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Deloitte Tax LLP | May 12, 2023

MULTISTATE INCOME/FRANCHISE TAX

Iowa enacts pass-through entity tax election

Tax Alert

Overview

On May 11, 2023, Iowa House File 352 (H.F. 352) was enacted into law. Under the legislation, pass-through entities may make an annual election to pay an entity level state tax for taxable years beginning on or after January 1, 2022.

This Tax Alert summarizes some of the provisions of H.F. 352 related to the pass-through entity tax election.

Iowa pass-through entity tax election

- Effective for taxable years beginning on or after January 1, 2022. The election will only apply to taxable years for which the limitation on individual income tax deductions under IRC section 164(b)(6) applies.
- Eligible pass-through entities include S corporations and partnerships, except for publicly traded partnerships.
- A separate election shall be made for each tax year on a form and at a time prescribed by the Iowa Department of Revenue ("Department").
- There is ambiguity in the law for when the election is due, particularly for taxable years ending prior to the enactment of this legislation.
- The election for that year is irrevocable once made and shall be binding on the electing pass-through entity and all its partners or shareholders.

Pass-through entity tax calculation

- The pass-through entity tax is imposed on taxable income of the pass-through entity allocated and apportioned to the state under the rules adopted by the Department. There is ambiguity in the law whether taxable income for Iowa residents may include income sourced to other states.

- The tax rate for the pass-through entity tax is equal to the highest individual income tax rate under Iowa Code section 422.5A (8.53% for 2022 and 6% for 2023).

- The pass-through entity tax shall be due with the pass-through entity's tax return.

- The pass-through entity tax shall be reduced by the franchise tax credit flowing up from a lower tier partnership, the composite credit flowing up from a lower tier partnership, and the Iowa pass-through entity tax credit flowing up from a lower tier partnership. No other credits can be claimed against the pass-through entity tax.

- A net operating loss or other loss carry-back or carry-forward shall not be claimed by an electing pass-through entity.

- The electing pass-through entity is liable for the entity-level tax imposed, including applicable penalties and interest. However, the Department may assess direct or indirect partners and shareholders for taxes owed in the event that the electing pass-through entity fails to timely make any pass-through entity tax payment required for any reason.

Pass-through entity tax credit

- Partners or shareholders of the electing pass-through entity may claim a credit against their Iowa income tax equal to a percentage of the pass-through entity tax paid by the electing pass-through entity.

- The pass-through entity tax credit percentage each tax year is equal to 100% minus the highest individual income tax rate for the applicable tax year, with the result multiplied by the partner's or shareholder's pro rata share of the pass-through entity tax paid (91.47% for 2022 and 94% for 2023).

- If an electing pass-through entity is itself a partner or shareholder in another electing pass-through entity, it may claim the pass-through entity tax credit.

- Any credit in excess of the partner's or shareholder's tax liability is refundable. In lieu of claiming a refund, the partner or shareholder can elect to have the overpayment shown on the partner's or shareholder's final, completed return credited to the tax liability for the following tax year

- A non-resident individual who is a partner or shareholder of an electing pass-through entity shall not be required to file an Iowa individual income tax return if the only Iowa source income of the individual is from the electing pass-through entity, the pass-through entity tax credit equals or exceeds their Iowa individual income tax liability, and if the electing pass-through entity files and pays the pass-through entity tax due.

Other considerations

- An electing pass-through entity is not required to file a composite return for the same tax year for which the pass-through entity tax election is made.

- Electing pass-through entities are required to make estimated payments of tax for the taxable year if the amount of tax payable, less credits, can reasonably be expected to be more than $1,000 for the taxable year.

- Estimated tax payments are not required for tax years beginning prior to the enactment of this legislation.

- The Department may waive penalty and interest for a return filing or pass-through entity tax payment for a taxable year ending prior to the enactment of this legislation.

Get in touch

Steven Kelly

Have a question relating to this or any other pass-through entity tax regime? Reach out to one of our national multistate pass-through entity tax specialists.

Greg Bergmann
Todd Hyman
Jason Kang
Hernan Stigliano
Roburt Waldow
Andrew Cardaci
Dan Daly
Alyssa Keim
Fiona Pan
Amanda Sterling
Shirley Wei
Olivia Schulte