

## A CAPITAL (GAINS) OFFENSE

### Unnoticed But Lasting Change Undermines Iowa's Tax Code

The research is in and the data are clear: Iowa's outdated, and increasingly leaky, tax code needs reform. Over time, special provisions have been incorporated to give advantage to different special interests, while tax accountants and attorneys have found ways to manipulate the code to help their clients escape taxes. The Iowa public knows this; a 2004 poll<sup>1</sup> showed that Iowa voters believe that Iowa's tax system has become skewed over time, primarily benefiting wealthy Iowans and large corporations at the expense of working families and small business. More recently, fresh research by independent and state fiscal experts shows problems with loopholes and giveaways in the Iowa tax code. A prime example of how the tax code has been skewed to benefit the wealthy: Iowa's special treatment of capital gains.

Using public state data, the Iowa Fiscal Partnership has highlighted several features of Iowa's tax code that let businesses shelter substantial Iowa profits from corporate income taxes. Corporate tax loopholes and giveaways reported on previously — the absence of combined reporting and the refundability provision of the research activities credit — collectively drain the state treasury of over \$100 million annually. Primarily, these breaks benefit only large, multinational corporations, which often compete in Iowa against local businesses in the sale of goods and services.

Iowa's treatment of certain capital gains shows the breaks are not only to corporations, but to certain very high-income individuals as well — yet another tax giveaway that deserves legislative attention.

A capital gain is the profit made when an asset (such as stocks, real estate, or a business) is sold for more than was paid for it. While many taxpayers have some capital gains, the lion's share of capital gains income goes to those at the very top of the income scale — nationally 83 percent went to those making over \$200,000 in 2005. Most states with a personal income tax treat capital gains income as they do other income, while a few states tax that income at a lower rate. Iowa, however, is nearly unique, totally excluding certain capital-gains income from any state income tax. Iowa's exclusion applies to *any* gain derived from *any* of these:

- Livestock used for breeding
- Timber held for more than one year
- Sales of businesses or farms held for more than 10 years in which the taxpayer "materially participated."

### ***TENS OF MILLIONS SLIPPED AWAY, VIRTUALLY UNNOTICED***

This special Iowa capital gains exclusion was initially limited to 45 percent of the first \$17,500 in capital gains income in any year. It was expanded in 1998 to be a total exclusion on all capital gains, no matter how large. Remarkably, this slipped into state law with very little public attention or scrutiny, tucked into a much larger piece of income-tax legislation. As a result, the annual cost to the state treasury from this preferential treatment of capital gains rose from \$2.5 million to over \$30 million nearly overnight.

The Iowa Department of Revenue recently estimated the cost of Iowa's capital gains provision for tax year 2008 at \$48.9 million.

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Simply limiting the amount of the total exclusion from income to \$200,000 for married joint filers and \$100,000 for single filers would reduce this cost by more than one-half and affect just 600 tax filers. The

table at right shows the impact of such a limitation. Thus, the vast majority of capital gains tax sheltering helps the highest-income Iowans. Those with adjusted gross incomes over \$250,000 represent only the top 1 percent of Iowa tax filers yet receive 92.5 percent of the benefits. See the box below for two illustrations of whom this provision benefits.

Iowa needs to systematically review its overall tax code, starting with an examination of tax loopholes, tax credits and tax expenditures that have grown in number and size over the last several decades with little or no oversight. This review should examine all such provisions according to their consistency with recognized tax principles – fairness, accountability, revenue adequacy, competitiveness, simplicity, public benefit, and stability and predictability.

### ***TAKING JUDICIOUS ACTION***

In the short term, Iowa lawmakers can save the state millions of dollars by limiting the capital-gains exclusion to a fixed amount. Iowa lawmakers could save the state treasury \$14.5 million annually simply limiting the capital-gains exclusion to \$200,000 for married joint tax filers and \$100,000 for single tax filers.

This revenue then could pay for real tax reform for working families in the \$20,000 to \$40,000 income range who pay a disproportionate share on their income in taxes. Increasing the state Earned Income Tax Credit to 12 percent would provide 186,000 Iowa tax filers and 500,000 Iowans overall with significant tax savings and could easily be financed from the revenue gained by limiting the capital gains exclusion affecting only 600 of Iowa's wealthiest tax filers.

### **Capital Gains Break Helps Higher-Income Households** **Effect of Exclusion Limits: \$200,000 Married Couples/\$100,000 Singles\***

<u>Income level</u>	<u>Households Affected</u>	<u>Dollars Recovered</u>
\$0 – 99,999	135 (.001% of filers)	\$ 298,572
\$100,000 – 249,999	196 (.015% of filers)	\$ 1,541,522
\$250,000 +	272 (1.04% of filers)	\$ 22,714,397

\*2005 data, Iowa Department of Revenue

### **HOW IOWA'S CAPITAL GAINS LAW LETS RICH IOWANS ESCAPE TAX**

#### **Software Developer**

In the first hypothetical example of how this law works, consider a computer software developer who started his business in 1990, making a six-figure income. In 2001, he develops a patented software application that attracts the attention of a multinational software corporation, which buys the business for a cool \$3 million, resulting in a \$2.7 million profit for him.

*Under Iowa capital gains law, this person would not pay one penny to Iowa on the \$2.7 million profit. If Iowa treated capital gains the way other states did, he/she would owe Iowa taxes of about \$240,000, but this person's federal taxes would be reduced by \$70,000 as a result.*

#### **Real Estate Developer**

In our next example, an investor pays \$20,000 for land adjacent to the north side of an Iowa city, planning eventually to develop it. A decade later, after a zoning deal with the city and another \$20,000 invested to develop the land into parcels for high-end residences, the value of the land has risen ten-fold. The investor receives \$400,000 for it.

*Under Iowa capital gains treatment, the profit on that sale is not subject to any Iowa taxes. If Iowa treated capital gains the way other states do, the seller would owe about \$32,000 in state taxes on his \$360,000 profit, but this would be offset by a lower federal tax bill of \$10,000.*

<sup>1</sup> Selzer and Associates poll for Iowa Fiscal Partnership, report at <http://www.iowafiscal.org/research/040308.html>. The poll found 65 percent of those expressing an opinion believed Iowans making over \$200,000 pay less than they should in Iowa taxes, while 52 percent believed those making \$20,000 or less a year pay more than they should. The survey also showed 52 percent believed small businesses paid about the right amount in tax, while 65 percent believed big, multistate businesses operating in Iowa paid less than they should, and 56 percent considered closing tax loopholes to be a "good way" and another 34 percent an "acceptable way" to raise revenue to avoid cuts.