FINAL 2018 GOP TAX PLAN (SF 2417)

Senate Democratic Caucus Analysis - May 5, 2018

Overall tax bill impact

The Republican tax plan will result in a major transformation of Iowa's tax system that will eventually reduce revenues by more than $1 billion annually.

These reductions initially come from reductions in individual and corporate tax rates, along with expanded expensing deductions for farmers and small businesses and a new tax deduction for most businesses organized as LLCs and S-corporations. More reductions will take place in the future when the plan proposes overhauling Iowa's tax system to change what income is subject to tax for individuals and major reductions in the top tax rates. The bill also includes an expansion of Education Savings Accounts for private K-12 education expenses, expands Iowa's sales tax to apply to more online sales, and makes a number of changes to existing tax credits.

These tax cuts will have a devastating impact on the state's ability to provide efforts to train more Iowans for the jobs of tomorrow, to increase family incomes and to help create more opportunities for our children and grandchildren. Iowa will be in a state of constant budget crisis where state resources will be decreasing over time.

This bill reduces general fund revenues by over $100 million in FY19. The tax plan would reduce revenues in FY20 by over $261 million. In tax year 2024, the bill is projected to reduce individual and corporate income taxes by over $1 billion.

Cuts in state spending on many programs will result in an increase in property taxes. More school districts will be subject to the "budget guarantee" and will rely on property tax increases to balance their budgets. Public safety and mental health service shortfalls will fall back onto local governments who are reliant on property taxes. Senate Republicans have already started the process to get rid of the commercial property tax backfill, shifting even more costs for local services onto property taxpayers.

A portion of this revenue loss is made up by modernizing the state sales tax system to more effectively collect taxes owed for sales done online. The bill also expands the state sales tax to include digital goods and services, taxi service and ride-sharing companies, room rental services (VRBO and Travelocity) as well as changes to the definition of "manufacturer" to overturn an Iowa Supreme Court decision (*Sherwin Williams)*. The net impact of sales tax changes in the bill is around $67 million in FY19 and $117 million in FY20.

The proposed business tax credit changes are projected to have a minor impact on overall revenues in the near term. The limitations on what industries can claim the Research Activities Credit and "base year" calculations will reduce awards through the program but not substantially. The bill does include a 5-year extension to the deadline for certifying qualified investment funds under the Innovation Fund program and a one-year extension to the Targeted Jobs withholding tax credit program in certain cities (Sioux City, Council Bluffs, Burlington, and Fort Madison).

The bill also eliminates two income tax credit programs that supported solar and geothermal energy system installations. These programs have created jobs across the state and supported renewable energy and energy efficiency improves to homes, farms, and businesses.

FINAL 2018 GOP TAX PLAN (SF 2417)

Senate Democratic Caucus Analysis - May 5, 2018

Individual income tax changes

The initial income tax changes included in the proposal will:

- Leave the existing income tax system and brackets in place but will reduce the rates for tax year 2019.

	Iowa Current Law*			Und	
	Over	But Not Over	Tax Rates	TY 2018	TY 2019 - 2022
[1]	**$0**	**$1,628**	0.36%	No change	0.33%
[2]	**$1,628**	**$3,256**	0.72%	No change	0.67%
[3]	**$3,256**	**$6,512**	2.43%	No change	2.25%
[4]	**$6,512**	**$14,652**	4.50%	No change	4.14%
[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%

- For tax year 2018, the bill couples Iowa's tax code with the federal tax changes regarding the expansion of the EITC and teaching expense deductions.
- Increases for Section 179 expensing are phased in. For tax year 2018, the limit is raised to $70,000/$280,000 annually for individual income taxes only, not corporate. The bill also institutes a K-1 tax form "fix" so the limit on expensing is extended to every member of the business rather than having all partners cumulatively limited to the expensing threshold. Additionally the legislation would not couple with federal changes that eliminated "like-kind" exchanges from qualifying under Section 179. Those exchanges and the K-1 "fix" will end in tax year 2020.
- Expands qualifying education expenses for 529 savings plans to include private K-12 education beginning in tax year 2018.
- For tax year 2019, the plan provides for general individual and corporate tax code coupling. Section 179 expensing is increased to $100,000/$250,000 for both individual and corporate returns.
- Includes the new qualified business deduction, which provides businesses that file under the individual income tax system (LLCs, S-Corp, partnerships, etc.) a major new deduction on federal income taxes. This deduction is equal to 20 percent of the qualified income from the business. The deduction is phased-in over a period of 4 years beginning in tax year 2019.
- The bill fully couples Iowa's tax code with federal tax changes for tax year 2020. Also, the bill will automatically couple Iowa's tax code with federal changes in the future. Currently, Iowa only couples with federal tax changes by passing legislation to implement the changes.
- The bill does not couple Iowa's tax code with "bonus depreciation" provisions. Iowa has routinely not coupled with this provision in the past.

