



Iowa Department of  
**REVENUE**

**Iowa's S Corporation Apportionment Tax Credit  
Tax Credits Program Evaluation Study**

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**By  
Angela Gullickson**

**Tax Research and Program Analysis Section  
Iowa Department of Revenue**

**Preface**

During the 2005 Legislative Session the Iowa Department of Revenue received an appropriation to establish the Tax Credits Tracking and Analysis Program to track tax credit awards and claims. In addition, the Department was directed to perform periodic evaluations of tax credit programs. This is the first evaluation study completed for this administrative tax credit.

This study and other evaluations of Iowa tax credits can be found on the [Tax Credits Tracking and Analysis Program web page](#) on the Iowa Department of Revenue website.

## Table of Contents

I. Introduction .....	5
II. S Corporation Apportionment Tax Credit .....	5
III. S Corporation Apportionment Tax Credits in Other States .....	7
IV. Analysis of S Corporation Apportionment Tax Credit Claims .....	8
V. Conclusion .....	9
Tables and Figures.....	12
Table 1. How Corporation Income Is Taxed in Neighboring States .....	13
Table 2. How Corporation Income is Taxed in Other States.....	13
Table 3. S Corporation Apportionment Tax Credit Claims, Tax Years 2006 - 2014...	14
Table 4. Number of 1120S Returns Filed by Tax Year, Tax Years 2010 – 2015.....	14
Figure 1. Adjusted Gross Income of All Households Compared to Households With S Corporation Apportionment Tax Credit Claims, Tax Years 2006 - 2013.....	15
Figure 2. Adjusted Gross Household Income of All Households with Schedule E Pass-Through Income Compared to Households With Schedule E Pass-Through Income and S Corporation Apportionment Tax Credit Claims, Tax Year 2013.....	16

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## **I. Introduction**

The S Corporation Apportionment (S Corp) Tax Credit went into effect for tax years beginning on or after January 1, 1996. A taxpayer is eligible to claim the S Corp Tax Credit when he or she is an Iowa resident who is also a shareholder of an S Corporation that conducts business within and without Iowa. The tax credit is nonrefundable with no carry forward and cannot be transferred to another taxpayer. Originally, the tax credit could only be claimed against individual income tax. However, effective in tax year 2013 and subsequent tax years, the tax credit can be claimed on a fiduciary return filed by estates and trusts.

Section II of this study provides information about the S Corporation Apportionment Tax Credit. Section III provides information about how other states apportion pass-through income and Section IV looks at the statistics related to the S Corp Tax Credit. Section V concludes this study.

## **II. S Corporation Apportionment Tax Credit**

The S Corp Tax Credit is considered an administrative tax credit. As an administrative credit, the S Corp Tax Credit is not intended to change behavior or encourage economic activity like many other State tax credits. The intent of the tax credit is to make tax treatment of S corporations similar to C corporations who are entitled to apportion income within and without Iowa. A C corporation is a business structure that creates a new, separate, legal entity distinct from its owners. This means that shareholders' personal assets are protected from any liability incurred by the corporation. A C corporation is a taxable entity where income from the activities of the business is taxed on the Iowa corporation income tax return, IA 1120. An S corporation, formed to comply with sub-chapter S of the Internal Revenue Code, provides the same limited liability of a C corporation. However, all income from the activities of the business is passed-through to the shareholders and included on Iowa individual income tax returns. S corporations, required to file the IA 1120S information return annually, are limited to less than 100 shareholders and all owners must be people; shareholders cannot be other corporations or partnerships. Businesses can also be structured as Limited Liability Companies (LLC) which allows for multiple owners, or "members", to benefit from limited liability. The profits or losses of the business organization pass directly through to the members' individual income tax returns.

When businesses conduct activity in more than one state, there are different ways in which each state determines the share of income of the business which is subject to state taxation. In Iowa, a single sales factor is used for apportioning income of C corporations. Single sales factor apportionment determines a business's tax liability based solely on sales within the state as a share of total sales. Other states use three factor apportionment which includes not only sales within the state, but also payroll paid to employees in the state and the value of property located in the taxing state. With three factor apportionment, the three factors — property, payroll, and sales — are

computed as ratios of the taxpayer's presence in the state over the taxpayer's presence everywhere. If a state uses multiple factor apportionment the state dictates whether the factors are considered equally or if they weigh the factors differently. It is up to each state how they determine the apportionment for taxing businesses and whether that apportionment applies to all forms of businesses.

