

Revitalizing Iowa's Corporate Income Tax

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Iowa Fiscal Partnership

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Iowa Fiscal Partnership

The Iowa Fiscal Partnership is a joint initiative of the Iowa Policy Project and the Child & Family Policy Center, two nonprofit, nonpartisan Iowa-based organizations that cooperate in analysis of tax policy and budget issues facing Iowans. IFP reports are available on the web at <http://www.iowafiscal.org>.

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The Iowa Policy Project

Formed in 2001, the Iowa Policy Project uses promotes public policy that fosters economic opportunity while safeguarding the health and well-being of Iowa's people and the environment. Based in Mount Vernon, IPP's principal office is at 120 N. Dubuque St., Iowa City, IA 52245.

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Executive Summary

April 2006

Revitalizing Iowa's Corporate Income Tax

By Peter S. Fisher

Iowa's corporate income tax collections have been on the decline for at least two decades. Between 1981-84 and 2001-04, average annual corporate income tax revenue fell in real terms from \$272 million to \$126 million, a drop of \$146 million or 54 percent. In the early 1980s, the corporate income tax accounted for 6.9 percent of state tax revenue; in the most recent period, it generated only 2.4 percent. What accounts for this precipitous decline, and what can and should be done to reverse it? And if it raises so little money, why tax corporations at all? These are the questions addressed in this report.

Why Have Corporate Tax Revenues Fallen So Far?

There appear to be four principal reasons for the decline of the state corporate tax in Iowa:

- (1) About one-fourth of the \$146 million drop in Iowa corporate tax revenue since the early 1980s is attributable to tax credits enacted since 1984; these credits cost about \$36 million annually in the 2001-04 period.
- (2) The increasingly aggressive use of tax avoidance strategies by corporations has been identified as a major cause of declining state tax revenues nationally. Estimates of the multi-state Tax Commission and the Iowa Department of Revenue suggest that these tax avoidance measures produce annual revenue losses in excess of \$50 million in Iowa.
- (3) Iowa's relatively slow growth could have accounted for about a 12 or 13 percent drop in revenue, or another \$35 million, though this can be only a rough estimate. Because multi-state corporations pay taxes only in proportion to their sales in Iowa, Iowa's declining share of the U.S. population and of gross state product, and hence the state's declining share of purchases, results in a declining share of corporate profits apportioned to Iowa.
- (4) Based on national studies, it appears likely that much of the remaining lost revenue, in the neighborhood of \$25 million, is attributable to the increasing use of pass-through entities in place of traditional or C corporations. Subchapter S corporations and Limited Liability Companies and Partnerships have become increasingly popular over the past 15 years. Under these forms of organization, profits are passed through to individual shareholders or partners, who pay taxes on the profits under the individual income tax. Thus some of the decline in corporate tax revenue has been offset by more business income being taxed under the individual income tax. There remains a question

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as to whether the out-of-state owners of such pass-through entities are paying all of the Iowa income tax that is due and whether the state is taking measures to ensure that they do. Investigation of this issue is beyond the scope of this report.

The decline in corporate tax revenue has been sharper in Iowa than in most states with a corporate tax, both in absolute terms and as a share of state tax collections or of gross state product. In part, this may be attributed to Iowa's slow growth, but it also appears that some features of Iowa tax law make the state particularly susceptible to tax avoidance, and Iowa has not adopted measures that have been implemented in other states to counter aggressive tax planning.

The Case for the Corporate Income Tax

The case for taxing corporations begins with a simple issue of fairness. Corporations doing business in Iowa benefit from the investments that Iowa state and local governments have made in education, infrastructure and public safety services. Government is responsible for educating their workers and the children of their employees, for building and maintaining the roads and water and sewer systems that businesses rely upon, and for protecting business property and the employees of the business. Since a corporation's ability to generate profits from Iowa operations depends on public services, corporations should pay their share of the cost of providing those services. Shareholders, the majority of whom reside outside the state, should not get a free ride, earning more dividends because Iowa does not charge them for the public costs of doing business in our state. Neither should consumers across the world benefit from subsidized prices through our failure to charge Iowa producers their share of public costs.

Does the corporate income tax harm economic growth? Much research has been conducted over the past 30 years on the effects of state taxation on state economic growth. The conclusion is that state tax cuts are a marginally effective and very expensive tool for attracting business from one state to another. Since state and local taxes falling on businesses represent only about 1.2 percent of the total cost of doing business in the United States, state tax incentives that reduce this fraction provide very little leverage over the location decision. For the vast majority of investment and location decisions, therefore, tax incentives will be swamped by differences in other economic factors. Furthermore, Iowa's corporate income tax is already among the lowest; Iowa ranked 44th in terms of corporate tax revenue as a percent of state personal income in 2001-02.

Revitalizing Iowa's Corporate Income Tax

Since the 1980s, the actual corporate income tax rates themselves have not changed significantly and do not account for the decline in corporate tax collections. Factors other than tax rates account for this decline. Specifically, the state of Iowa spends in excess of \$30 million annually on corporate income tax credits, and loses in excess of \$50 million to aggressive tax planning measures that exploit loopholes in our tax code. The long-term viability of the corporate income tax depends in large part on the state's ability to limit the revenue drain from tax credits and to ensure that corporate tax avoidance is minimized. These efforts, in turn, require good information on the use, cost and effectiveness of tax credits, and on the mechanisms of tax avoidance and the revenue losses that result.

The state is making significant strides in monitoring the use of tax credits. In fact, the Tax Credits Tracking and Analysis System now being developed by the Iowa Department of

Revenue, in response to state legislation, could become a model for other states. Under this system, all business tax credits that serve an economic development purpose will be tracked and consolidated by taxpayer. This credit tracking system is a prerequisite for conducting analyses of the effectiveness of credits. But this tracking and analysis system should go further. Taxpayers have a right to know how their taxes are being spent, on tax credits just as much as on direct expenditures. Once the tax credit tracking system is functioning, the bottom line — total value of credits used — should be available to taxpayers by recipient. Such disclosure of state tax credit amounts by recipient is required by law in eight states.

We also need a better understanding of the magnitude of the revenue losses from tax avoidance and of the new methods corporate tax attorneys are devising to manipulate taxable income. To this end, we recommend that the Iowa Department of Revenue and Finance be directed to prepare an annual report on tax avoidance and be provided the auditing resources necessary to produce such a report. The report should catalog the kinds of avoidance mechanisms discovered by auditors, identify whether they have been or could be subject to legal challenge, provide an estimate of the revenue losses from their use, and discuss the tax law changes that would eliminate use of the device or strengthen the state's position in challenging their use.

A large number of Iowa corporations pay no corporate income tax. Of the approximately 36,500 corporate returns each year from 1995 through 2003, about 15,200 apportioned income on the basis of sales and therefore reported their gross receipts. Of those, about 8,750 had gross receipts of \$1 million or more, and a little over half of those (about 4,650) paid no Iowa corporate income tax.¹ The taxpayers of Iowa deserve to know why so many large, multistate corporations pay no tax. While firms appropriately pay no tax when they have losses instead of profits, the recession of 2001 is not the explanation. Even during the boom years of 1995-1999, almost half of the large apportioning corporations paid no tax. We should know how much of this is due to tax avoidance (or evasion).

There are a number of things that can be done to deal with the problem of tax avoidance. The most important is the adoption of combined reporting, now in effect in 17 states. Under combined reporting, a variety of profit-shifting strategies (whereby a firm shifts profits to subsidiaries that are not taxed, or taxed at a lower rate) are rendered ineffective, because the parent firm and its subsidiaries are combined for purposes of calculating state tax liability. Other reforms discussed in the report deal with more technical issues in the corporate tax: adopting a better definition of tax nexus, adding a "throwback" provision to the apportionment rules so that so-called nowhere income does not escape taxation, and clarifying the definition of business income vs. non-business income.

