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

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## **Preface**

Iowa Code Section 2.48 directs the Department of Revenue to review certain tax expenditures it administers. The review shall consist of evaluating the tax credit and assess its equity, simplicity, competitiveness, public purpose, adequacy, and extent of conformance with the original purpose of the legislation that enacted the tax expenditure, as those issues pertain to taxation in Iowa. This is the third 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.

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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 both in Iowa and outside of the state. 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 also 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 tax credit gives S corporation owners' and shareholders the option to apportion income in a manner similar to that which is provided for C corporations. A C corporation is a business structure that creates a new, separate, legal entity distinct from its owners as provided in sub-chapter C of the Internal Revenue Code. 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. S corporations, by contrast, are formed to comply with sub-chapter S of the Internal Revenue Code. They provide, 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 fewer 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 may pay tax only on the income attributable to Iowa under the single sales factor.

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, but claims 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.

A taxpayer who is an Iowa resident and a shareholder of an S Corporation that conducts business both in Iowa and outside of the state 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. Any tax credit in excess of Iowa tax liability expires and cannot be used. The tax credit cannot be transferred 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 Tax Treatment in Other States**

S corporations receive pass-through tax treatment at the federal level, meaning that income is taxed at the shareholder level. Most, but not all, states follow federal treatment for S corporations. Some states (and the District of Columbia), tax S corporations at the entity level, the same as other corporations. These include: District of Columbia, Louisiana, New Hampshire, Ohio, Tennessee, and Texas.<sup>1</sup> Some states, like New Jersey and Rhode Island, allow the individual owners of the pass-through entity an income tax credit for their share of the pass-through entity tax paid by the entity.<sup>2</sup>

Among Iowa's neighboring states, none 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.<sup>3</sup> 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. In addition, S corporations in Wisconsin may now elect to be taxed at the entity level or at the pass-through level.<sup>4</sup>

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<sup>1</sup> Article on pass-through entities state tax treatment in CCH group.com website.

<http://news.cchgroup.com/2019/01/24/state-entity-level-tax-on-pass-through-entities/news/state-tax-headlines/>

<sup>2</sup> Article on pass-through entities state tax compliance in Bradley.com website. <https://www.bradley.com/-/media/files/insights/publications/2017/07/passthroughentitiesfacemyriadstateleveltaxescomplianceobligati.pdf>

<sup>3</sup> Sources: Revenue agencies in respective states

<sup>4</sup> Article on Wisconsin treatment of pass-through entities in BDO.com website.

<https://www.bdo.com/insights/tax/state-and-local-tax/wisconsin-enacts-election-permitting-pass-through#>

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 apportionment 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 other states, most treat limited liability companies (LLCs) and limited liability partnerships (LLPs) the same as other pass-through entities.

#### **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 nearly 53,000 claims totaling over \$892 million (see [Table 2](#)). On average, 2,900 taxpayers claim the S Corp Tax Credit each year with an average claim of \$16,948. Annual claims total \$49.5 million each tax year, on average, with total claims reaching a high of \$73.9 million and the average claim reaching more than \$31,000 in 2023.

For tax years 2012-2023, each year on average, there were 39,000 corporations filing 1120S – Schedule K1 tax returns with pass-through income for almost 60,000 shareholders (see [Table 3](#)). Meanwhile, an average of 3,100 shareholders filed S Corp Apportionment Tax Credit claims per year for that same period. Thus, between 3 and 8 percent of S Corp shareholders claim an S Corp Apportionment Tax Credit each year. The low utilization could reflect that many S corporations have 100 percent of sales in Iowa, that shareholders choose 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 3,100 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. Households that claimed the S Corp Tax Credit in a tax year generally had a much higher adjusted gross income (AGI) than households that did not file S Corp Tax Credit claims over tax years 2006 through 2023 (see [Figure 1](#)). For households without an S Corp Tax Credit claim, approximately 80.4 percent of households had an AGI of less than \$100,000, measured in 2023 dollars. That compares to 9.9 percent of households that filed S Corp Tax Credit claims in that income group.