While C corporations are allowed to apportion income before taxation in Iowa, shareholders are required to include all income from the S corporation in calculating taxable income under the individual income tax, even if some of that income results from sales outside of Iowa. The S Corp Tax Credit attempts to equalize apportionment treatment of income between C corporations and S corporations. The S Corp Tax Credit is structured so that the owners of the S corporation effectively pay tax only on the income attributable to Iowa under the single sales factor. Thus the tax credit should result in a similar fiscal impact as if Iowa were to allow S corporations to apportion income prior to pass-through to shareholders.

Iowa shareholders also have the option to claim the Out-of-State Tax Credit on the IA 1040 if the income passed-through from the S corporation is subject to tax by another state. However, taxpayers cannot claim both the S Corp Tax Credit and the Out-of-State Tax Credit. It may be more beneficial for the taxpayer to claim the S Corp Tax Credit instead of the Out-of-State Tax Credit when either sales occur in states without an income tax or when sales occur in states with a lower income tax burden than Iowa. A shareholder who has elected to apportion income by claiming the S Corp Tax Credit and then elects not to apportion income in a tax year, maybe to claim the Out-of-State Tax Credit instead, cannot re-elect to again claim the S Corp Tax Credit for three tax years immediately following the first tax year in which the shareholder elected not to apportion income, unless the Director of the Iowa Department of Revenue consents to the election.

Although similar to S corporations, other pass-through entities must pass-through income to owners attributed to sales outside of Iowa. However, this tax credit does not apply to owners of any other type of pass-through entity. Note that these owners can claim an Out-of-State Tax Credit if the pass-through income was subject to tax by another state, but otherwise, the owners have no other option to equalize tax treatment with C corporations if the pass-through receives income from activities outside of Iowa. To extend tax equity to these other forms of business by making those owners eligible for the S Corp Tax Credit would likely increase claims.

A taxpayer who is an Iowa resident and a shareholder of an S Corporation that conducts business within and without Iowa can claim the S Corp Tax Credit by completing the IA 134 and the IA 148 Tax Credits Schedule. However, the tax credit can only be claimed up to the taxpayer's tax liability as it is nonrefundable with no carry forward, therefore any tax credit in excess of Iowa tax liability expires and cannot be used. The tax credit cannot be transferred, or sold, to another taxpayer. At its inception, the tax credit could only be claimed against individual income tax given that shareholders can only be individuals. Effective beginning in tax year 2013, the S Corp

Tax Credit can be claimed on a fiduciary return filed by estates and trusts as recognition that ownership shares can be passed into a trust.

### **III. S Corporation Apportionment Tax Credits in Other States**

Before considering how states apportion income from pass-through entities, it is useful to discuss how states apportion C corporation income. According to the Federation of Tax Administrators website ([www.taxadmin.org](http://www.taxadmin.org)), twenty states use single factor apportionment and nine states use three factor apportionment. An additional nine states use a double weighted sales apportionment factor and one state uses triple weighted sales apportionment. There are four states that do not tax corporation income. The remaining seven states either offer a combination of methods or have a unique apportionment method.

When looking at how neighboring states handle taxing income from pass-through entities, the first thing that is noticeable is that no other state offers a tax credit similar to Iowa's S Corp Tax Credit (Table 1). Most of Iowa's neighboring states also apportion C corporation income using a single sales factor. With the exception of Wisconsin, all of Iowa's neighboring states apportion pass-through entity income in the same manner as C corporations. In Wisconsin, taxpayers file an Out-of-State Tax Credit for income attributed to another state.

Also of interest is whether S corporations are treated the same as other types of pass-through entities, such as limited liability companies and partnerships. In all neighboring states, except Missouri, the apportionment of income is treated the same for all pass-through entities. Missouri is similar to Iowa in that the apportionment method is only applicable to S corporations. It should be noted that when considering Iowa's neighboring states, South Dakota does not have an individual income tax.

In an effort to find out how other states tax pass-through income, a request for information was addressed to contacts in other state revenue departments. The number of states that responded was relatively low. In addition to the five neighboring states, an additional seven states responded. Four states (Maine, Michigan, Oregon, and Rhode Island) use a single sales apportionment factor. Massachusetts and Kansas use three factor apportionment and Ohio has no corporation income tax, rather it taxes gross receipts of businesses. While Ohio does not have a corporation income tax, shareholders of pass-through entities are required to use three factor apportionment to determine the taxable income. All pass-through entities are treated the same and Ohio does not offer any credit similar to Iowa's S Corp Tax Credit.