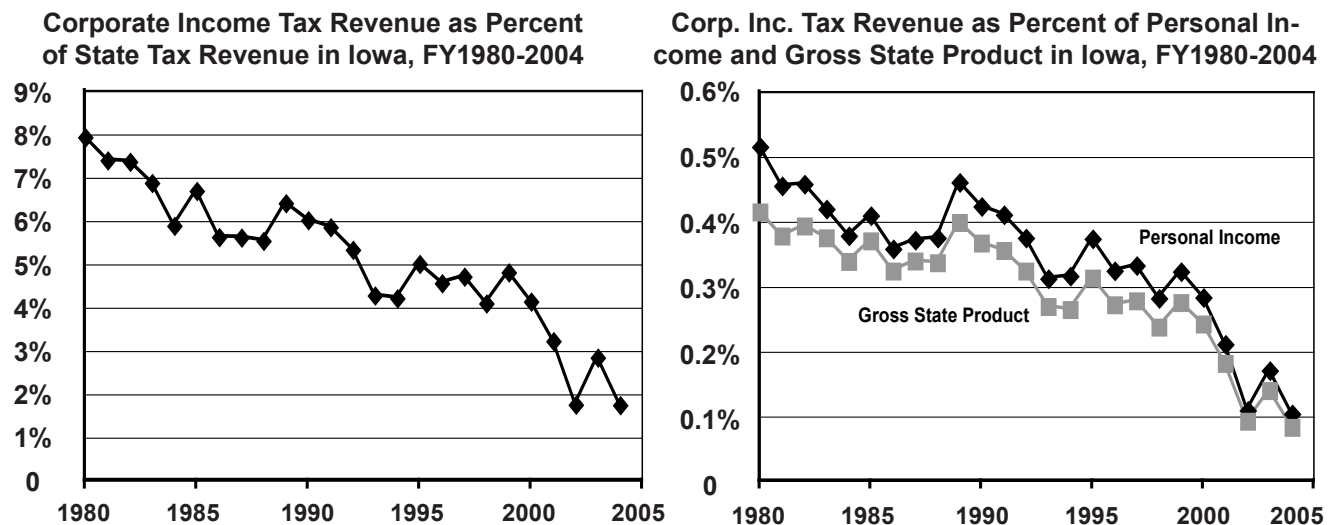
The measures proposed could raise in excess of \$50 million annually in corporate income tax revenue. They would do so while making the state tax system fairer by equalizing the treatment of multistate firms, who are in a position to exploit loopholes in the tax laws, and firms doing business entirely within the state. In the absence of such reform measures, we can expect to see a continuing erosion of revenues as more and more firms decide they can no longer afford to watch their competitors engaging in "aggressive tax planning," with immunity, while they continue to pay their full share of the costs of doing business in the state.

Chapter 1

Is the Corporate Income Tax on its Deathbed?

Iowa's corporate income tax has been on the decline for at least two decades. A glance at the charts below would lead one to conclude, in fact, that it will disappear altogether in the next few years unless it is put on life support soon. Twenty-five years ago, the corporate income tax provided 8 percent of the state's total tax revenue; today it generates less than 2 percent. Twenty-five years ago the tax generated revenue equal to a little over four-tenths of a percent of the value of state output; today it is down to just one-tenth of a percent.

Figure 1. The Decline of Corporate Income Tax Revenue in Iowa, 1980-2004



Source: U.S. Bureau of the Census, Census of Governments, State Tax Collections.

One might be tempted to argue that the recent low point is just due to the recession. After all, the corporate tax is a tax on profits, and we expect profits to fall dramatically in a recession, don't we? There are several problems with this conclusion. First, corporate tax revenues did not rise during the long expansion of the 1990s. Second, they started falling precipitously before the onset of the recession in 2001. Furthermore, corporate profits have not suffered in 2003 and 2004. In fact, the economic recovery has largely been a corporate profit recovery, with little of the benefits showing up in higher wages. Yet the tax has not rebounded.² The charts, in other words, show long-term decline, not a temporary downturn as a result of the business cycle.

To provide a better summary of trends over the past 25 years, we consider three four-year periods: 1981-84, 1990-93, and 2001-04. Each period begins with the first year of a recession, thus providing comparability, since corporate income tax revenue is sensitive to the business cycle. During the first period, the corporate income tax produced \$272 million annually (in 2004 dollars). It accounted for 6.9 percent of state tax revenue and represented 0.43 percent of state personal income (see Table 1). In the most recent period, the tax generated only \$126 million annually (again in 2004 dollars), which was just 2.4 percent of revenue and 0.15 percent of income. Most of this decline occurred since the early 1990s.

If the corporate tax in the most recent period 2001-04 had generated as much revenue as it did 1981-84, as a share of total taxes or of the state economy (gross state product), it would have produced \$345-360 million annually, an additional \$220-235 million each year. The shift away from the corporate income tax means that individuals are picking up a larger share of the tab for state government. The individual income tax and the state sales tax in fiscal 2005 accounted for 73 percent of state tax revenue, up from 67 percent just since 1992. Excise taxes on tobacco products and gasoline, use taxes, the insurance premiums tax, and other minor taxes, account for the rest.

Table 1. Iowa Corporate Income Tax Revenue

| | Tax as a percent of: | | | Revenue (2003-04 dollars) | |
|--------------------|----------------------|-----------------|---------------------|---------------------------|------------|
| | Total State Taxes | Personal Income | Gross State Product | Total (millions) | Per Capita |
| Average: 1981-1984 | 6.9% | 0.43% | 0.37% | \$ 271.7 | \$ 94.0 |
| Average: 1990-1993 | 5.4% | 0.38% | 0.33% | \$ 262.7 | \$ 93.9 |
| Average: 2001-2004 | 2.4% | 0.15% | 0.12% | \$ 125.6 | \$ 42.8 |

Source: US Bureau of the Census, Census of Governments, State Tax Collections.

Why did the state corporate income tax fall so far over this period? Why should we tax corporations to begin with? What can be done to revitalize this important source of state revenue? What can be done to make the tax more transparent and accountable? These are the questions that we address in this report.

How Does Iowa's Corporate Income Tax Work?

The basic structure of Iowa's corporate income tax is described below in the form of an abbreviated version of a hypothetical tax return, which includes the major features of the tax. The numbers shown are for purposes of illustration and are not necessarily representative.

| | |
|---|---------|
| 1. Net income from Federal tax return before federal net operating loss | \$1,000 |
| 2. Less: Deduction for 50% of Federal tax paid | - 200 |
| 3. Equals: Income subject to apportionment | 800 |
| 4. Apportionment percentage (percent of firm's sales destined for Iowa) | 25% |
| 5. Income apportioned to Iowa (line 3 X line 4) | 200 |
| 6. Less Iowa net operating loss carried forward | -20 |
| 7. Equals Iowa Taxable Income | 180 |
| 8. Computed Tax | 21 |
| 9. Less Credits | -5 |
| 10. Equals: Net Tax | 16 |

Chapter 2

Explaining the Decline in Corporate Tax Revenue

In sorting out the causes of the long-term decline in corporate income tax revenue in Iowa, we must first determine whether Iowa is merely a participant in some national trend, or if we are unusual in some respect. It could be that corporate profits have simply become a smaller share of the economy. It could be that changes in the form of business organization away from corporations are reducing corporate tax revenue everywhere. We might find that the base of the federal corporate income tax has changed and, since Iowa conforms to most aspects of the federal base, that this has reduced the base of the Iowa corporate tax. It could be that changes in Iowa tax law and the enactment of incentives and preferences play a role. It has been suggested that Iowa's slow population growth could be a factor. Finally, it could be that corporations have been more aggressively exploiting loopholes in the laws of Iowa and of other states to avoid state corporate income taxes.

National Trends

Revenue from state corporate income taxes has been on the decline nationally for over two decades. In 1980, total state corporate income tax revenue in the United States represented 0.51 percent of total gross state product (GSP). This figure declined by more than half, to 0.27 percent by fiscal years 2003 and 2004. The drop has been much more precipitous in Iowa, however, where the tax as a share of GSP fell to just one-fourth of its 1980 level by 2004. In 1980, Iowa ranked 30th among the 50 states in terms of corporate tax revenue as a percent of gross state product; by 2004 the state's rank had fallen to 46th. As a percent of total taxes in the 50 states, the corporate tax amounted to 9.7 percent in 1980, but only 5.2 percent in 2004. Again, however, the corporate tax fell much more dramatically in Iowa over this same period — from 7.9 percent to 1.7 percent of tax revenue.³

Research has also shown that the average effective corporate tax rate—state corporate tax collections as a percent of corporate profits — has fallen. According to the Multi-state Tax Commission, the average effective rate across all states fell from about 9 percent during the 1980s to 5.9 percent in 2001.⁴ Steven Maguire of the Congressional Research Service finds an average effective state corporate tax rate of about 7 percent in the 1980s, declining to 4.6 percent in the late 1990s, then rising a little to 5.2 percent in 2000-2002.⁵

Are Profits Falling?

Perhaps the corporate income tax has become less important nationally and in Iowa because corporate profits have become a smaller share of total income or economic activity. If profits are a smaller share of GSP, then a tax on profits would be a smaller share of GSP even if nothing else had changed. Corporate profits averaged 8.3 percent of national income in 1980-85, reached 11.0 percent in the boom of the latter 1990s, and averaged 9.9 percent from 2000 to 2004.⁶ Thus corporate profits have become a larger share of national income in the past 25 years, not a smaller share.

Is More Business Income Taxed at the Individual Level?

