Iowa and I.R.C. §179 Coupling*

Roger A. McEowen

Kansas Farm Bureau Professor of Agricultural Law and Taxation
Washburn University School of Law, Topeka, KS
and
Tax Director, Agribusiness and Cooperatives, Midwest Region
CliftonLarsonAllen, West Des Moines, IA

roger.mceowen@washburn.edu / roger.mceowen@claconnect.com

Overview

Iowa has historically “coupled” with federal tax legislation, with the exception of first-year “bonus” depreciation. Thus, any change in federal tax legislation is mirrored by Iowa (“coupled”) so that taxpayers have consistency in reporting on both the federal and Iowa returns.

The Problem

In mid-January, Governor Branstad told a business group that he would leave conformity (coupling) with the recently modified I.R.C. §179 (retroactively reinstated to a maximum of $500,000 with a dollar-for-dollar phase-out beginning at $2,000,000 of qualified asset purchases during the tax-year) out of the state budget for fiscal 2016. The result would be that Iowa taxpayers would be limited to a maximum I.R.C. §179 deduction of $25,000 on the Iowa return for 2015 and future years (the Congress made the maximum I.R.C. §179 amount permanent). It should be noted that the maximum expense method depreciation amount has been set at $500,000 since 2010. Iowa has coupled with the federal provision up until 2015.

Note: While many small businesses view I.R.C. §179 as the key tax provision to be coupled with the federal provision, there are numerous other Code provisions involved in coupling, including:

- The exclusion for IRA contributions to charity (I.R.C. §170);
- The exclusion of gain from qualified small business stock (I.R.C. §1202);
- Basis adjustment for S corporation charitable contributions (I.R.C. §1367);
- The built-in gain tax five-year recognition period (I.R.C. §1374);

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• The $250 above-the-line educator expense deduction (I.R.C. §62);
• The exclusion of home mortgage debt forgiveness (I.R.C. §108);
• The qualified tuition deduction (I.R.C. §222);
• The optional state and local sales tax deduction (I.R.C. §164);
• Conservation easement deductions (I.R.C. §170); and
• The deduction for food inventory contributions (I.R.C. §170)

Just with respect to I.R.C. §179, the lack of coupling for 2015 would result in an unanticipated state tax increase for 2015 for those taxpayers that made significant qualified asset purchases in 2015. That would be the result unless the Iowa legislature ignores the Governor’s wishes and includes an I.R.C. §179 coupling provision in legislation this session.

**The Importance of Coupling**

Coupling with the I.R.C. §179 provision is important to agriculture and other small businesses. The lower level of expense method depreciation on the state return (as compared to the federal return) will change some decisions. While it will not likely stop investments in agricultural equipment, it will likely slow down some purchase decisions. The enhanced expense method amount is beneficial to farmers and other small businesses, particularly those that buy qualified assets without financing the purchase price and who do not need to dispose of the purchased assets on which expense method depreciation has been claimed because of low crop prices or other reasons.

**Federal data.** The Tax Foundation has shown the I.R.C. §179 provision to be heavily utilized by small businesses in general and agriculture in particular. The following illustrates this:
As the chart shows, the use of I.R.C. §179 varies widely by industry. Agricultural businesses applied I.R.C. §179 to 38.56% of their investments, the highest percentage of any industry. That is because the agricultural industry is characterized by many small businesses that are able to use the provision without being phased out as would be larger business entities. Those other businesses typically find first-year bonus depreciation to be more beneficial.

### State data

At the Iowa level, Iowa Department of Revenue (IDOR) data involving electronically filed returns for the 2012-2014 tax years indicate that 88,426 returns filed in 2012 claimed I.R.C. §179 and 39.7% of those were returns where a Schedule F was filed. In 2013, 87,081 returns were filed with 37.7% of those being returns with a Schedule F. In 2014, 86,906 returns were filed and 37.8 percent of those had an associated Schedule F. In terms of total dollars of expense method depreciation claimed, in 2012, the number was $2,734,530,303. Of that amount, $1,820,596,133, or 66.6% was claimed on Schedule F farm returns. The total amount increased slightly in 2013 to $2,772,029,790, but the percentage of that amount claimed on Schedule F farm returns dropped to $1,752,132,740, or 63.2%. In 2014, a further reduction to $2,237,489,668 occurred, with 54.2 percent of that amount, or $1,213,672,818 claimed on Schedule F farm returns.

**Note:** For 2012, another 24.8% percent of the total amount of expense

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1 This section is a summary of data compiled by Amy Harris, Chief Economist and Division Administrator, Research and Analysis, IDOR.
method depreciation claimed on Iowa returns was claimed by individual members of flow-through entities, some of which were likely farming operations. That percentage was 27.8% in 2013 and 34.1% in 2014.

**Note:** With respect to the total amount of expense method depreciation claimed in order to account for the approximately 10% of all returns that are not filed electronically, the total amount of expense method depreciation claimed in 2012 was estimated to be $3,138,088,482. In 2013, that number was estimated to be $3,107,656,715, and in 2014 the estimate was $2,477,840,164.