Michigan and Oregon tax pass-through income in the same manner as C corporations and all pass-through entities are treated equally. Maine and Rhode Island use single sales factor apportionment for C corporations however they use different methods for pass-through entities. Both Kansas and Massachusetts employ three factor apportionment for C corporations. However, in Kansas all income reported by a

taxpayer on Schedule E from a pass-through entity is exempt from individual income tax. In Massachusetts, shareholders are only required to report income that is sourced to the state based on the formula that C corporations use to apportion income. None of the states have a tax credit that is similar to the S Corp Tax Credit and all of the states treat all pass-through entity types the same.

#### **IV. Analysis of S Corporation Apportionment Tax Credit Claims**

While the S Corp Tax Credit has been available to be claimed since the 1996 tax year, information about those claims has only been available since the 2006 tax year when the IA 148 Tax Credit Schedule was implemented. Since 2006, there have been over 22,000 claims totaling over \$410 million (see Table 3). On average, 2,468 taxpayers claim the S Corp Tax Credit each year with an average claim of \$18,358. Annual claims average \$45.3 million each tax year. On average, of total S Corp Tax Credits available, less than one percent go unclaimed and expire each year. The low expiration is not surprising given that the tax credit is calculated to equal the taxpayer's income tax owed on the share of S corporation income attributed to out-of-state sales.

In the most recent complete tax year there were over 50,000 1120S informational tax returns filed by S corporations doing business in Iowa (see Table 4). This is a good indicator of the number of S corporations located in Iowa which should range between 50,000 and 5 million since each entity has between 1 and 100 shareholders. It also implies that a very small number of shareholders claim an S Corp Tax Credit, between an estimated 5 and 0.05 percent. The low utilization could reflect that many S corporations have 100 percent of sales in Iowa, that shareholders chose to use the Out-of-State Tax Credit, or shareholders are nonresidents and are thus not eligible to claim the S Corp Tax Credit. Keep in mind that it is likely that many shareholders making claims to the S Corp Tax Credit could be shareholders of the same S corporation, thus the number of S corporations responsible for the tax credit claims is likely below the 2,468 average number of claims in a tax year.

Also, of interest is how households that claim the S Corp Tax Credit compare to all other households. As expected, households that claim the S Corp Tax Credit in a tax year generally have a much higher adjusted gross income (AGI) than households that do not file S Corp Tax Credit claims over tax years 2006 through 2013 (see Figure 1). For households without an S Corp Tax Credit claim, nearly 86 percent of households have AGI of less \$100,000, measured in 2014 dollars. That compares to less than 15 percent of households that filed S Corp Tax Credit claims.

In tax year 2013, the most recent year with complete tax data, there were over 98,000 Iowa households that reported profits and/or losses from a pass-through entity on the Schedule E. That compares to just over 2,100 households that claimed an S Corp Tax Credit, where all claimants also reported pass-through income on their Schedule E. An analysis was completed that compared the AGI of households that reported pass-through income on their Schedule E to the AGI of households that claimed an S Corp



Tax Credit (see Figure 2). When looking at households with Schedule E pass-through income, the distribution is much more even across income brackets than in Figure 1 when all Iowa taxpayers were included. However, the skewness of income for taxpayers with S Corp Tax Credit claims compared to non-claimants is still starkly apparent. While 40 percent of households with Schedule E pass-through income reported AGI above \$100,000, 82 percent of households that filed S Corp Tax Credit claims reported AGI above \$100,000 in tax year 2013. Keep in mind that the \$35.0 million in S Corp Tax Credit claims in tax year 2013 translates into as much as \$390 million in non-Iowa source S corporation pass-through income that these taxpayers included on their tax returns, and thus included in AGI, but was effectively excluded from tax as a result of the tax credit claims.

## **V. Conclusion**

While the S Corporation Apportionment Tax Credit is an administrative tax credit, the purpose is to create tax equity between C corporations and S corporations. Many of the states that provided information regarding the taxation of pass-through entity income have similar tax treatment for C corporations and S corporations, but that equity is applied at the point of determining what income is taxable, not through a tax credit like in Iowa. Most states go even further and treat other pass-through entities, such as partnerships and LLCs, in the same manner as S corporations. While expanding the S Corp Tax Credit to include those additional types of pass-through entities would certainly come with a price tag, it would also even the playing field between the different entity types with regard to how they are taxed.