States have permitted new kinds of business organization — so-called pass-through entities — in recent decades, and enhanced the tax advantages of such entities as well. In addition to the traditional business partnership, there are limited partnerships, limited liability companies (LLCs), and subchapter S corporations.⁷ Businesses established under the laws for such entities are not generally taxed at the business level.⁸ In other words, the partnership, LLC, or S corporation does not itself pay taxes as a regular corporation (or C corporation) would. Instead, all net income is passed through to the individual partners or shareholders, who then report that income on federal and state individual income tax returns. Thus business profits of pass-through entities are taxed under the individual income tax and not the corporate income tax.⁹ If businesses have increasingly been forming as pass-through entities rather than corporations, or have been converting from C- to S corporations, we would see a decline in the share of business profits taxed under the corporate tax and an increase in the share subject to the individual tax.¹⁰

S corporations have been growing rapidly in number due to federal law changes enacted in 1986, 1990, 1993 and 1996. By 2002, S corporation returns had grown to nearly 59 percent of all federal corporate returns filed. The gross receipts reported on the S corporation returns, however, represented only 19.8 percent of total corporate receipts.¹¹ S corporations, by and large, are small. It cannot be assumed that all of this S corporation income would have been reported as C corporation income if Congress had not created the S corporation. S corporations have been formed by many entities, such as law firms, that previously had been partnerships. Still, the increasing popularity of S corporations is a factor in the decline of the corporate tax.

A study of corporate tax return data in Georgia from 1991 to 2002 showed that conversions from C corporations to S corporations over that period produced a 9.5 percent reduction in annual corporate tax revenue by 2002.¹² Other research indicates that the growth of LLCs accounts for a significant share of the decline in state corporate income tax revenue. In fact, the rise of LLCs appears to have reduced state corporate income tax revenue by about a third.¹³

From Internal Revenue Service statistics it is possible to get some indication of the relative importance of S corporations in Iowa vs. the rest of the country. In 2002, S corporation returns were 53 percent of all corporate returns filed with an Iowa domicile.¹⁴ This is a smaller fraction than for the U.S. as a whole. Thus while the increasing use of pass-through entities appears to account for a significant part of the overall decline in state corporate income taxes nationally, a disproportionate decline in corporate tax revenue in Iowa has occurred despite a lower prevalence of S corporations.

Has the Federal Tax Base Shrunk?

The corporate income tax in Iowa is based to a large degree on definitions of taxable income in the federal corporate income tax. While Iowa does not automatically conform to changes in federal law, the Iowa General Assembly has typically brought Iowa law into conformity as each new federal change takes effect.¹⁵

During the 1980s, the federal base declined with the new depreciation provisions in 1981 and then expanded with the base-broadening measures in the 1986 tax act.¹⁶ The result was an increase in the effective federal rate for the decade of the 1980s, and an increase in the

effective state rate overall as states conformed to the federal changes. The federal tax base then shrank about 10 percent in the 1990s, accounting for part of the decline in the average effective state corporate income tax rate during that period. However, researchers have concluded that changes in the federal corporate tax base during the 1980 to 2002 period do not account for the decline in corporate tax revenue at the state level.¹⁷

In Iowa, the corporate tax declined throughout the decade of the 1980s, when the federal tax base was expanding. There have, however, been some recent changes in federal law that were adopted in Iowa and that have caused significant revenue losses. The Iowa Department of Revenue estimates that bonus depreciation, section 179 expensing, and other changes cost the state about \$30 million in 2005, though the state may regain much of the bonus depreciation losses in future years.¹⁸

Has Iowa Enacted More Tax Credits?

The major features of the Iowa corporate income tax have remained constant over the past 25 years: Single-factor apportionment, the deductibility of 50 percent of federal taxes, and the rate structure.¹⁹ But the fine print has changed a lot. The state has enacted a range of special tax credits that have cut corporate tax liability.

The major credits put in place since 1980 are shown in Table 2 and more detail about a few of these credits is provided below. In addition, there are several minor credits enacted in recent years for which no cost estimates are available: The corporation tax credit for certain sales taxes paid by a third-party developer (2004), credit for contributions to an economic development region revolving fund (2005), and renewable energy tax credits (2006). Furthermore, some non-refundable tax credits were made refundable for value-added agricultural and biotechnology firms, thus increasing their cost to the state.

Table 2. Major Corporate Income and Franchise Tax Credits Since 1980

| Credit | Year Begun | Annual Revenue Loss (\$ millions) | |
|--|------------|-----------------------------------|------|
| | | Average: 2001-02 | 2003 |
| Iowa New Jobs Credit | 1985 | 1.7 | 2.4 |
| All research activities credits | | 23.4 | 31.8 |
| Research Activities Credit | 1985 | | |
| Double research activities credit | 1994 | | |
| Alternative research activities credit | 2000 | | |
| Investment Tax Credit | 1994 | 8.3 | N/A |
| Minimum tax credit | | 2.2 | N/A |
| Sub-total | | 35.6 | |
| Venture Capital Credits | 2002 | N/A | N/A |
| New Capital Investment Program | 2003 | N/A | N/A |
| High-Quality Job Creation Program | 2005 | N/A | N/A |
| Wage-benefit tax credit | 2005 | capped at \$10 million | |

Source: Iowa Department of Revenue, "Tax Credits Available for Individual Income, Corporation Income, and Franchise Tax," updated as of July 1, 2005; Iowa Department of Revenue, "Progress Report: Progress on Developing the Tax Credits Tracking and Analysis System," December 2005.

New Jobs Tax Credit

Iowa's New Jobs Tax Credit applies to businesses that have entered into a Chapter 260E job training agreement with an Iowa community college and have increased employment at least 10 percent. The credit is equal to six percent of qualifying wages and cost \$1,224 per eligible job in 2005.²⁰

Research Activities Credits

A business that increases its research activities is allowed to deduct 6.5 percent of its increased research expenditure from its Iowa tax. This is a credit, not a deduction, and it is fully refundable. If the credit is larger than the tax due, the excess credit becomes a negative tax — the state pays you instead of you paying them. An “additional research activities credit” allows an additional 6.5 percent credit for businesses in the New Jobs and Income Program or the Enterprise Zone Program. The “alternative research activities credit,” enacted in 2000, provides an alternative method of calculation that is advantageous to some taxpayers.

In establishing its research activities credits, Iowa allowed corporations (and individual income tax filers) to opt for the best of both worlds in selecting the credit they would use, going well beyond the federal (and most other state) credits. For 2003, the research activities credits on the corporate income tax amounted to \$31.8 million, a 143 percent increase from the \$13.1 million cost in 1999 prior to the addition of the alternative credit. In one year, a single firm received a refund from the state in excess of \$11 million from this credit.²¹

Investment Tax Credit

The New Jobs and Income Program, established in 1994, created an investment tax credit. This allows businesses to take a credit against their taxes equal to 10 percent of the cost of plant and equipment purchased. Estimates are not available for the more recent incentive programs, including the High Quality Jobs Creation Program, which in 2005 replaced the New Jobs and Income Program and the New Capital Investment Program.

It is clear that tax credits have played a role in reducing corporate income tax revenue in recent years. Table 2 indicates that the major corporate tax credits totaled about \$36 million annually in 2001 and 2002, and would be substantially higher than \$36 million in 2003 if the investment and minimum credits were included. These credits continue year after year without scrutiny. Unlike appropriations, tax credits do not require annual action by the General Assembly and often are not subject to any cap on their annual cost.

Slow Growth

A January, 2004 report by the Iowa Legislative Services Agency titled “Iowa Corporate Income Tax Revenue” pointed out that Iowa's population has been growing more slowly than most other states. Sales of goods and services will grow more rapidly in states with more population growth, so that Iowa over time will have become a smaller share of the national market. Since most states apportion the income of multi-state corporations using a formula that relies at least in part on sales within that state, Iowa's apportioned share of the income of corporations selling in national markets has probably declined.

Over the period 1995-2003, multistate apportioning corporations have accounted for on average 75 percent of total Iowa corporate income tax revenue. (There is no discernible

trend in this proportion over the nine-year period). Thus a shift in apportionment could have a significant effect on total revenue. Since slow growth has been a long-term trend in Iowa, this factor may account for part of the long-term decline in corporate tax revenue since 1980.