The IDOR data also reveals that most of the Schedule F farm returns claiming expense method depreciation claimed less than $25,000 on the Iowa return for 2012 (51.1% of all Schedule F farm returns claiming some amount of expense method depreciation). However, in 2012, most expense method depreciation ($645,725,933) was claimed on farm returns where $100,000 to $200,000 of expense method depreciation was claimed. In 2013, the highest percentage of farm returns claiming expense method depreciation claimed less than $25,000 (53.6%), but the highest amount ($602,636,255) of expense method depreciation claimed was by those farmers who claimed from $200,000 to $500,000 of the deduction (34.4%). For tax year 2014, the largest user group (63.7%) was again those farm taxpayers that claimed less than $25,000 of expense method depreciation, but the largest total amount of expense method depreciation was claimed by those farm taxpayers claiming in the range of $25,000 to $100,000 of the deduction (36.4%).

To summarize the IDOR data for tax years 2012-2014, agriculture was the heaviest user of I.R.C. §179, and its usage well exceeded the national average of 38.56% as computed by the Tax Foundation based on IRS data for tax year 2012. The data also reveal that the provision is heavily used by relatively small farming operations as well as larger operations.

**Note:** The Iowa data reflect usage of I.R.C. §179 on individual income tax returns. While I.R.C. §179 is utilized on Iowa corporate returns, a lower percentage of those returns are electronically filed. It is possible that there could be less farm usage of I.R.C. §179 on corporate returns. The Tax Foundation data cited above tracks corporate investment that is subject to I.R.C. §179. Thus, the reader is cautioned in making direct comparisons of the two data sets.

For 2014, the IDOR data indicate that the amount of I.R.C. §179 claimed by farmers that was less than $25,000 was approximately $161 million.2 Thus, had Iowa not coupled with the enhanced I.R.C. §179 amount allowed on the federal return and the Iowa amount had remained at $25,000, approximately $1.06 billion of I.R.C. §179 would not have been allowed. However, a portion of that amount (approximately 10 percent) would have been allowed as regular depreciation. Thus, a conservative estimate of the amount of I.R.C. §179 disallowed in 2015 due to lack of coupling would be approximately 75 percent of the 2014 amount (not including amounts under $25,000). The 75 percent factor is based on a slow-down over the past few years of the utilization of I.R.C. §179 due to the slowing of the farm economy and the relatively heavier usage of I.R.C. §179 in earlier years. That 75 percent multiplier would yield a disallowed amount of $789 million. Subtracting off the 10 percent that would be allowed as regular depreciation yields a net amount disallowed of $710 million. Multiplying that amount by

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2 The conclusions of the paragraph were expressed by Paul Neiffer, partner with CLA, in his blogpost of Feb. 21, 2016, Farm CPA Today.
an average tax rate of 6 percent yields a cost to Iowa farmers of approximately $43 million. The actual cost would likely be higher because the number does not reflect amounts of I.R.C. §179 reported on partnership and S corporation returns in 2014 (and the associated K-1s).

**Inconsistency of the Governor’s Position**

At the time the Governor announced that coupling on I.R.C. §179 would not be included in his budget proposal because there was no room for it in the state budget, he announced a new $15 million tax credit for “bio-renewable chemical production.” He claimed that the tax credit would be revenue neutral because it would be funded from existing incentive tax credit programs.

The Governor’s proposed budget provides for $277.3 million in fiscal 2017 for tax credits, illustrated as follows:

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<th>Iowa Budgeted Economic Development Tax Credits</th>
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**Capped credits**

- IDED Awarded Sales Tax Refund: 20.1
- Enterprise Zone Program: 3.1
- Enterprise Zone Program - Housing component: 12.6
- High Quality Jobs Program: 15.3
- Historic Preservation/Cultural District Credit: 49.0
- Redevelopment Tax Credit: 7.1
- Renewable Energy Credit: 11.6
- Solar Energy System Tax Credit: 3.8
- Venture Capital Innovation Credit: 5.4
- Venture Capital Fund of Funds: 0.8
- Venture Capital Seed Capital Fund: 2.2
- Wind Energy Production: 1.6
- Workforce Housing Incentive: 5.4

**Total: 137.8**

**Uncapped Credits**

- Biodiesel Blended Fuel: 17.9
- E-15 Gasoline Promotion Credit: 0.3
- E-85 Gasoline Promotion Credit: 2.5
- Ethanol Promotion Credit: 1.5
- Geothermal Heat Pump Credit: 2.5
- Industrial New Job Credit: 40.5
- New Capital investment program ITC: 0.2
- New Jobs and Income Program Tax Credit: 3.1
- Research Credit: 58.5
- Supplement Research Credit: 6.6
- Targeted Jobs withholding Credit: 5.9

**Total: 277.30**

Source:
http://www.iowastateandtax.gov/index_files/2017_BudgetInBrief.pdf
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Tax credits go exclusively to the taxpayers favored to receive the particular credit. Indeed, in Iowa, the Iowa Department of Revenue’s (IDOR) research credit report for calendar year 2014 showed that $42.1 million of the $56.9 million in credits was soaked up by only 16 taxpayers. In addition, IDOR’s data showed that approximately two-thirds of the 2014 credits were “refunds,” meaning that the credit exceeded the taxpayer’s liability for the year, so the state issued a check for the difference. In addition, some of the credits are “refundable.” That means that it is a straight-out cash subsidy to those taxpayers whose credit exceeds their state tax liability.