Although an average of 2,400 taxpayers in Iowa claim the S Corp Tax Credit each tax year, this is only a small fraction of shareholders in Iowa S corporations. The claims reduce individual income tax revenues by an average of \$45.3 million each tax year. It is likely that a change allowing S corporations to apportion Iowa-source pass-through income similar to other states would have a similar fiscal impact. However, given the relatively small utilization of the S Corp Tax Credit by Iowa shareholders, it is possible that the tax credit actually results in a lower cost.

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**Iowa's S Corporation Apportionment Tax Credits  
Tax Credits Program Evaluation Study  
Tables and Figures**

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**Table 1. How Corporation Income Is Taxed in Neighboring States**

State	How C Corporations Apportion Income	How Pass-Through Entities Apportion Income	Are All Pass-Through Entities Treated Equally?	S-Corp Apportionment Tax Credit
Illinois	Single Sales Factor <sup>1</sup>	Single Sales Factor <sup>1</sup>	Yes	No
Iowa	Single Sales Factor	All income is subject to tax but owners can file Out-Of-State or S Corp Tax Credit	No, only available for S-Corporations	Yes
Minnesota	Single Sales Factor <sup>2</sup>	Single Sales Factor <sup>2</sup>	Yes	No
Missouri	Eight different methods are available	Eight different methods are available	No, only available for S-Corporations	No
Nebraska	Single Sales Factor	Single Sales Factor	Yes	No
South Dakota	No Income Tax			
Wisconsin	Single Sales Factor <sup>3</sup>	All income is subject to tax but owners can file Out-Of-State Tax Credit	Yes	No

<sup>1</sup> Except insurance companies, financial organizations and transportation companies which have special single-factor apportionment formulas.

<sup>2</sup> If use of the default apportionment system does not fairly determine income, a taxpayer may petition for, or the Commissioner may require, the use of an alternative method.

<sup>3</sup> Some industries have industry-specific methods for apportionment.

Source: Various state departments of revenue

**Table 2. How Corporation Income is Taxed in Other States**

State	How C Corporations Apportion Income	How Pass-Through Entities Apportion Income	Are All Pass-Through Entities Treated Equally?	S-Corp Apportionment Tax Credit
Kansas	Three Factor Apportionment	Income reported on Schedule E from PT is exempt	Yes	No
Maine	Single Sales Factor	Multi-state pass-through entities apportion income and deductions at the entity level utilizing the apportionment formula that applies to C corporations.	Yes	No
Massachusetts	Three Factor Apportionment for most businesses	Shareholders only report income for the pass-through that can be sourced to the state based on the formula that C-corporations use to apportion income.	Yes	No

**Table 2 (continued). How Corporation Income is Taxed in Other States**

State	How C Corporations Apportion Income	How Pass-Through Entities Apportion Income	Are All Pass-Through Entities Treated Equally?	S-Corp Apportionment Tax Credit
Michigan	Single Sales Factor	Single Sales Factor	Yes	No
Ohio	No Corporation Income Tax	Three Factor Apportionment	Yes	No
Oregon	Single sales factor for most businesses	Single sales factor for most businesses	Yes	No
Rhode Island	Single Sales Factor	Three Factor Apportionment	Yes	No

Source: Various state departments of revenue

**Table 3. S Corporation Apportionment Tax Credit Claims, Tax Years 2006 - 2014**

Tax Year	Number of Claims	Total S Corporation Apportionment Tax Credit Available	Total S Corporation Apportionment Tax Credit Claimed	Average Tax Credit Claim	Percent of Available Tax Credits Claimed
2006	2,263	\$48,929,077	\$48,842,238	\$21,583	99.82%
2007	2,425	\$39,589,782	\$39,279,064	\$16,198	99.22%
2008	2,503	\$41,794,941	\$41,375,747	\$16,530	99.00%
2009	2,263	\$33,250,052	\$32,239,585	\$14,246	96.96%
2010	2,525	\$40,341,370	\$39,987,032	\$15,836	99.12%
2011	2,561	\$45,416,928	\$45,284,405	\$17,682	99.71%
2012	2,598	\$60,703,652	\$60,150,207	\$23,153	99.09%
2013	2,552	\$35,040,802	\$35,038,599	\$13,730	99.99%
2014*	2,520	\$65,742,775	\$65,541,701	\$26,009	99.69%
Total	22,210	\$410,809,379	\$407,738,578		
Average	2,468	\$45,645,487	\$45,304,286	\$18,358	99.25%