Iowa's population represented 1.24 percent of the United States population in 1981-84, but fell to 1.02 percent for the 2001-04 period.²² So if nothing else had changed, the 18 percent decline in Iowa's population share (from 1.24 percent to 1.02 percent) itself would produce an 18 percent decline in apportioned income of multi-state corporations.²³ More to the point, Iowa's share of total U.S. gross state product fell from 1.13 percent to .95 percent over this period, a 16 percent drop. Most sales of corporations are to other corporations, not directly to consumers, so GSP may be a better indication of the size of the Iowa market. Since apportioning corporations account for about 75 percent of Iowa's corporate income tax revenue, slow population growth may thus have produced about a 12 percent to 13 percent decline in total corporate tax revenue from 1981-84 to 2001-04.²⁴

Corporate Tax Avoidance

A final explanation for the large loss in tax revenue is that corporations increasingly have exploited a variety of loopholes and accounting devices to reduce their state tax bills. Some have argued that this is the most significant factor behind the general decline in state corporate income tax revenue since the late 1980s. The Multistate Tax Commission estimated that the use of tax shelters reduced state corporate income tax revenue by about 35 percent in 2001.²⁵ A survey of state tax administrators found that "aggressive tax planning" and reduced compliance were the factors most likely to have contributed to declines in state corporate tax revenue. This survey evidence was corroborated by a statistical analysis that suggested tax avoidance and tax planning were major factors contributing to the decline of state corporate tax revenue nationally.²⁶ It is generally acknowledged that, over the last 20 years, the scope of tax avoidance strategies has expanded and firms have been using them more "aggressively," often a euphemism for pushing into the grey area between avoidance and evasion.

Profit Shifting

A common device for reducing state corporate income tax liability involves the shifting of profits from one state where a firm does business and pays taxes, to another state where the firm is not taxed, or is taxed more lightly. In some variants of this practice, the form of the profits is changed (from business income to interest, for example). This device is available, of course, only to corporations with operations (or at least mailing addresses) in more than one state.

One of these devices has become known popularly as the Geoffrey loophole, named for the firm Geoffrey Inc., a subsidiary of Toys "R" Us. Geoffrey Inc. is one of over 600 corporations that have their headquarters in a not very large building in Wilmington, Delaware. These are shell corporations. They have no real staff, and their only function is to serve as a tax-free haven for corporate profits. Geoffrey, Inc, for example, owns the Toys "R" Us trademark, and its only purpose is to collect royalties on that trademark from Toys "R" Us stores across the country. The amount Geoffrey can charge for royalties is not determined in an "arms-length" transaction; it is an arbitrary amount, and the only real constraint is the fear that too blatant use of the device could trigger serious counter-measures by the states.

Here's how the tax loophole works. Toys "R" Us is required to pay Iowa corporate income taxes on the profits it makes from its stores in Iowa. Toys "R" Us deducts from its profits the royalties

its Iowa stores pay to Geoffrey for use of the Toys “R” Us name. Thus, part of the Toys “R” Us profits earned in Iowa disappear, and part of its Iowa tax burden goes with it. Geoffrey Inc. and hundreds of other Passive Investment Companies, or PICs, have been established in Delaware, where they can shift profits that would have been taxable in Iowa and many other states. In Delaware, those profits go tax free because Delaware does not tax royalty income earned by a company whose activities are limited to managing intangible assets.²⁷

Toys “R” Us is not the only culprit here. Table 3 lists some of the other large, multistate businesses that make profits in Iowa and then send them elsewhere to escape tax.

This practice not only robs the Iowa treasury, but also is unfair to local businesses that compete with these companies for sales, and to other national corporations doing business in Iowa that have not resorted to the PIC device to avoid state taxes. Local businesses pay taxes on all their profits; they have nowhere to shift them.

Another form of profit-shifting analogous to the passive investment company maneuver involves loans between a parent and its subsidiary. Suppose a corporation with headquarters in South Dakota, where there is no corporate income tax, has a subsidiary in Iowa. The subsidiary sells its services entirely within Iowa. It files Iowa income tax as a separate entity and pays taxes on all its profits because 100 percent of its sales are within the state. Now suppose the parent firm lends the subsidiary a large sum of money at a high interest rate. The interest costs of this loan will be deducted by the subsidiary on its Iowa tax return, lowering its Iowa net income and Iowa tax. The interest will be income to the parent, but it pays no tax on that income in South Dakota. This is a simple way to transform profits earned in Iowa into interest income earned in South Dakota. And the loan can be perpetually rolled over, creating a permanent deductible expense in Iowa. Similar maneuvers can be employed between parent and subsidiary companies to create other kinds of deductible expenses that shift profits. For example, the out-of-state parent firm could own the Iowa facilities and charge the Iowa subsidiary above-market rent.

Profit-shifting can also be accomplished through a device called transfer pricing. Suppose an Iowa firm, which is a subsidiary of a South Dakota corporation, manufactures GPS systems for golf carts. The Iowa facility sells some of those systems to cart manufacturers in Iowa, and the rest to the parent corporation in South Dakota. It will pay tax on its profits from GPS sales, but only in proportion to the sales to Iowa destinations. Now suppose the Iowa firm sells the systems at a cut-rate price to its corporate parent. This will reduce the profits of the Iowa subsidiary, and hence reduce its Iowa tax liability. (It will also increase the sales factor in the Iowa apportionment formula, but the net effect would still be a substantial decline in taxable income in Iowa.) It will also increase the profits of the South Dakota parent, by reducing its

Table 3.
Examples of Firms Using
the ‘Geoffrey Loophole’

American Greetings
Budget Rent-A-Car
Burger King
CompUSA
ConAgra Foods
Dress Barn
Gap
Home Depot
Honeywell International
K-Mart
Kohls
Long John Silver’s
Marsh Supermarkets
Payless Shoes
Radio Shack
Sherwin-Williams
Stanley Works
The Limited Brands
Tyson Foods
Circuit City Stores
Staples

Source: The Wall Street Journal

costs, but those profits escape taxation because South Dakota has no corporate income tax. Once again, the parent corporation shifts profits out of Iowa to avoid tax here and lower its overall tax bill. This is illustrated in the table below.

Table 4. How Transfer Pricing Can be Used to Shelter Income from Iowa Tax

| | Unit Sales | Price | \$ Sales | Cost/unit | Profit/unit | Profit |
|--|---------------------|---------------------------|-------------|-----------|-------------|-------------|
| <i>Without transfer pricing</i> | | | | | | |
| Sales within Iowa | 10,000 | \$200 | \$2,000,000 | \$100 | \$100 | \$1,000,000 |
| Sales to parent corp. in S.D. | 10,000 | \$200 | \$2,000,000 | \$100 | \$100 | \$1,000,000 |
| Total | 20,000 | | \$4,000,000 | | | \$2,000,000 |
| Iowa share of sales | 50.0% | \$2,000,000 / \$4,000,000 | | | | |
| Profit apportioned to Iowa | \$ 1,000,000 | 50% of \$2,000,000 | | | | |
| Iowa tax at 12% | \$ 120,000 | | | | | |
| <i>With transfer pricing</i> | | | | | | |
| Sales within Iowa | 10,000 | \$200 | \$2,000,000 | \$100 | \$100 | \$1,000,000 |
| Sales to parent corp. in S.D. | 10,000 | \$125 | \$1,250,000 | \$100 | \$ 25 | \$ 250,000 |
| Total | 20,000 | | \$3,250,000 | | | \$1,250,000 |
| Iowa share of sales | 61.5% | \$2,000,000 / \$3,250,000 | | | | |
| Profit apportioned to Iowa | \$ 769,231 | 61.5% of \$1,250,000 | | | | |
| Iowa tax at 12% | \$ 92,308 | | | | | |

Transfer pricing can be employed in other situations. Suppose the GPS manufacturer and the golf cart manufacturer were subsidiaries of the same parent corporation and that both corporations were located in Kansas. However, the golf cart manufacturer has sales offices and hence a tax connection in Iowa. Under current Iowa law, the cart manufacturer would pay Iowa income tax based on the proportion of its sales destined to Iowa. The GPS manufacturer would pay no Iowa tax because its sales are all destined for Kansas. If the GPS manufacturer charges a high price for its components sold to the golf cart manufacturer, this could reduce or even eliminate the profits of the cart firm, and hence reduce or eliminate its Iowa tax (and its tax in any other state where it has sales and a tax connection). It would have no effect on the combined profits of the GPS firm and the cart firm, both firms being part of the same corporate group.

Nowhere Income

As we have explained earlier, multistate corporations must apportion their total profits among the various states in which they are taxable. Each state has rules for apportionment; most apportion using some combination of payroll, property and sales (three-factor corporate income tax apportionment). That is, the share of a firm's income that is apportioned to Kansas is based on the share of its total U.S. payroll and property located in Kansas, and on the share of its sales destined for Kansas. In Iowa, it is based solely on sales (single-factor corporate income tax apportionment).

Not all of a firm's income ends up being apportioned to a state. There is some income that is taxed at the federal level, but is not taxed at the state level. This has been called "nowhere income." It arises when a corporation earns income in a state (or on sales to the federal

government) where it does not have a “taxable nexus” (a taxable connection), because it does not meet definitions for “doing business in the state.”²⁸ In the process of apportioning income to Iowa, that income will not be assigned to Iowa and will go untaxed.

