
[1]	**$0**	**$1,628**	0.36%	No change	0.33%	[1]	**$0**	**$6,000**	4.40%
[2]	**$1,628**	**$3,256**	0.72%	No change	0.67%	[2]	**$6,000**	**$30,000**	4.82%
[3]	**$3,256**	**$6,512**	2.43%	No change	2.25%	[3]	**$30,000**	**$75,000**	5.70%
[4]	**$6,512**	**$14,652**	4.50%	No change	4.14%	[4]	**$75,000**	**or more**	6.50%
[5]	**$14,652**	**$24,420**	6.12%	No change	5.63%				
[6]	**$24,420**	**$32,560**	6.48%	No change	5.96%				
[7]	**$32,560**	**$48,840**	6.80%	No change	6.25%				
[8]	**$48,840**	**$73,260**	7.92%	No change	7.44%				
[9]	**$73,260**	**or more**	8.98%	No change	8.53%				

*Current tax brackets are indexed under current law. TY 2019 brackets are reported in this table.

**Proposed tax brackets are indexed . TY 2023 brackets are reported in this table.

Note: The rate and bracket change in TY 2023 only occurs if revenue targets are met.

Besides changes in tax brackets and rates, this proposal includes other revisions as follows.

TY 2018: The proposal would couple with the following provisions effective in tax year 2018:

- Allowing rollovers between 529 and Achieving a Better Life Experience (ABLE) accounts for individuals with disabilities in 2017 federal law changes
- Definitional changes regarding retirement savings and business accounting rules in 2017 federal law changes
- The extension of higher Earned Income Tax Credits for married households and households with three or more children in 2015 federal law changes
- The above-the-line deduction for teachers' education expenses in 2015 federal law changes
- Expanded definition of qualified education expenses under the 529 education savings plans in 2017 federal law changes to include K-12 tuition
- Expand Section 179 cap and investment limit to $70,000/$280,000 from $25,000/$200,000 and allow shareholders or partners to depreciate expensing received from pass-throughs that exceeds the Iowa cap, where each entity cannot exceed the federal cap, 20 percent per year in the subsequent five tax years

TY 2019-TY 2022: The proposal would make the following changes effective beginning tax year 2019:

- The proposal would conform with the Internal Revenue Code effective for tax year 2019 and later, and thus coupling with:
  - AGI changes –
    - Elimination of the domestic production activities deduction
    - Elimination of the moving expenses deduction for non-military moves
    - Elimination of alimony payment deduction and elimination of alimony received as income for agreements after December 31, 2018
  - Itemized deduction changes -
    - Elimination of the income limitation on itemized deductions

        - Elimination of home equity interest deduction and casualty deduction for non-disaster related losses
        - Elimination of itemized deduction for unreimbursed job expenses and tax preparation services
- No bonus depreciation
- No coupling with the State and local tax deduction cap
- TY 2019 - Expand Section 179 cap and investment limit to $100,000/$400,000 and allow shareholders or partners to depreciate expensing received from pass-throughs that exceeds the Iowa cap, where each entity cannot exceed the federal cap, 20 percent per year in the subsequent five tax years
- TY 2020 - Expand Section 179 cap and investment limit to fully couple with the federal cap and investment limit ($1 million/$2.5 million that are annually indexed)
- TY 2020 - Couple with the federal repeal of like-kind exchange (1031) for all but real property
- TY 2019 and TY 2020 - Allow 25% of the federal qualified business income deduction from Iowa taxable income
- TY 2021 - Allow 50% of the federal qualified business income deduction from Iowa taxable income
- TY 2022 - Allow 75% of the federal qualified business income deduction from Iowa taxable income

TY 2023: If revenue targets are met, the proposal would implement the following additional provisions:

- Use federal taxable income as the basis for Iowa taxable income beginning in TY 2023 with various adjustments:
    - Subtract Social Security benefits taxed by the federal government
    - Subtract military pension income and active duty pay
    - Subtract the Iowa current law pension exclusion
    - Subtract 529 and ABLE contributions up to the Iowa annual exemption limit
    - Subtract interest on federal securities
    - Add interest on instruments that are federally-exempt but not state exempt
    - Add any bonus depreciation claimed on the federal return and adjust depreciation accordingly
    - Subtract any income included at the federal level for education loan payments made by employers
    - Allow taxpayers aged 65 or older with Iowa income below $100,000 (Iowa taxable income plus pension exclusion, Social Security benefits, federal standard deduction/itemized deduction, and qualified business income deduction) to deduct all health insurance premiums (as under Iowa current law)
    - Subtract AmeriCorp Education Award payments
    - Subtract contributions to a Homebuyer Savings Account up to eligible limits
    - Allow taxpayers qualifying for the current Iowa capital gain deduction for real farm property sales, including material participation and ownership, who make a sale to a lineal descendant, to continue to qualify for the deduction

- Eliminate federal deductibility, except in tax year 2023 a deduction is allowed for any payments for prior tax years and any refunds for prior tax years must be included
- Revise tax rates and brackets (see Table A)

- Eliminate other Iowa-specific adjustments not included above (such as the Iowa capital gain deduction and the additional health insurance premiums currently deductible in Iowa)
- Eliminate the option of choosing married filing separate on the same return and double the brackets for married taxpayers
- Eliminate the Iowa Alternative Minimum Tax, allow nonrefundable claims of any available Iowa Alternative Minimum Tax Credit in TY 2023 and eliminate the tax credit effective in TY 2024
- Redefine net income for the purposes of applying the filing thresholds and the alternate tax to include either the federal standard deduction or federal itemized deductions (effectively returning the measure to mimic current law) and the federal qualified business income deduction

In addition to these changes effective for individual income taxpayers, it was assumed that similar changes would be implemented for composite filers, as appropriate. Composite filers are nonresident shareholders of companies with Iowa-source income; the company can file one return on behalf of all shareholders for whom the company is the only source of Iowa income. The Department specifies the calculation of tax for those filers in the administrative rules. The data available on those filers includes only the amount of Iowa-source income from that company. It was assumed that the same income would be the starting point of taxation except for the allowance of the qualified business income deduction estimated to be applicable to the shareholders.

Individual Income Tax Micro Model

This analysis employs the IDR individual income tax micro model, using data for tax year 2016. In order to estimate tax liability in years after 2016, individual tax return data used by the model are adjusted for anticipated growth in income and changes in the size and age distribution of the population. The income growth forecasts are based on various income projections produced by external economic models using data primarily from Moody's Analytics. Future projections do not assume any specific unusual growth or recessionary periods. The population changes are based on REMI projections for the State of Iowa. The model forecasts both federal and Iowa tax liability for each household under current law. The forecasted changes in liability by tax year under the proposals are timed into State fiscal year changes using historical patterns of withholding, estimates, final returns, and refunds.

Please note that all major provisions of the new federal law passed in December 2017 (including a modification to the federal QBI enacted March 2018) that impact individual income tax, and other minor provisions for which data is available have been included in the baseline.

Individual Income Tax Fiscal Impacts

For TY 2018, TY 2019, TY 2021, TY 2023, and TY 2024 distributional impacts under this proposal are presented in Tables 2-16. Distributional impacts for only Iowa residents during those same tax years are presented as well.

Example taxpayers for TY 2019, TY 2021, TY 2023, and TY 2024 are presented in Tables 7B, 10B, 13B, and 16B. The 35 modeled example households, based on average outcomes for actual taxpayers forecasted to fit the specified characteristics, differ by filing status, number of dependents, age of primary taxpayer, income groups measured using Iowa adjusted gross income under current law (ranges to target $25,000, $50,000, $100,000, $250,000, and $500,000).

The overall tax year and fiscal year estimated impacts are presented in Table 17. However, these results do not include several coupling provisions that were estimated outside the model. Those impacts are reflected in the final tables (see Tables 21 and 22).

Corporation Income Tax (Division VII)

The proposal would couple with 2015 and 2017 tax law changes effective in TY 2019 including the Section 179 cap and limit, matching those available for individual income taxpayers, but no bonus depreciation.