Beginning tax year 2023, the bill could change Iowa's individual income tax system dramatically assuming two conditions are met:

- General fund net receipts for FY22 (or after) exceed $8.31 billion.
- Net general fund receipts for that year must grow at least 4 percent above the year prior (equal to or more than 104 percent of previous year's net receipts).

- The basis for determining Iowa taxable income will be calculated on federal taxable income. This will incorporate all federal tax deductions into the Iowa tax code.
- The bill eliminates many of the Iowa specific adjustments to taxable income. A summary of those adjustments is included at the end of the document.
- The bill removes the state standard deduction. The federal standard or itemized deductions will be factored into the tax code by using federal taxable income as the base.
- The bill creates a new deduction for businesses for payments for the principal or interest of a qualified education loan incurred by the employee.
- The bill eliminates federal deductibility, reduces brackets and lowers rates for tax year 2023:

	TY 2023 and after**		
	Over	But Not Over	Tax Rates
[1]	**$0**	**$6,000**	4.40%
[2]	**$6,000**	**$30,000**	4.82%
[3]	**$30,000**	**$75,000**	5.70%
[4]	**$75,000**	**or more**	6.50%

- The bill also repeals the individual alternative minimum tax and the associated credit. This tax is paid by a small number of filers who then have the ability to receive a credit for the tax paid in later years if the AMT tax was in excess of the tax liability.

Corporate income tax

Tax rates for corporations will be reduced beginning in tax year 2021:

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%

- The bill eliminates the existing 50 percent federal deductibility provision in Iowa's tax code.

- The bill fully couples Iowa's tax code with federal tax changes for tax year 2020. Also, the bill will automatically couple Iowa's tax code with federal changes in the future. Currently, Iowa only couples with federal tax changes by passing legislation to implement the changes.
- The bill does not couple Iowa's tax code with "bonus depreciation" provisions. Iowa has routinely not coupled with this provision in the past.
- The bill also repeals the corporate alternative minimum tax.

Tax Credits

The bill makes a large number of changes to tax credits and tax incentives.

- The bill revises the Taxpayer Trust Fund and eliminates the Taxpayer Trust Fund tax credit. The fund would be revised so that it would hold money deposited from "excess revenues" and be available to finance future tax policy changes, including but not limited to increasing the general retirement income exclusion or reducing tax rates. This was created in 2013. The fund receives money when general fund revenues exceed REC estimates, up to $60 million. The plan would eliminate the cap on transfers.
  - The Taxpayer Trust Fund tax credit has been issued twice since it was created. Tax credits from the fund are only issued when the fund has a balance in excess of $30 million.
- Extends the Targeted Jobs withholding tax credit by one year. The program was to expire after June, 30, 2018.
- Provides a five-year extension for the certification of a qualified investment fund under the Innovation Tax Credit program.
- The bill places a number of restrictions on the use of the Research Activities Credit:
  - The bill specifies which industries are able to claim the credit. Eligible businesses are in manufacturing, life sciences, software engineering, or aviation and aerospace.
  - The bill prohibits persons engaged in agricultural production, commercial and residential repair and installation including HVAC, plumbing, security and electrical systems from claiming the credit.
  - The business claiming the credit must also claim and be allowed the federal RAC credit to receive the state credit.
  - The bill removes the ability of a business to receive a refund or carryforward supplemental RAC credits issued under the HQJ.
  - Defines "base amount" for the determination of what expenditures a business is eligible to claim under the program. This is meant to restrict the base amount to what was intended by the original legislation.
- Repeals the alternative minimum tax credit. This credit is unnecessary with the repeal of the AMT. Provides for transition period.
- Expands who is an eligible student to receive a tuition grant under the Student Tuition Organization tax credit program. The threshold for eligibility is increased from 300 percent of

the federal poverty level to 400 percent of the federal poverty level. The tax credit program cap is increased by $1 million to $13 million annually for tax year 2019.

- Repeals the geothermal heat pump tax credit beginning in tax year 2019.
- Repeals the solar energy system tax credit beginning in tax year 2019. The credit is not allowed for any installations after July 1, 2018.

529 plans - Education Savings Account expansion

The bill includes language to incorporate the recent federal expansion of qualified expenses allowed under 529 college savings plans. The recent federal tax bill expanded the allowed expenses under the program to include private K-12 education expenses. Maximum contributions for this purpose are $10,000 annually.

The 529 saving plan was established as a means of encouraging savings for higher education expenses with contributions limited to $3,000 per year. The plans are invested in qualified securities and are designed to accumulate value while a child ages in order to pay for college. This new method will allow for the payment of expenses in the same year, essentially creating a tax deduction for private education expenses.