Let’s take a simple example. Suppose John Deere makes a tractor in Waterloo and sells it to a dealer in Illinois. The income on that tractor gets taxed in Illinois because the sale is in Illinois, not Iowa, and John Deere has a tax nexus (it owns lots of property) in Illinois. But suppose instead Deere ships the tractor to a state where the company has no facilities, and no tax nexus. The income on that tractor doesn’t get taxed in that state (no nexus) and the profits don’t get taxed in Iowa either (because the sale is outside of Iowa). That’s nowhere income.

Not all states have a problem of nowhere income. This is because they adopt the “throwback rule,” discussed in the next chapter.

De-Nexed Income

Another loophole in the state corporate income tax has to do with an arcane legal term, “nexus.” “Nexus” means “connection.” A business has a tax nexus if it has a sufficient connection to a state; nexus renders the business subject to that state’s corporate income tax. According to federal law²⁹, a firm is not doing business in a state, if:

- It is only soliciting orders for sales of goods (through salespeople working out of their homes or visiting from out of state) and nothing else.
- Its orders are sent out-of-state for approval, and
- Its orders are filled by shipping goods in from out-of-state.

If a business has a physical presence, such as a store, or if it installs or repairs what it sells, it does have a nexus and can be taxed. Yet businesses can have fleets of traveling salespersons and sell hundreds of millions of dollars of goods in the state and make millions of dollars of profit by doing so, but not be taxable by the state. This also applies to a subsidiary selling an important manufactured part to a single other business, which assembles it into a finished product.

This is a huge loophole. Businesses can establish sales fleets to travel and market their goods, without establishing a nexus. And if businesses need to install or service what they sell (computers, manufacturing equipment, medical equipment), they can create a separate subsidiary to do the installation and service.³⁰ Therefore, the profits from their sales remain free of Iowa income tax even though the service component may be essential to the profitability of the sales operation. The service subsidiary is taxable but need not show a profit because it can simply under-price its services and therefore transfer its profits to the main company. Of course, the company does have to pay taxes in the state where it has a taxable nexus (though this might be a state such as Nevada, where there is no corporate tax).

The nexus loophole can also be used to avoid tax on a manufacturing facility. To see how this works, imagine an auto manufacturer with a plant in Iowa that produces transmissions and ships them to an assembly plant in Alabama, which then sells finished vehicles across the U.S. Since the Iowa plant is owned by the larger corporation, that corporation would pay taxes to Iowa based on its sales of cars in Iowa. Having the plant in Iowa gives the firm tax nexus (it owns property here), allowing Iowa to tax a share of the corporation’s total income (the share apportioned to Iowa on the basis of sales of cars to Iowa). Now suppose the transmission plant is spun off as a wholly owned subsidiary. The parent firm now has no tax nexus in Iowa, since it has no sales facilities here and its manufacturing facilities now belong to a separate legal

entity. The transmission firm files Iowa income taxes as a separate entity and pays no Iowa income taxes because all of its sales are destined for Alabama.

Non-business Income

Multistate corporations do not apportion all of their income. While business income — profits arising from the sale of the firm's goods or services — is apportioned among the states in which the firm does business, non-business income (rents, royalties, capital gains) is generally assigned entirely to the headquarters state. Since Iowa is not home to a large number of corporate headquarters, we do not get to tax much non-business income. More importantly, corporations headquartered elsewhere but taxable in Iowa have an incentive to define as much income as possible as "non-business income" on their Iowa returns. An audit is needed to determine if all of this non-business income is reported as such in the headquarters state; if not, the firm has created more "nowhere income" that goes entirely untaxed. An audit is also needed to determine if the firm has misclassified some business income (which would be taxable in Iowa) as non-business income assigned to the headquarters state, which a firm has an incentive to do if the headquarters state does not have an income tax or if it applies a lower tax rate.

The Cost of Tax Avoidance

How much revenue does Iowa lose in total due to the domestic tax sheltering schemes described above? The Multistate Tax Commission estimated that sheltering was responsible for a \$25 million to \$53 million reduction in state corporate income tax revenue in Iowa in 2001.³¹ The Department of Revenue's estimate of losses from a variety of profit shifting devices and other avoidance strategies was about \$40 million in 2004. It thus appears likely that the overall revenue losses currently are in excess of \$50 million annually. Again, while all states may be subject to such tax avoidance strategies, some states have taken action to restrict these practices. While this does not provide a full explanation for the decline in Iowa's corporate income tax revenue, it appears to play a very significant, contributing role.

Summary

Between the 1981-84 period and 2001-04, average annual corporate income tax revenue in Iowa fell in real terms from \$272 million to \$126 million, a drop of \$146 million or 54 percent. National studies indicate that changes in the federal corporate income tax probably do not account for much, if any, of the decline in state corporate tax revenue over this period. (However, more recent changes have produced a sizable drop in revenue in 2005.) These studies indicate that the major causes of decline are increased corporate tax planning and avoidance, and the shift to pass-through forms of business organization: S corporations and LLCs. States have also greatly expanded the number and scope of tax credits during this period.

It appears that about one-fourth of the \$146 million drop in Iowa corporate tax revenue since the early 1980s is attributable to tax credits enacted since 1984, since these credits cost about \$36 million annually in the 2001-04 period. We also estimated that Iowa's relatively slow growth could have accounted for about a 12 percent drop in revenue, or another \$33 million. Estimates of the Multistate Tax Commission and the Iowa Department of Revenue suggest that the increasingly aggressive use of tax avoidance strategies by traditional C corporations

produces annual revenue losses in excess of \$50 million. From the national studies, it appears likely that much of the remaining \$25 million in lost revenue is attributable to the increasing use of pass-through entities (S corporations and LLCs) in place of C corporations. That this effect is not larger is consistent with data showing that S corporations are not as prevalent in Iowa as they are nationally.

Chapter 3

Why Tax Corporations?

There are those who argue that the corporate tax should be eliminated on principle because it amounts to double taxation. Corporations don't pay taxes, people pay taxes, so we should tax all income at the personal level. Others argue that the decreasing corporate tax burden is a good thing because it stimulates the state economy. Furthermore, they argue, everyone else is doing it, so we have to cut corporate taxes to remain competitive with other states. Finally, some have argued that we should abandon the attempt to tax corporations on pragmatic grounds — it is futile to tax the corporation at the state level, because the corporate tax attorneys will always be two steps ahead of state policy makers and department of revenue auditors.

There also are those who argue that we should not tax individual income, as that reduces the incentive to work and make a profit. There are others who argue against taxing property and against taxing sales. There almost always are arguments that can be raised for exempting activities or items from taxation. At the same time, there are broadly recognized and accepted tax principles that the Iowa Fiscal Partnership has used in examining tax policy that can be applied to whether or not to tax corporate profits. When evaluated against these principles, there is a strong case for the corporate income tax playing a significant role in state tax revenue.

Fairness and the Case for the Corporate Income Tax

The corporate income tax is a tax on profits, and as such it reduces the amount of profits available for distribution to shareholders. So it is certainly the case that the corporation as a legal entity does not bear the tax, but rather particular people — the owners of that corporation — ultimately bear that tax. It is also possible that some of the corporate income tax is shifted to consumers in the form of higher prices.³² Ultimately, all taxes are paid by people — the property tax, the income tax, the sales tax, the gasoline tax.

The fact that the corporate tax is paid by people in no way undercuts the case for imposing the tax. Corporations doing business in Iowa benefit from the investments that Iowa state and local governments have made in education, infrastructure and public safety services. Government is responsible for educating their workers and the children of their employees, for building and maintaining the roads and water and sewer systems that businesses rely upon, and for protecting business property and the employees of the business. Since a corporation's ability to generate profits from Iowa operations depends on public services, corporations should pay their share of the cost of providing those services. Shareholders, the majority of whom reside outside the state, should not get a free ride, earning more dividends because Iowa does not charge them for the public costs of doing business in our state. Neither should consumers across the world benefit from subsidized prices through our failure to charge Iowa producers their share of public costs.

It is true that corporations pay other taxes to support public services, most notably local property taxes. But a balanced system of taxation would include taxes on profits, since businesses vary widely in the importance of real property. Some very profitable businesses may have relatively little in the form of taxable real property while others are property intensive. The deductibility of local property taxes on the state corporate tax helps to offset these disparities, reducing the net burden of the property tax for property intensive firms, and making sure that firms that pay little in property taxes do contribute to financing public services.

Another fairness issue has to do with the double taxation argument. For corporations, profits are taxed at the corporate level, and then the portion of after-tax profits that is distributed as dividends is taxed on the individual level, since the dividends are part of taxable income for the shareholders. While this has been used as an argument for not taxing dividends, it has been shown that much of dividend income (as much as half) has not in fact already been taxed but has escaped taxation at the corporate level.³³ On the other hand, not all corporate income that is taxed is distributed as dividends, so abolishing the corporate income tax would go well beyond the elimination of double taxation.