On average, there were over 93,000 Iowa households that reported income from a pass-through entity on the Schedule E. That compares to fewer than 2,300 households that claimed an S Corp Tax Credit who also reported pass-through income on their Schedule E. An analysis was completed that compared the AGI of these two groups of households (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 quite pronounced. While 49 percent of households with Schedule E pass-through income reported AGI above \$100,000, 92 percent of households that filed S Corp Tax Credit claims reported AGI above \$100,000 over tax years 2013-2023. The \$74 million in S Corp Tax Credit claims in tax year 2023 translates into at least \$823 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**

The S Corporation Apportionment Tax Credit is an administrative tax credit that provides S corporation owners and shareholders the option to apportion income in the same manner as C corporations.

Although an average of over 2,900 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 \$49.6 million each tax year.

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



**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> In Illinois: Except insurance companies, general businesses, financial organizations, federally regulated exchanges, and transportation companies which have special single-factor apportionment formulas.

<sup>2</sup> In Minnesota: 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> In Wisconsin: Some industries have industry-specific methods for apportionment. Effective 2019, S-Corporations may elect to be taxed at the entity level and apply tax credit at that level. The tax credit may not be claimed at the individual shareholder level.

Sources: Revenue agencies in respective states

**Table 2. S Corporation Apportionment Tax Credit Claims,  
Tax Years 2006 – 2023**

Tax Year	Total S Corporation Apportionment Tax Credit				
	Number of Claims	Tax Credit Available	Tax Credit Claimed	Average Tax Credit Claim	Percent of Available Tax Credits Claimed
2006	2,389	\$49,808,047	\$49,703,568	\$20,805	99.79%
2007	2,530	\$39,540,342	\$39,233,619	\$15,507	99.22%
2008	2,633	\$41,708,466	\$41,287,315	\$15,681	98.99%
2009	2,379	\$33,275,224	\$32,294,181	\$13,575	97.05%
2010	2,662	\$40,498,033	\$40,137,718	\$15,078	99.11%
2011	2,744	\$46,422,653	\$46,518,408	\$16,953	100.21%
2012	3,054	\$59,726,791	\$61,156,817	\$20,025	102.39%
2013	2,996	\$35,502,985	\$35,181,873	\$11,743	99.10%
2014	3,087	\$60,059,562	\$59,742,877	\$19,353	99.47%
2015	3,276	\$48,495,254	\$46,978,295	\$14,340	96.87%
2016	3,367	\$45,983,204	\$44,879,557	\$13,329	97.60%
2017	3,514	\$46,550,709	\$44,631,535	\$12,701	95.88%
2018	3,433	\$59,906,303	\$57,522,113	\$16,756	96.02%
2019	3,439	\$50,506,577	\$48,005,074	\$13,959	95.05%
2020	2,927	\$66,943,757	\$63,058,913	\$21,544	94.20%
2021	2,995	\$50,825,911	\$52,564,120	\$17,551	103.42%
2022	2,905	\$56,406,939	\$55,352,568	\$19,054	98.13%
2023	2,312	\$76,568,743	\$73,904,552	\$31,966	96.52%
Total	52,642	\$908,729,500	\$892,153,103		
Average	2,925	\$50,484,972	\$49,564,061	\$16,948	98.18%