**Note:** One of the refundable credits is the Research Activities Credit. According to the IDOR 2015 Research Activities Credit Annual Report, $57,147,847 in research credits were claimed in 2015, with corporations claiming slightly more than $50 million of that amount. Of that total, the “refunded” amount exceeded $44 million with approximately $42 million of that refunded to corporations. **Eight** corporations claimed the credit in excess of $1 million in 2015 totaling over $35 million of the $57 million handed out in 2015.
By contrast, the I.R.C. §179 deduction can be utilized by any non-rental business with taxable income that buys qualified fixed assets (up to $2.5 million annually). It makes no difference what type of business is involved, and whether or not that business is politically favored.

The Iowa Legislative Service Bureau, for fiscal year 2015, estimated an $88.5 million revenue loss due to conformity with I.R.C. §179. The estimate is a $97.6 million reduction in revenue for fiscal year 2016. However, that number is misleading as stated by itself. Without coupling on I.R.C. §179, the state obviously would show more revenue in the first year without coupling than with coupling. However, without coupling, the enhanced I.R.C. §179 amount is not available with respect to an asset which means that relatively more income tax basis remains available for depreciation to be deducted on the Iowa return. That’s a key point because it means that while the state would show a revenue gain in year 1, increased depreciation deductions would be claimed in the succeeding years which would translate into less revenue for the state in the out years, everything else remaining the same. For example, the Legislative Services Agency estimates that coupling (see LSA Fiscal Note on HF 2092, introduced into the Iowa Senate on Feb. 4, 2016) would result in a revenue increase in fiscal year 2017 exceeding $10 million, and almost $60 million over the first five years alone. So, over the long run, whether the state couples or not is effectively “revenue neutral.” By contrast, tax credits remain in place every year – as noted above, $277.3 million for the next fiscal year. The credits generate no offsetting revenue in future years.

Whether credits are better for the Iowa economy than an ag or other small business that is incentivized to buy new equipment and other qualified assets because of coupling with the enhanced I.R.C. §179 is an open question. But, credits are typically not closely analyzed for their anticipated costs and benefits before they are enacted. Instead, the credits seem to flow from effective lobbyists and end up picking winners (those who get the credit) and losers (those that don’t receive the credit). Expense method depreciation is not concerned with picking winners and losers. All small businesses with business income can benefit.

**Impact of Lack of Coupling**

As noted earlier, Iowa has coupled with the federal Code provisions on the enhanced I.R.C. §179 amount since 2010. If that is not done again for 2015, that will result in an unexpected tax increase for those businesses that bought qualified assets in 2015. It also means that those taxpayers will have to maintain a separate Iowa fixed asset schedule for assets that the taxpayer would have otherwise been able to write off. As applied to farmers, for those who made significant asset purchases in 2015, the inability to deduct the bulk (if not all) of the purchase price of those assets will result in an unanticipated tax increase for 2015. Given the significantly lower crop prices in 2015 as compared to prior years, the lack of I.R.C. §179 coupling would add insult to injury. It would also be a symbolic victory of selected businesses over Iowa farming operations. Iowa farming operations will get a tax increase that will be used to pay for subsidies for favored businesses.

**Summary**

The unexpected lack of conformity with the enhanced I.R.C. §179 will trigger a state tax increase for many Iowa farming operations for 2015. While the revenue increase from lack of coupling occurs in year one, enhanced depreciation deductions in subsequent years negate that revenue increase. Thus, coupling is typically revenue neutral over a five-year period. Also, the I.R.C.
§179 deduction is available regardless of the type of business claiming it. Far more businesses potentially benefit from coupling than do those shown special favoritism by special tax credits as the Governor prefers.

**Update:** Shortly after the circulation of this paper in mid-February, the author met with the Iowa Secretary of Agriculture and communicated with the Secretary of the Iowa Department of Revenue and the Governor’s office concerning the issue of coupling and the need to extend the farm filing deadline beyond March 1. On February 26, the author was notified that the farm filing deadline would be extended by the IDOR. On February 29, the author and Nicholas Pirotte (also of CLA) met with Governor Branstand to discuss the issue. Shortly thereafter, the Governor announced a change of heart on the coupling issue and negotiations began with the Iowa Senate on the coupling issue (the Iowa House had earlier passed a coupling bill). A few days later a deal was reached with the Senate on a full coupling bill (SSB 3171) resulting in Iowa allowing up to $500,000 of expense method depreciation on the Iowa return for 2015. The bill, redesignated as HF2433, passed the House on March 15, 2016 by a 79-18 margin and then passed the Senate unanimously later the same day. The Governor signed the bill on March 21, 2016.