More to the point, were Iowa to abolish the corporate income tax, it would be providing the bulk of the tax relief to nonresident shareholders, since the bulk of the corporate income tax is paid by apportioning corporations (who are therefore multi-state operations, not small Iowa family corporations). Furthermore, Iowa is not collecting personal income tax on those dividends to out-of-state residents and therefore is not imposing double taxation on the bulk of corporate profits.

A basic principle of tax fairness is horizontal equity: taxpayers with equal ability to pay should pay about the same amount of taxes. To maintain horizontal tax equity, changes should be made in Iowa's corporate income tax to ensure that corporations operating largely within the state are not disadvantaged by policies that permit corporations with multistate operations and out-of-state subsidiaries to engage in tax avoidance. Furthermore, in a world where investments in human capital are more critical than ever, and where over half of the state budget goes to education and other human capital programs, it is only fair that the corporations benefiting from those public investments contribute to their financing.

The Corporate Tax, Economic Competitiveness and Economic Growth

Another principle of good tax policy is that it should not serve as a disincentive to economic growth and that any exemptions or incentives should serve a broader public purpose.

Much research has been conducted over the past 30 years on the effects of state taxation on state economic growth. The conclusion is that state tax cuts are a marginally effective and very expensive tool for attracting business from one state to another. Since state and local taxes on businesses represent only about 1.2 percent of the total cost of doing business in the United States, state tax incentives that reduce this fraction provide very little leverage over the location decision. For the vast majority of investment and location decisions, therefore, tax incentives will be swamped by differences in other economic factors.³⁴

The typical tax incentive package offered by a state to attract manufacturing investment can be expected to be a decisive factor in the location decisions of firms in only about one in 10 instances. Ninety percent of the tax revenue lost from incentives thus goes to firms who would

have made the same location decision without the incentives, and thus represents an inefficient use of the state's resources. Furthermore, if public services must be cut to finance the tax incentives, even this minimal level of effectiveness will in all likelihood be lost. Public services matter to business. Tax and service cuts can actually have a negative effect on state growth in the long term, undermining the state's ability to finance the investments in our workforce and infrastructure that provide the foundations for growth.

Iowa has established a wide array of business incentives but has produced little hard evidence that these incentives actually produce economic growth.³⁵ Providing such tax breaks and incentives as a stimulus to the economy needs to be weighed against other strategies to stimulate growth for which there is a clear public purpose, such as maintaining a strong system of education and workforce training.

Revenue Adequacy and Balance: Is It Really Hopeless?

A third important tax principle related to the corporate income tax is the need for a stable revenue base. On its face and unlike some other revenue sources, corporate activity and profits should grow over time and should help to diversify Iowa's funding base, provided it is structured to reflect changes in the structure of corporate Iowa and America.

Over the past several decades Iowa has suffered more drastic declines in corporate tax revenue than most other states. This has put greater demands upon other parts of the tax system. Clearly it is possible to devise state tax policy that maintains a larger revenue stream from the corporate income tax and to do so while adhering to recognized tax principles; other states have apparently been successful in doing this. In the next chapter we provide an outline of how reform can be accomplished. It is possible to increase corporate income tax revenues and make the tax fairer, without harming the state's economic competitiveness.

Chapter 4

How to Revitalize Iowa's Corporate Income Tax

The challenge for Iowa policy makers is to enact reform that levels the playing field and stabilizes this potentially significant source of state revenue. As we saw in Chapter 2, the major causes of revenue decline subject to state policy were the expansion of tax credits and the increasingly aggressive use of tax avoidance mechanisms. In the next chapter we will discuss measures to insure that corporate tax incentives and tax credits are more transparent, subject to oversight and review, and used in a more cost-effective way. In this chapter, we focus on measures to address corporate tax loopholes.

Plugging the Nexus Loopholes

We do not know how much revenue the State of Iowa is losing because of corporations taking advantage of ambiguities in nexus rules. A first step, then, would be to require all corporations selling goods in Iowa, or delivering goods into the state, to publicly disclose the volume of those sales. This would apply to all corporations with Iowa sales, whether or not they currently file a corporate income tax.

A second step would be to adopt the guidelines recommended by the Multistate Tax Commission (MTC). These guidelines define clear thresholds for in-state business activity that establish nexus for purposes of the corporate income tax, and thus remove the ability of firms to claim that they are exempt because they fall within the "gray area" of the nexus rules.³⁶

A third step would be to amend state law to incorporate two provisions:

- The State of Iowa asserts corporation income tax nexus to the limits permitted by the U.S. Constitution and applicable federal law.
- The state considers corporations selling services and intangibles into the state to have corporate income tax nexus if they engage in regular and systematic solicitation of the Iowa market.

Finally, Iowa could take advantage of the fact that state government is a significant purchaser of goods and services from corporations. Iowa could insist, in its procurement policies, that goods are purchased from businesses that actually have a taxable nexus in the state. (At a minimum, this could require that businesses state whether or not they do have a taxable nexus in the state, as a start at some public accountability.)

Giving Nowhere Income a Home

As pointed out above, a loophole in Iowa's apportionment formula allows some corporate income to escape taxation in any state. Iowa could follow the practice of a number of states by requiring that sales from Iowa to a state where the corporation has no taxable nexus be "thrown back" to Iowa. In our example, the profits on the tractor produced in Iowa and then shipped to a nowhere state get thrown back to Iowa, because that's where the tractor was produced.

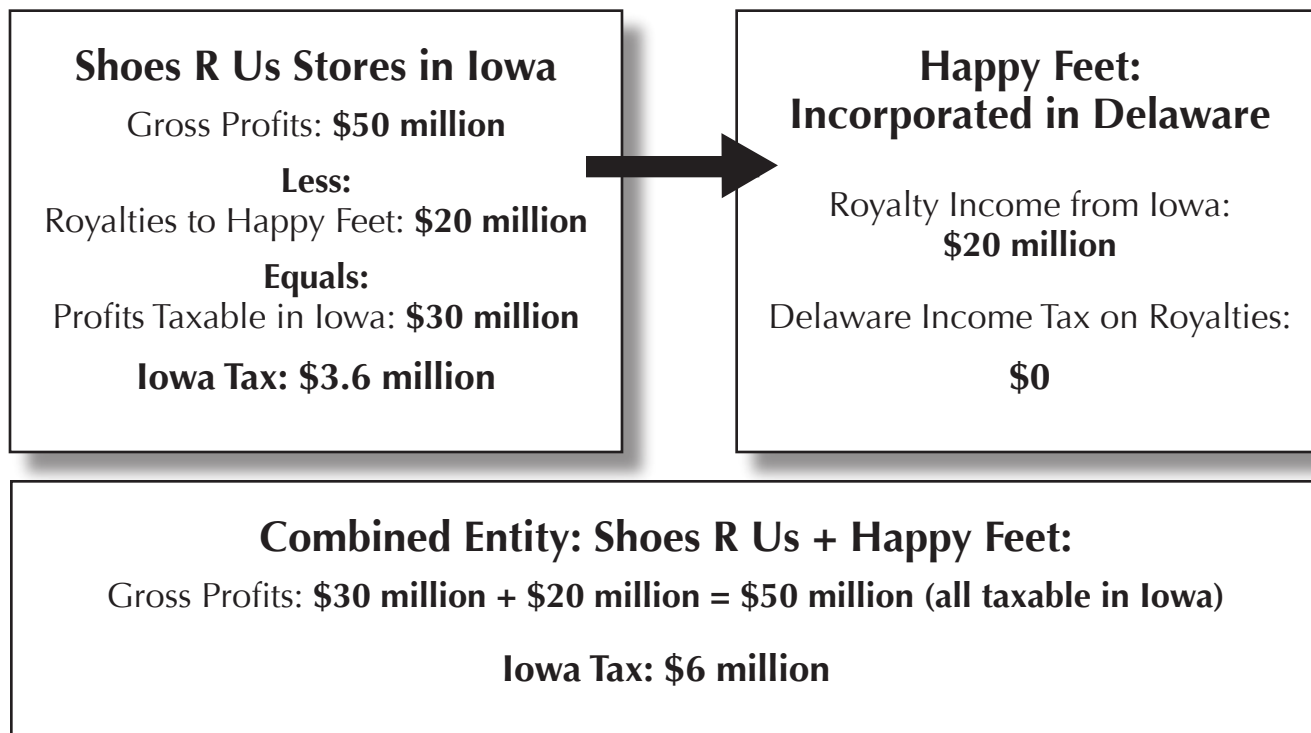
Most Iowa businesses get their income from their sales and activities in Iowa. Yet they also may compete with multistate corporations that make profits all over the country. To be fair, both should be taxed on all the income they make.