Source: Iowa Department of Revenue

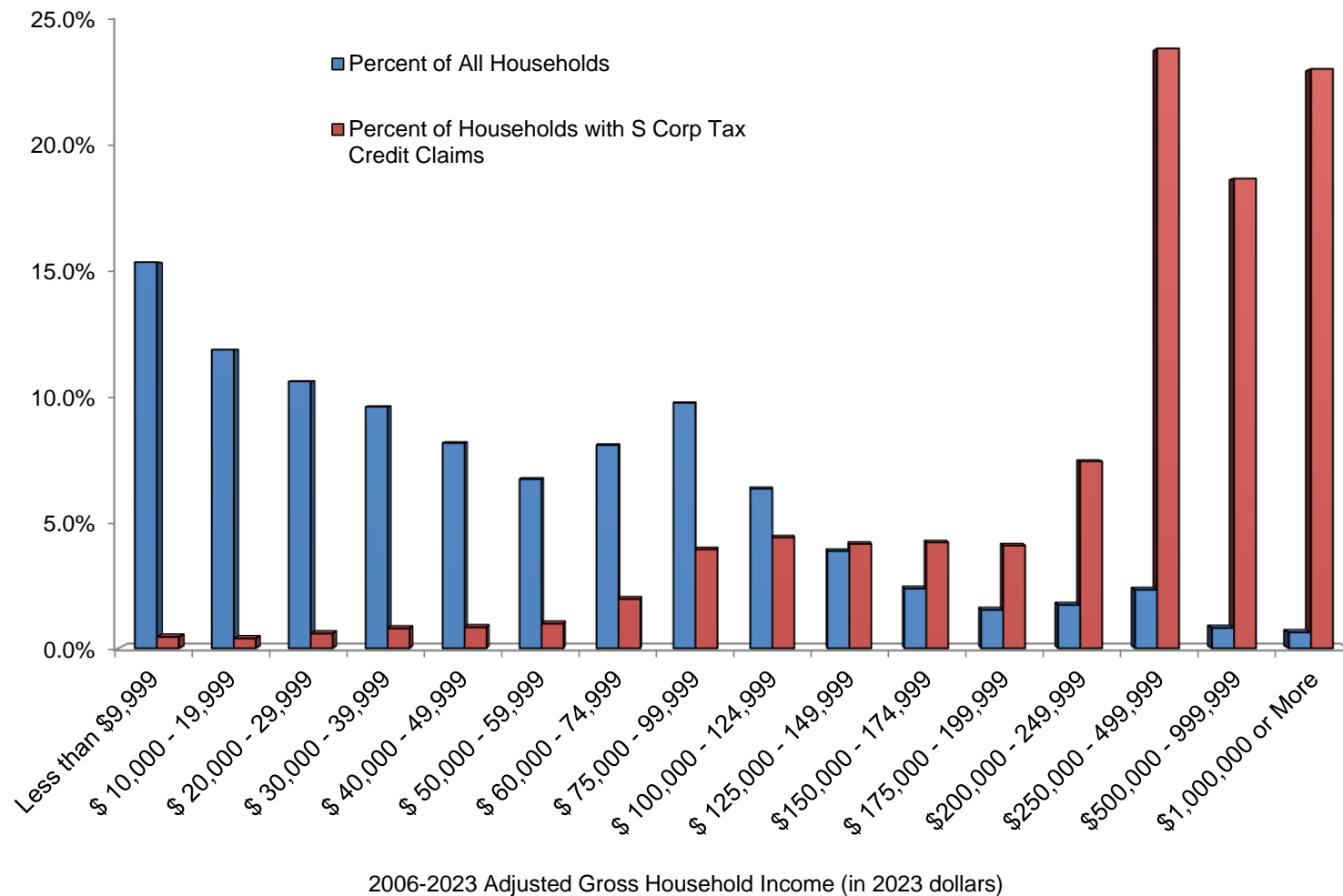
**Table 3. Corporations Filing 1120S SchK1 Returns and Number of Shareholders Claiming S Corp Apportionment Tax Credit**

Claim Year	Number of Corp. filing IA1120S SchK1	Number of Shareholders*	Tax Apportionment Credit Claims	Percent of Total Shareholders
2012	23,052	38,915	3,054	7.8%
2013	28,974	47,818	2,996	6.3%
2014	30,981	50,747	3,087	6.1%
2015	32,748	52,453	3,276	6.2%
2016	35,016	55,510	3,367	6.1%
2017	36,915	57,838	3,514	6.1%
2018	38,692	59,687	3,433	5.8%
2019	40,100	61,364	3,439	5.6%
2020	41,273	62,355	2,927	4.7%
2021	42,579	63,555	2,995	4.7%
2022	59,618	79,410	2,905	3.7%
2023	59,930	78,884	2,312	2.9%
Total	469,878	708,536	37,305	
Average	39,157	59,045	3,109	5.3%

