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Fiscal Note

Fiscal Services Division

HF 2638 – Retirement Income Exemption, Deferred Compensation Plans (LSB5596HV)
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Fiscal Note Version – New

Description

House File 2638 excludes up to $500,000 of a nonqualified deferred compensation plan or attributable earnings from the computation of net individual income tax for someone who is disabled, 55 years of age or older, or the surviving spouse of an individual or a survivor having an insurable interest in an individual who would have qualified for an income tax exemption.

The Bill applies retroactively to tax years beginning on or after January 1, 2024.

Background

Beginning in tax year (TY) 2023, 2022 Iowa Acts, House File 2317 (Income Tax Rate Reduction and Exemptions Act) exempted all income defined as retirement income from the State individual income tax for disabled taxpayers and taxpayers aged 55 years or older. The exemption also applied to a deceased person's retirement income that is received by a surviving spouse or a person with an insurable interest in the deceased person. House File 2317 did not alter the full retirement pay exemption available to retired military personnel, which is not based on age or disability. House File 2317 also excluded retirement income from the calculation of Iowa's universal and age-based low-income full exemptions from individual income tax.

According to the Internal Revenue Service, a nonqualified deferred compensation plan is an elective or nonelective plan, agreement, method, or arrangement between an employer and an employee to pay the employee compensation in the future. A qualified deferred compensation plan is subject to compensation deferral limits, similar to 401(k) and 457(b) plans, while a nonqualified deferred compensation plan is deferred compensation with no federal legal deferral limit that is subject to tax at a later date. 42 C.F.R. §413.99 defines qualified and nonqualified compensation plans for federal tax purposes. Nonqualified deferred compensation plans do not adhere to federal requirements specified in 26 U.S.C. §401(a). Nonqualified compensation plans may be used by individuals who already contribute the maximum to qualified compensation plans and represent another method for tax-free retirement contributions. Nonqualified compensation plans do not allow early distributions, loans, or rollovers (unlike qualified plans), and tax must be paid on distributions when made. Nonqualified compensation plans can have varying structures, compositions, and conditions for disbursements.

The Iowa Department of Revenue (IDR) submitted a rulemaking to the Administrative Rules Review Committee in February 2024 that listed qualified retirement income for income tax exemptions. Nonqualified deferred compensation plans described in 26 U.S.C. §409A do not qualify for an income tax exemption under current Iowa law, per the IDR.

Assumptions

- Under the Bill, there are taxpayers in Iowa who will realize income tax benefits from their deferred compensation plans, although the IDR does not have an informed estimate of these fiscal impacts.

- The Bill will have a negative fiscal impact on the General Fund and local surtax due to the reduction in income tax liability.

Fiscal Impact

House File 2638 would have a negative fiscal impact on the General Fund, although an estimate cannot be made due to a lack of information on deferred compensation plans in Iowa.

Sources

Internal Revenue Service
Iowa Department of Revenue
Legislative Services Agency

/s/ Jennifer Acton

March 4, 2024

Doc ID 1447496

The fiscal note for this Bill was prepared pursuant to Joint Rule 17 and the Iowa Code. Data used in developing this fiscal note is available from the Fiscal Services Division of the Legislative Services Agency upon request.

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