To solve the other “nowhere income” problem — arising when non-business income is misreported and goes untaxed — the state should share information with other states to ensure that non-business income declared on the Iowa return (and not apportioned to or taxed by Iowa) is fully reported on the firm’s tax return in the headquarters state, where such income should be assigned and taxed. Iowa should also adopt the MTC regulations that detail when income may be apportioned.³⁷

Adopting Combined Reporting

Fourteen states (including Illinois, Nebraska and Minnesota) have closed the PIC or Geoffrey loophole by requiring “combined reporting” of profits. Under combined reporting, all profits from the in-state business (such as the Toys “R” Us stores) and any out-of-state subsidiaries (such as Geoffrey Inc.) must be combined and reported on the Iowa return, including any royalties earned by the PIC subsidiaries. The royalty deduction no longer reduces the company’s taxable profits because it is added back in as income for the subsidiary. Toys “R” Us then is taxed fairly on the legitimate profits made in the state.

An imaginary example of how the PIC loophole shifts profits and reduces taxes, and how this benefit is eliminated through combined reporting, is shown below:



Combined reporting also eliminates the gains from other methods of profit shifting. The shifting of profits from an Iowa subsidiary to an out-of-state parent through the charging of interest on loans from the parent to the subsidiary, or the charging of high rents on Iowa facilities owned by

the parent, or charging management fees to the subsidiary, would no longer be advantageous. The interest or rental income or management fees gained by the out-of-state firm would now be part of the profits of the combined corporation, and part of that combined income would be apportioned to Iowa.

Combined reporting addresses two other problems noted in the earlier chapter. First, corporations with sales facilities and permanent sales or installation or service staff would be taxable because those facilities establish nexus. Such corporations may now set up installation or sales subsidiaries in Iowa that protect the corporation's overall profits from Iowa tax, limiting the Iowa tax liability to the profits of the subsidiary. Combined reporting would merge the profits of the subsidiary and the profits of the parent corporation before apportioning income to Iowa, thus eliminating any gain from tax sheltering through the subsidiary.

Second, combined reporting would eliminate another significant abuse: Transfer pricing. Profits cannot be arbitrarily shifted from one state to another by the use of subsidiaries that buy and sell from each other, if all those subsidiaries must be combined for purposes of taxation. This transfer pricing takes the form of low prices charged by an Iowa firm for sales of components to an out-of-state parent corporation, or exorbitant prices sold by one firm to a related firm that does have nexus in Iowa. With combined reporting, the higher profits of the out-of-state parent (from artificially low component costs) or the out-of-state supplier (from artificially high component costs) are combined with the low profits of the subsidiary that is doing business in Iowa, and then apportioned to Iowa. The advantage from transfer pricing is eliminated.

The Iowa Department of Revenue estimated that combined reporting would have brought in about \$40 million in additional revenue in 2004. A combined reporting law should be accompanied by the adoption of MTC rules that spell out when related corporations should be combined. The state should also adopt a rule requiring that, whenever a corporation taxable in Iowa is also taxable in one of the 16 combined reporting states, it must include in the Iowa "unitary group" all subsidiaries that were reported as part of a unitary group in any other combined reporting state. This prevents a firm from changing the definition of what is the unitary group from state to state in order to reduce tax payments.³⁸

Summary

The measures proposed in this chapter together could raise in excess of \$50 million annually in corporate income tax revenue. They would do so while making the state tax system fairer, equalizing the treatment of multistate firms, who are in a position to exploit loopholes in the tax laws, and firms doing business entirely within the state. In the absence of such reform measures, we can expect to see a continuing erosion of revenues as more and more firms decide they can no longer afford to watch their competitors engage in "aggressive tax planning," with immunity, while they continue to pay their full share of the costs of doing business in the state.

Chapter 5

Corporate Tax Reform: Increasing Accountability and Transparency

The long-term viability of the corporate income tax depends in large part on the state's ability to limit the revenue drain from tax credits and to ensure that corporate tax avoidance is minimized. These efforts, in turn, require good information on the use, cost, and effectiveness of tax credits; and on the mechanisms of tax avoidance and the revenue losses that result.

Tax Credit Monitoring and Disclosure

The state is making significant strides in monitoring the use of tax credits. In fact, the Tax Credits Tracking and Analysis System now being developed by the Iowa Department of Revenue, in response to state legislation, could become a model for other states. Under this system, all business tax credits that serve an economic development purpose will be tracked and consolidated by taxpayer for the first time. This includes credits reported by C-corporations and credits claimed on individual tax returns as a result of business income received from a pass-through entity such as an S-corporation or an LLC. While the taxpayer-specific data will remain confidential, useful reports will be possible from this data, summarizing the total annual cost of the credits by a variety of factors, including the type of credit, the industry or size of the firm (by assets, income, or employment), and the domicile of the corporation (Iowa or out-of-state).³⁹ Most importantly, this data will permit effectiveness evaluations because the receipt of credits can be tied to the subsequent record of the corporation in terms of the creation of new jobs or the maintenance of Iowa employment levels.

The state of Iowa spends in excess of \$30 million annually on corporate income tax credits. This is revenue that could be funding other state programs or channeled into general tax relief. It is therefore important to be able to evaluate these credits: How much does the credit cost, what benefits does the credit generate, and is this a cost-effective way to achieve the legislative objectives that provide the rationale for the credit? The credit tracking system is a prerequisite for such analyses. But it should go further. Taxpayers have a right to know how their taxes are being spent, and this right currently gives them access to detailed budget information, including who secured what state contract for how much money, and what salary a given state employee is paid. The public has access to such information because that is the only way to ensure a measure of accountability in government. Tax credits should be accorded the same status. They are tax expenditures, and that they are granted through the tax system rather than an appropriation does not change the fact that they cost money, that they benefit particular parties and not others, and that they are supposed to achieve some public purpose. Once the tax credit tracking system is functioning, the bottom line should be available to taxpayers by recipient. That is, taxpayers should be able to find out how much corporation X received in tax credits, by credit. This is simply a good government issue.

Tax credits are made available to corporations on a voluntary basis. If a corporation chooses to make use of a credit, a condition of that use should be public disclosure. Transparency does

not mean that entire corporate tax returns (which corporations contend may contain proprietary information and therefore need to remain confidential) are made public, but only that uses of specific tax credits and exemptions be public record.

Disclosure of state tax credit amounts by recipient is required by law in eight states. North Carolina, Washington and West Virginia require reporting for certain specific state tax credits, showing by company the dollar amount of each credit received.⁴⁰ Illinois, Maine, Minnesota, Connecticut and North Dakota go beyond this, requiring company-specific data on jobs created and (except for Connecticut) the wages associated with those jobs, and covering economic development assistance more broadly.⁴¹

Tax Avoidance Reports

The use of a variety of devices for shifting corporate tax liability from one state to another, and avoiding part or all of a corporation's Iowa income tax, has undoubtedly been a significant factor in the precipitous decline in revenue since 1980. We do not know for certain the annual revenue losses from the use of these devices, nor can we be certain that we have even identified all of them. We do know that the state has challenged the legality of some of these avoidance schemes as used by a number of firms.

Clearly some of the reforms discussed in the preceding chapter would deal with many of these problems. But we need a better understanding of the magnitude of the revenue losses and of the new ways corporate tax attorneys are devising to manipulate taxable income. To this end, we recommend that the Iowa Department of Revenue and Finance be directed to prepare an annual report on tax avoidance and be provided the auditing resources necessary to produce such a report. The report should catalogue the kinds of avoidance mechanisms discovered by auditors, identify whether they have been or could be subject to legal challenge, provide an estimate of the revenue losses from their use, and discuss the tax law changes that would eliminate use of the device or strengthen the state's position in challenging their use through the courts.

Summary

The recommendations provided above are designed to make Iowa's corporate tax system more accountable — another important tax principle. Under Iowa tax law, once a tax credit is established, it generally continues unless it is modified or repealed by the General Assembly. A credit is generally open-ended and not subject to any limitation in size. The state's new tax credit tracking system will allow for the first time an analysis and review of credits to determine if they are serving a public purpose. We hope that the full potential of this system is realized. The recommendations here are to make tax credits and expenditures much more transparent, placing them on a more equal footing with annual appropriations. Similarly, the tax avoidance reports would enable the state to at least partially keep up with newly developing corporate tax avoidance strategies and to develop the information needed to assess the merits of various loophole closing measures.