\*Resident shareholders only

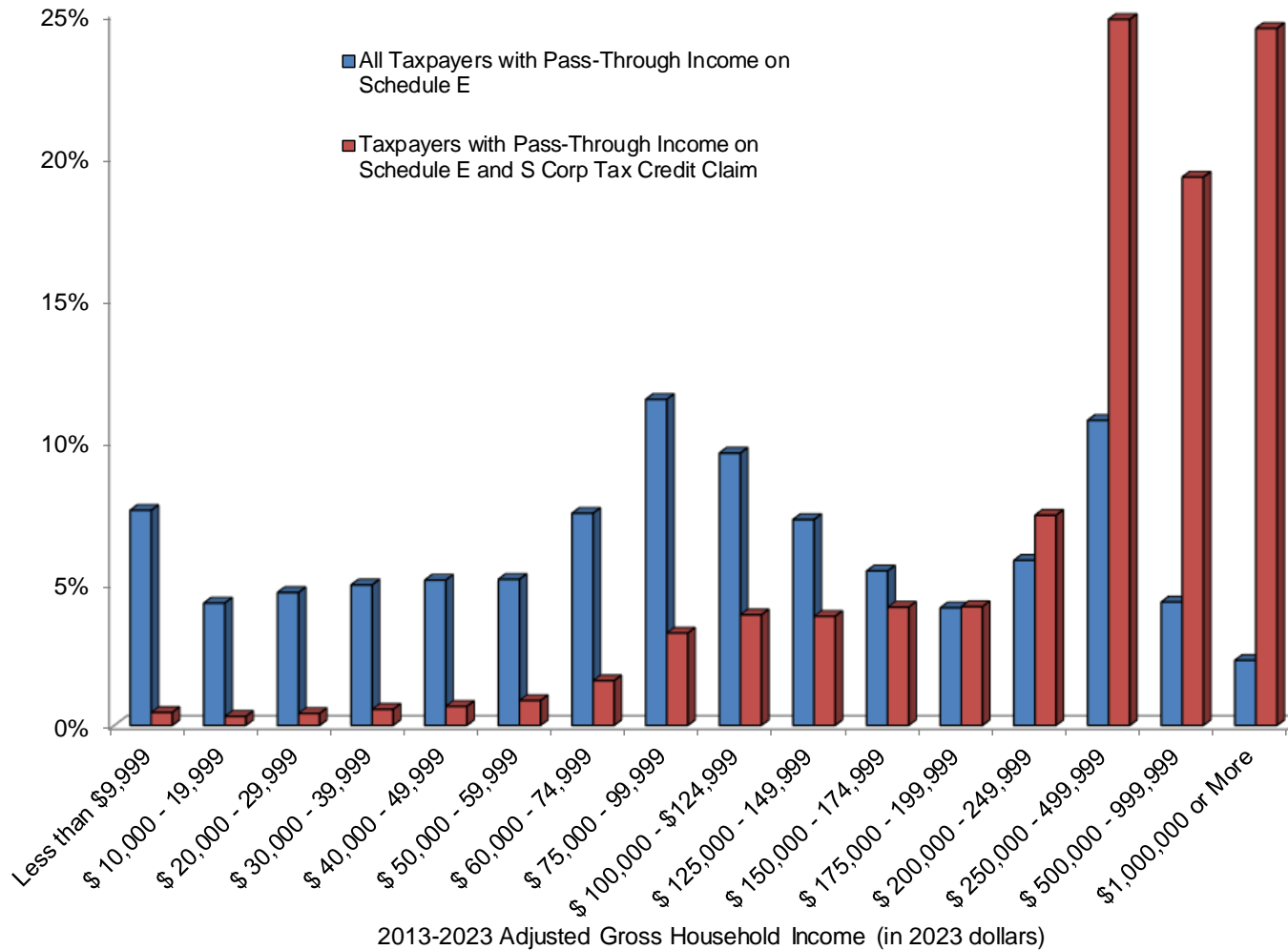
Source: Iowa Department of Revenue, Form IA1120S SchK1

**Figure 1. Adjusted Gross Income of All Households Compared to Households With S Corporation Apportionment Tax Credit Claims, Tax Years 2006 - 2023**



Source: Iowa Department of Revenue

**Figure 2. Adjusted Gross Income of All Households with Schedule E Pass-Through Income Compared to Households With Schedule E Pass-Through Income and S Corp Apportionment Tax Credit Claims, Tax Years 2013-2023**



Source: Iowa Department of Revenue