In TY 2021, federal deductibility would be eliminated (with the necessary transition year), the AMT would be eliminated, and rates would be reduced as noted in Table B.

Table B. Corporation Income Tax Rates Under Current Law and Proposed

Tax Bracket	Current Law	Proposed TY 2021 and Later
$0 - $25,000	6.0%	5.5%
$25,000 - $100,000	8.0%	5.5%
$100,000 - $250,000	10.0%	9.0%
$250,000 and Above	12.0%	9.8%

Corporation Income Tax Micro Model

This analysis employs the IDR corporation income tax model using tax returns filed for form years 1990 through 2015. Tax liability for each return is forecasted for future years using economic growth projections for income, adjustments, and tax credits. The growth forecasts are based on external economic models using data primarily from Moody's Analytics. Projections do not assume any specific unusual growth or recessionary periods. The model uses the historic relationships between tax liabilities and State fiscal year receipts and refunds to translate form year tax liability changes into State fiscal year revenue changes.

Corporation Income Tax Fiscal Impacts

The estimated tax year and fiscal year impacts of the proposal are presented in Table 18. With changes first effective for tax years beginning on or after January 1, 2021, impacts are not expected to be realized until FY 2021.

Distributional impacts of the proposal are presented in Table 19 including the share of corporation income taxpayers expected to experience decreases and increases in total Iowa tax liability for tax year 2024.

Sales and Use Tax (Division X)

The rise of the internet and the sharing economy has rendered many states' sales and use tax laws inefficient and inequitable. Laws written with traditional retail stores and mail-order catalogs in mind do not translate to the modern developments of subscription services and online marketplaces. This proposal modernizes the sales and use tax code in order to end the inherent favoring of internet-based businesses over traditional retailers.

The estimate focuses on six major components.

- Digital Goods
- Ride Sharing
- Subscription Services
- Online Sellers
- Online Marketplaces
- Manufacturing Definition
- Online Travel Companies Websites

The first component ends the exemption for goods purchased and delivered online, such as e-books, games, and phone apps. The exemption was enacted when the internet was new and few goods were delivered digitally. Today, digital delivery is becoming the main form of purchase for nearly all media. The fiscal impact of this component is estimated using the tax expenditure of exempting digitally-delivered goods from the Department's TY 2015 Tax Expenditure Study. In most cases, the retailers to which sales are attributed already have nexus in Iowa and thus would be required to remit sales and use tax on these purchases. Thus, it is assumed that companies affected would fully comply with this provision. The bill also clarifies that all photography services are taxable.

The second component, as part of the delineation of taxable services in Section 67, establishes taxation of all ride services including traditional taxi services and internet-based ride-sharing businesses. The fiscal impact of this component is estimated using NAICS data on traditional taxi services as well as revenue reports from specific online ride-sharing services.

The third component expands the sales and use tax base to capture the change in consumption from tangible good purchases such as video game cartridges and CDs to subscription services including streaming audio and video, software as a service, legal research databases, genetic analysis, online file storage, software, and gaming. The fiscal impact is the sum of multiple estimates based on revenue reports from specific companies providing these services. Given that these sectors are part of the new economy and are growing at rate faster than traditional retail, the annual growth rate used for almost all components is in excess of five percent per year, with some components estimated at more than 10 percent annual growth.

The fourth component expands the definition of sales tax nexus to include any retailer selling more than $100,000 of products or making more than 200 separate sales into the state, whether or not through an online marketplace, or who uses software or data files installed on property used in the state. The fiscal impact of this component is estimated using data on the value of ecommerce sales nationally and data from various websites. The sales are assumed to be made primarily to consumers but business purchases are also likely included. Under the current *Quill* decision, it is assumed that approximately one quarter of small online sellers, each with $100,000 to $1.8 million in sales into Iowa, and one half of large online sellers, those with $1.8 million and more in sales into Iowa, would comply with this provision.