\* Incomplete tax year

Source: Iowa Department of Revenue

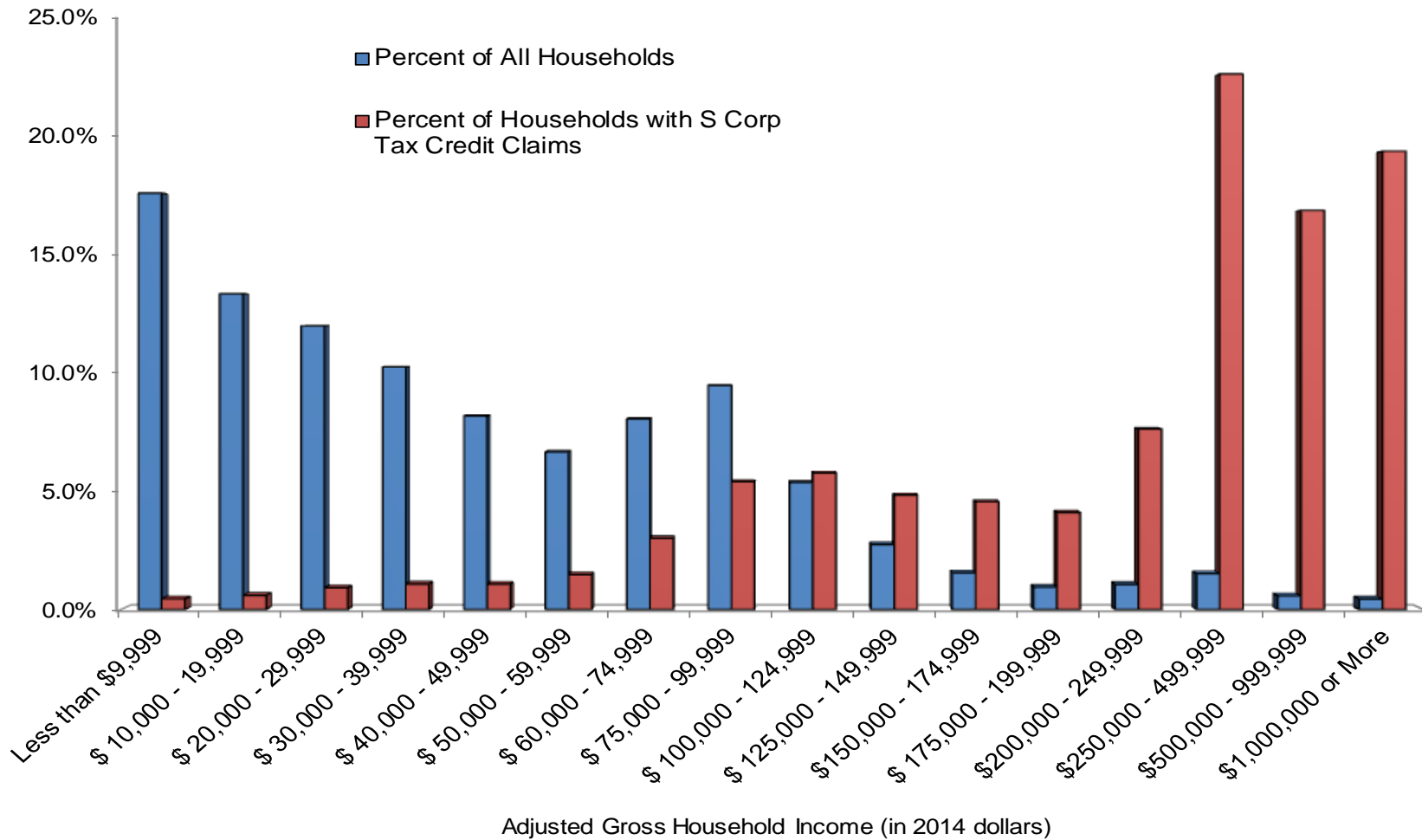
**Table 4. Number of 1120S Returns Filed by Tax Year, Tax Years 2010 – 2015**

Tax Year	Number of S Corporations Which Filed 1120S Returns
2010	46,661
2011	47,615
2012	48,927
2013	49,917
2014	50,473
2015*	21,394