Sales/Use Taxes

The main provisions of this portion of the bill are included in the Governor's proposal and are intended to provide for the collection of sales taxes owed for sales conducted over the internet to persons located in Iowa. It does this by expanding what is considered the nexus of the sale to include sales sourced to a person located in Iowa. Currently, nexus is restricted to the physical location of the seller so sellers located outside of Iowa are not obligated to collect and remit sales taxes. This issue is the subject of a case that was argued before the U.S. Supreme Court this April.

The bill also includes digital products and information services as an item that is subject to Iowa's sales and use tax. This extends the tax to digital downloads of movies, music, and books, as well as software. Information services includes "streaming" services such as Netflix and Hulu, genealogical research services like Ancestry.com, and others that involve the sending of digital information to the end user. The Department of Revenue has asserted that streaming television services like Netflix and Hulu are already subject to state sales tax requirements that apply to cable video services.

The bill would extend the sales tax to taxi services and ridesharing platforms. The bill creates exemptions for public transit, paratransit, and emergency and nonemergency medical transportation

The bill also expands sales taxes to services that facilitate the rental or use of lodging and automobiles. This would require ridesharing companies like Uber/Lyft, AirBnB/VRBO, and others like Travelocity that assist in these transactions to collect and remit sales taxes. The bill also makes these companies jointly liable for the taxes owed on services they assist in accommodating. This means booking services like

Travelocity are liable for taxes owed on hotel rooms reserved using their platform in the event the hotel does not remit the taxes owed to the state.

The bill would restrict who may qualify as a manufacturer to standards that were in force prior to an Iowa Supreme Court decision in a case involving Sherwin Williams. This definition of manufacturer would eliminate the ability of a number of businesses to claim the manufacturer exemption from sales tax owed on purchases of equipment and scale back the use of Iowa's sales tax exemption on manufacturing equipment.

Local Option Sales Tax (LOST) Election Approval changes

The bill strikes provisions in state law for LOST elections conducted in Polk and Johnson counties after January 1, 2019. The existing law requires contiguous cities to both vote to approve the implementation of a LOST. Because of this provision, cities like Des Moines, West Des Moines, and others in metro areas where a city that borders another community are not able to implement LOST even though the voters of that city had approved the measure.

Miscellaneous Administrative changes for the Department of Revenue

The first three divisions of the bill contain a number of administrative changes proposed by the Department of Revenue. The changes include:

- Establishing consistent interest accrual procedures across tax types administered by the department.
- Expands tax fraud penalties to include other tax items beyond credits and refund claims to include reimbursements, rebates, or other payments.
- Provides the department the authority to share information with the Attorney General's office and law enforcement in cases of suspected tax evasion.
- Codifies a recent Iowa Supreme Court (*Bass v. JC Penney Inc.)* ruling regarding class actions and private right of actions regarding overpayment of taxes collected by a private entity. An LSA legal update regarding the case is available here: http://www.iowacourts.gov/About_the_Courts/Supreme_Court/Supreme_Court_Opinions/Recent_Opinions/20160610/15-0334.pdf
- Dictates that the department will be the point of contact on behalf of political subdivisions and the state to ensure accurate geographical boundary information is provided to the US Census Bureau.
- Improves the procedure for the collection of the prepaid wireless service excise tax and the water service excise tax.
- Provides that political checkoff funds received by Revenue will be deposited into the General Fund. The checkoffs were eliminated last year but some amended returns are being submitted with money set aside for the checkoff.

Changes to Individual Income tax adjustments

The plan eliminates or phases out these deductions related to the calculation of Iowa taxable income:

- Employment of disabled individuals and former prisoners
- Organ donation
- AmeriCorps service income
- The cost of purchasing health insurance for spouse or dependents (only impacts Iowans taking the federal standard deduction)
- Net capital gains deduction, including the 50 percent deduction for capital gains associated with a qualified Employee Stock Ownership Program
- Restitution/compensation for property taken through involuntary condemnation/eminent domain
- Income earned by non-residents who conduct emergency response work for utilities in the event of a disaster
- Tax expenses for a fiduciary in the execution of an estate
- Compensation received as restitution for Agent Orange exposure, those kept in Asian-American internment camps during World War II, and those victimized by Nazis
- Income earned during active duty performed in Desert Storm, Bosnia-Herzegovina peace keeping, and second Iraq war operations

The plan appears to remove income from these provisions from calculation as Iowa taxable income:

- Certain intangible drilling and development costs described in IRC §57(a)(2).
- The percentage depletion amount with respect to certain oil, gas, or geothermal wells described in IRC §57(a)(1).75
- The depreciation taken on a speculative shell building, defined in Iowa Code section 427.1(27), that is owned by a for-profit entity receiving the proper tax exemption, unless the taxpayer is not using the building as a speculative shell building. For state income tax purposes, depreciation is computed and subtracted from federal adjusted gross income as if the building was classified as 15-year property.