The fifth component expands the definition of retailer to include any marketplace provider that facilitates sales into the state. This expansion is put in place to rectify the current disadvantage faced by traditional retailers required to charge sales tax on in-person sales at stores or market stands while retailers on online marketplaces claim to have no such requirement. The fiscal impact of this component is estimated by using data gathered from the websites of various online marketplace providers. This includes entirely digital marketplaces such as phone app stores, contingent on also eliminating the sales and use tax exemption on digital goods. It is assumed that online marketplaces who account for approximately half of associated sales would comply with this provision.

The sixth component relates to the definition of manufacturer for purposes of the manufacturing machinery and equipment exemption in the current Code section 423.47. The definition requires that a business be primarily engaged in manufacturing, and specifically excludes businesses that engage in retail. The Department's tax expenditure estimate of the manufacturing machinery and equipment exemption for FY 2017 is $132.7 million. Previous estimates related to that exemption suggested that "non-traditional manufacturers," which would likely become ineligible for the exemption under the proposal, account for roughly 10 percent of the cost of the exemption. The proposal would also define commercial enterprise, as related to certain exemptions, to include professionals.

The seventh component clarifies auto rental and hotel/motel tax obligations among lessors, lodging facilitators, and rental facilitators, in particular online travel companies. The Department has already successfully started collecting excise tax from some of these taxpayers, but the language changes are estimated to increase those collections.

The estimated fiscal impact of these sales and use tax changes are presented in Table 20. The proposal would make the change to the manufacturing definition effective upon enactment with a fiscal impact assumed to begin at the start of FY 2019, make other definition changes effective July 1, 2018, but all other changes are effective January 1, 2019, thus all other revenue impacts are estimated to begin on that date.

Local Sales Tax Impact Estimates

Under current law, one percentage point of the sales and use tax is dedicated to the Secure an Advanced Vision for Education (SAVE) program through December 31, 2029. Therefore, one-sixth of the estimated increased tax revenues would be transferred to the schools. The estimated difference in total net receipts for the State is net of that transfer to the school districts (see Table 21).

The changes to sales and use tax law would make all retailers selling items into the state or newly-taxable goods subject to the retail sales tax, thus also making those sales subject to the local option sales tax. Based on jurisdictions with LOST during FY 2018, it is assumed that 79% of sales will be subject to LOST in all future years (see Table 21). However, it is likely that changes made to the process for approving LOST in Division XI will lead to an expansion of that coverage.

Total Revenue Impact

Table 21 presents the estimated impact of individual income tax, corporation income tax, income tax credits, and sales and use tax changes on General Fund receipts on a fiscal year basis Table 22 presents the estimates on a tax year/calendar year basis.

Administrative Cost Impact

Individual and Corporation Income Tax Changes

Administrative impacts of the individual income tax changes in the bill encompass four types:

1. One-time form development to accommodate non-coupling provisions
2. Annual tax calculation updates resulting from changing tax rates and brackets
3. Increases or decreases in the required taxpayer and tax preparer education related to coupling
4. Redesign of the IA 1040 to reflect changes triggered in TY 2023

Provisions in the bill that would require the Department to develop a new form are the non-coupling with the Section 1031 like-kind exchanges for 2018 and 2019. Currently the State relies on the US 8824 for taxpayers to report these transactions and the resulting change in basis and deferred gains. That form will no longer be allowed at the federal level for personal property exchanges. The Department will have to develop a State form for that tracking. Likewise, the introduction of the Section 179 pass-through fix for tax years 2018 and 2019 will likely require the development of modifications to the IA 4562. It is estimated that these changes, dominated by the development of an additional form and instructions, would cost an estimated $10,000 in FY 2018 and FY 2019.

All other changes specified under the bill for tax years 2018 - 2022 that directly impact the calculation of Iowa tax liability such as lower tax rates would be completed during the Department's annual tax calculation updates and would not add additional administrative costs.

When the State is not coupled with the IRC, it creates additional administrative burden for staff. For example, the coupling proposed for 2018 will eliminate the need for the Department to create an additional form/worksheet for Iowa taxpayers to recalculate the federal Earned Income Tax Credit for Iowa purposes. Coupling with definitional changes save time for legal staff who would not need to prepare guidance for taxpayers and preparers. One significant example is the definition of allowable expenses under 529 plans. The Department would have to create instructions for Iowa taxpayers and preparers about when a withdrawal from a 529 does and does not have to be added to Iowa income if Iowa does not couple with the expansion to K-12 expenses. The coupling changes are expected to save an estimated $10,000 in FY 2018 and FY 2019.