\* Incomplete tax year

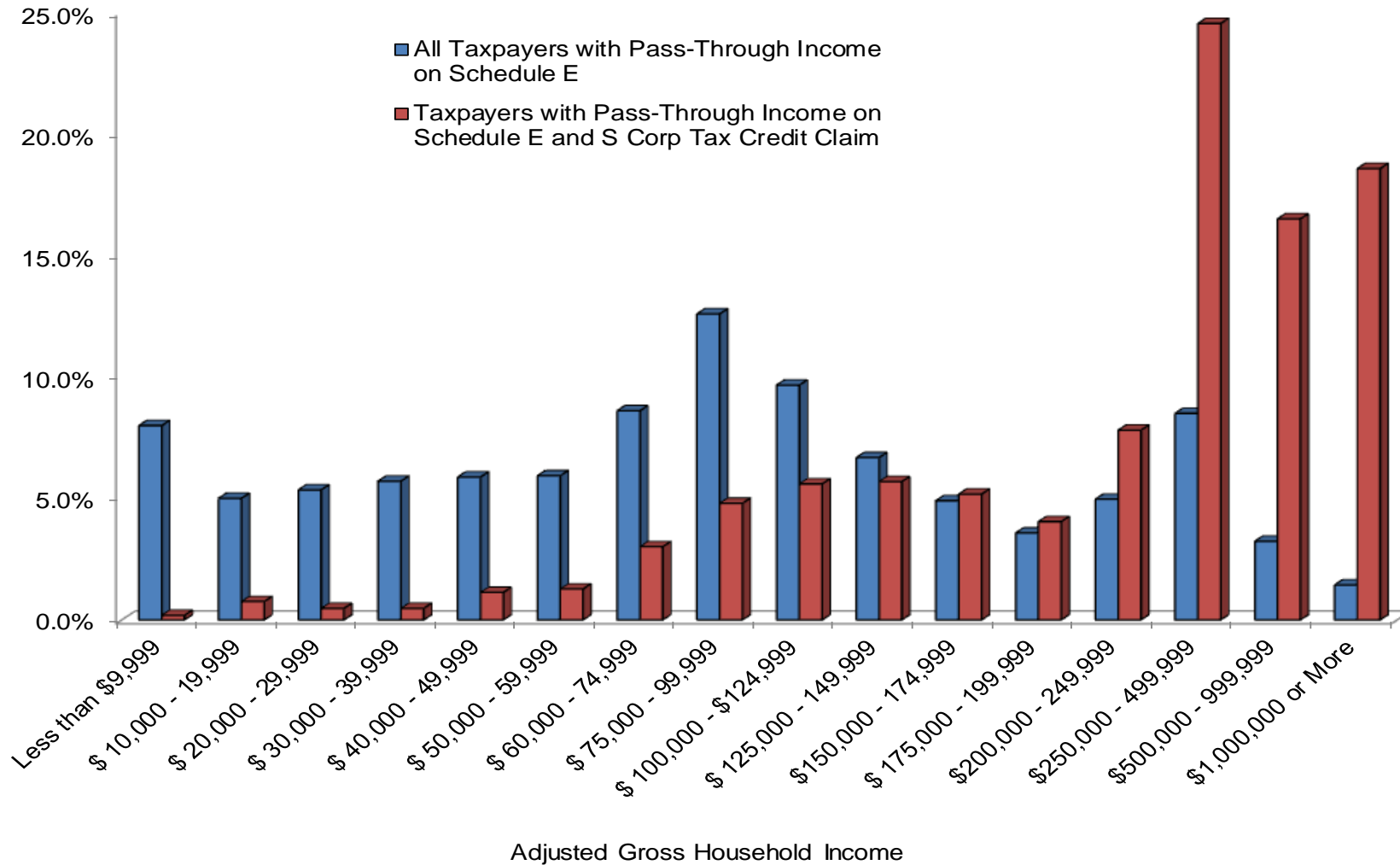
Source: Iowa Department of Revenue

**Figure 1. Adjusted Gross Income of All Households Compared to Households With S Corporation Apportionment Tax Credit Claims, Tax Years 2006 - 2013**



Source: Iowa Department of Revenue

**Figure 2. Adjusted Gross Household Income of All Households with Schedule E Pass-Through Income Compared to Households With Schedule E Pass-Through Income and S Corporation Apportionment Tax Credit Claims, Tax Year 2013**



Source: Iowa Department of Revenue