Notes

- ¹ Letter from Jay Munson, Iowa Department of Revenue, to Jeff Robinson, Legislative Services Agency, dated March 30, 2006, on the fiscal effects of a bill (LSB6621XK) to impose a minimum tax of \$10 on all corporations with gross receipts of \$1 million or more.
- ² Corporate profits taxes may be slow to recover after a recession ends as corporations carry forward net operating losses to reduce their taxable income. However, the federal corporate income tax was quicker to recover.
- ³ The source for the statistics in this paragraph is the U.S. Census of Governments, State Tax Collections, and the Bureau of Economic Analysis (for gross state product).
- ⁴ Multistate Tax Commission, *Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections*, July 15, 2003.
- ⁵ Steven Maquire, "Average Effective Corporate Tax Rates: 1959 to 2002." Library of Congress, Congressional Research Service, September 5, 2003.
- ⁶ Bureau of Economic Analysis, *National Income and Product Accounts*, Table 1.12 "National Income by Type of Income."
- ⁷ Both LLCs and S-corps offer shareholders the same benefits of limited liability that are granted to shareholders of regular C-corps. S-corporations are smaller, limited by law to 100 or fewer shareholders.
- ⁸ There are certain instances where an LLC must file a corporation tax return; see IRS explanation at <http://www.irs.gov/businesses/small/article/0,,id=137016,00.html>
- ⁹ The exception to this rule is the LLC that is owned by a regular corporation. That corporation's profits from the LLC are taxed as part of the total income of the corporation.
- ¹⁰ One is tempted to look at corporate profits as a share of national income to see if this share has declined as more business income accrues to pass-through entities. However, in the Bureau of Economic Analysis national income accounts, the net income of S-corporations is included in income of corporations generally, and it is not possible to determine how much of corporate income consists of the income of such pass-through entities.
- ¹¹ Kelly Luttrell, "S Corporation Returns, 2002," Internal Revenue Service. Available at <http://www.irs.gov/pub/irs-soi/02scorp.pdf>.
- ¹² Gary Cornia, Kelly Edmiston, David Sjoquist, and Sally Wallace, "The Disappearing State Corporate Income Tax," *National Tax Journal*, vol. 58, no. 1, March 2005, p. 115-138.
- ¹³ William Fox and LeAnn Luna, "Does the Advent of LLCs Explain Declining State Corporate Tax Revenues?" Unpublished working paper. Knoxville, TN: University of Tennessee. 2003.
- ¹⁴ IRS, statistics of income.
- ¹⁵ A shrinking federal base would have less of an effect on Iowa taxes, however, since the lowering of the conforming Iowa base is partly offset by the fact that, as federal taxes are decreased, the deduction for Federal taxes on the corporation's Iowa return is also decreased, increasing income taxable in Iowa.
- ¹⁶ The federal income tax, like the state income tax, incorporates special rules for depreciating buildings and equipment, rules that allow firms to deduct the cost of such property much sooner than normal and thus to reap the tax benefits of those deductions much sooner. The federal government has changed the rules for depreciation a number of times in the past 25 years, always making the rules more accelerated and hence more generous. Iowa has conformed to these rule changes. The total cost to Iowa of these depreciation provisions in 2000 was about \$135 million in both individual and corporate income tax revenues. The bulk of the revenue loss was from the corporate income tax, but Iowa's 2000 Tax Expenditure Report did not specify just how much.
- ¹⁷ Gary Cornia, Kelly Edmiston, David Sjoquist and Sally Wallace, "The Disappearing State Corporate Income Tax," *National Tax Journal*, vol. 58, no. 1, March 2005, p. 115-138.
- ¹⁸ Communication from Michael Lipsman, Iowa Department of Revenue, March 31, 2005. The losses from bonus depreciation (\$24.5 million), section 179 expensing (\$4.9 million) and other changes (\$6.7 million) were offset by about \$7.0 in other provisions that increased Iowa revenue.
- ¹⁹ The top rate was increased from 10 percent to 12 percent in 1981.
- ²⁰ Businesses with a 260E agreement may also take a "new jobs withholding credit." This credit is equal to 1.5 percent (or 3.0 percent, for firms in the New Jobs and Income or Enterprise Zone programs) of gross wages; the credit must be used to retire the bonds issued to finance the job training. The withholding credits cost the state an estimated \$37 million in 2000 and \$46.4 million in 2003. However, these credits represent lost individual income tax revenue and thus do not account for any of the reported reduction in corporate income taxes over the past 10 years.
- ²¹ Correspondence from Michael Lipsman, Iowa Department of Revenue, May 3, 2004.
- ²² These fractions are based on population figures from the U.S. Census Bureau's population estimates program at: <http://www.census.gov/popest/estimates.php>

23 This is because Iowa has always apportioned income solely on the basis of sales. Regardless of how other states apportion income, Iowa's share of a corporation's income depends only on Iowa's share of the corporation's sales.

24 The figures represent 75 percent of 16 percent and 18 percent. This trend could have been aggravated by acquisitions of Iowa corporations by out-of-state firms, to the extent that Iowa's share of corporate headquarters (and of corporations with a tax nexus here more generally) also declined as a result of the acquisitions. This possibility was noted in the LSA memo cited above.

25 "Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections." State Tax Notes 20, No. 3 (July 21, 2003), pp. 237-41.

26 Gary Cornia, Kelly Edmiston, David Sjoquist and Sally Wallace, "The Disappearing State Corporate Income Tax," National Tax Journal, vol. 58, no. 1, March 2005, p. 115-138.

27 Iowa law does require that intangible income be included in Iowa taxable income. This means that firms cannot use Iowa as a tax-free haven for royalty income they have earned, but it does not prevent a corporation from deducting royalty payments made to a Delaware subsidiary, which is the problem described in the Geoffrey loophole.

28 See next section for a definition of taxable nexus.

29 PL 86-272, enacted by Congress in 1959. PL 86-272 applies only to the sale of goods, and not to services or intangibles.

30 Some states would take the position that using a subsidiary to provide a service that is essential to sale of the product would create nexus; however, states have a mixed track record in making firms comply with this interpretation.

31 Multistate Tax Commission, Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections, July 15, 2003.

32 Firms producing in Iowa but selling in national or international markets will not be in a position to shift tax costs to consumers. They are selling in competitive markets where prices are set by the interaction of supply and demand and they cannot raise prices above the competition. It could also be argued that some of the tax is shifted to workers in the form of lower wages or to landowners through lower prices paid for commercial and industrial land. Such an effect can come about, however, only if the tax provides a significant disincentive to locating in Iowa and results in less corporate investment in the state. It is very doubtful that this has any significant effect on wages or land prices in Iowa.

33 Joel Friedman and Robert Greenstein, Exempting Corporate Dividends From Individual Income Taxes (Center on Budget and Policy Priorities, January 23, 2003).

34 See Peter S. Fisher and Elaine Ditsler, Taxes and State Economic Growth: The Myths and the Reality (Iowa Policy Project, May 2003); Robert Lynch, Rethinking Growth Strategies (Economic Policy Institute, 2004); Alan Peters and Peter Fisher, "The Failures of Economic Development Incentives," Journal of The American Planning Association, vol. 70, (Winter 2004); and Michael Wasylenko, "Taxation and Economic Development: The State of the Economic Literature," New England Economic Review (March-April 1997).

35 For an analysis of one particular economic development program, see the IPP report, <http://www.iowapolicyproject.org/2002-2004_reports_press_releases/040708-ivf.pdf>. Overall estimates of the tax incentives and business packages provided through Iowa public policy exceed \$400 million annually, with almost no overall accountability regarding their effectiveness in stimulating economic growth and employment. <<http://www.iowafiscal.org/2006docs/060124-IFP-wf-full.pdf>>

36 "Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272", available at http://www.mtc.gov/UNIFORM/pl86272_72701.pdf Iowa has not adopted this statement.

37 Multistate Tax Commission: Allocation and Apportionment Regulations. Adopted February 21, 1973; as revised through January 15, 2004. Available at: http://www.mtc.gov/UNIFORM/alloc_and_apport%20regs.pdf

38 For a comprehensive treatment of how a state can move from separate-entity taxation to combined reporting, see Michael McIntyre, Paul Mines, and Richard Pomp, "Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana." Louisiana Law Review, 2001. Reprinted in State Tax Notes, September 3, 2001.

39 Under current law, such reports will be possible only to the extent that the groupings are large enough to avoid violating the confidentiality of any one firm.

40 In Washington reports are available only individually and upon request; in North Carolina and West Virginia, the data can be accessed on the web.

41 In these four states, disclosure covers all subsidies or economic development assistance programs, though Maine and Minnesota require disclosure only if the assistance exceeds a threshold amount or if the firm exceeds a threshold size.

Iowa Fiscal Partnership

The Iowa Fiscal Partnership is a joint initiative of the Iowa Policy Project and the Child & Family Policy Center, two nonprofit, nonpartisan Iowa-based organizations that cooperate in analysis of tax policy and budget issues facing Iowans. IFP reports are available on the web at <http://www.iowafiscal.org>.