The changes to the Section 179 cap and investment limit would not initially fully couple Iowa with the federal provisions, thus, would continue to require taxpayer and tax preparer education efforts and would have no impact on Department administrative costs in the near term; however, beginning in TY 2020, the full coupling with the expensing provisions would eventually result in reduced staff time.

For tax year 2021, the Iowa 1120 would require updates to account for the elimination of federal deductibility and the AMT. These could also be accommodated through annual forms update processes with little additional cost.

For tax year 2023, the Iowa 1040 would need to be largely redesigned to move to federal taxable income as the starting point for calculating Iowa taxable income. However, the Department is in the process of a redesign to better accommodate scanning and data capture. It is anticipated that the two redesigns could be coordinated such that the costs related specifically to this proposal would be minor.

One of the Department's lead audit programs on the individual income tax return is the identification of errors in reporting federal tax refunds as an additional to Iowa taxable income. Each year, 15,000 taxpayers are billed for failing to add their prior year federal tax refund. It is estimated the Department dedicates nearly $0.5 million in audit staff time toward the billing and processing of these returns identified as having this error. In addition, thousands of other returns are caught in the initial processing of a refund claim as having incorrectly reported a federal refund. With many calculations automated and any manual review also including other up-front concerns (such as fraud), it is less straightforward to estimate any fiscal benefit from removing federal payments and refunds from the calculation of taxable income beginning in TY 2024. Because the Department would reallocate those audit resources, there is no administrative cost savings, only the ability to reassign those resources to address other taxpayer errors.

Likewise, the Iowa capital gain deduction requires significant audit time and those taxpayers often end up in the protest process. Elimination of eligibility for most sales under this deduction in TY 2023 is expected to allow the Department to reallocate audit and legal resources to address other taxpayer errors and questions.

Income Tax Credit Changes

The change to the Innovation Fund Tax Credit has no impact on the Department as the program is administered by the Iowa Economic Development Authority. The tax credit award administration has been moved to the Tax Credit Award, Claim & Transfer Administration System, and this change would not require any significant updates to that system.

The changes to the Research Activities Tax Credit will require updates to guidance and tax preparer education, but those can be done with existing resources.

The change to the School Tuition Organization Tax Credit is a simple parameter update to the CACTAS component currently under development by the Department.

The elimination of the Solar Energy System Tax Credit, awarded by the Department, will allow the Department to reallocate staff time to other tax credit administration tasks.

The elimination of the Geothermal Tax Credit after 2018 will allow the Department to forego future updates to the IA 140 used to make a claim to that credit. However, that will not be possible until the 10-year carryforward for those tax credits has expired.

Sales and Use Tax Changes

The changes to sales and use taxes would largely expand the number of taxpayers (online and subscription sellers) registering and filing returns using current Department systems and staff. The Department is currently developing new processes for platform sellers (marketplace, ride sharing, and online travel companies) to file returns covering multiple retailers selling with multiple jurisdictions (more complex for hotel/motel that includes local tax collection); therefore, the additional taxpayers subject to remit taxes would simply result in more taxpayers using those new processes.

Summary

The Department could create efficiencies in the development of these new sales and use tax processes and the new individual income tax calculations by modernizing our systems, which would come with increased costs. However, the work needed to implement the changes proposed in this bill can be handled by reallocating staff and resources from other duties and projects.

Overall, although there are some measurable administrative costs associated with some of the tax changes in the bill, other provisions in the bill would result in largely offsetting estimated cost savings. Other provisions can be accommodated under regularly-scheduled Department updates or solutions that would be necessary to address some provisions expanding the tax base will be developed by the Department regardless of the passage of this bill.

Please contact me at 281-0196 if you have any questions regarding this estimate.

Sincerely,

Amy Rehder Harris
Administrator, Research and Analysis Division