Ins and outs of a new Iowa tax loophole — mostly 'outs'

Costly deduction for business income being rushed with little scrutiny

By Charles Bruner for the Iowa Fiscal Partnership

The Qualified Business Income Deduction (QBID) is the official name for a new provision in the federal tax code that is estimated to have a cost to the federal treasury of about $50 billion annually. Some Iowa lawmakers want to adopt it in state law.

This deduction applies to the treatment of "pass-through" income that is reported on the individual income tax, as a subchapter S corporation, a limited partnership, or a sole proprietorship. These entities can fall into the definition of "small business" in terms of the number of workers employed and number of shareholders, but they can be highly profitable and by no means "small business" in terms of the money they make.

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Iowa is the only state in the country actively considering legislation that would intentionally adopt this new federal provision into its state income tax code, with a cost in Iowa estimated by the Department of Revenue to be in excess of $100 million annually, if the full 20 percent deduction is adopted. Revenue estimates are that 79 percent of the benefits will go to the top 5 percent of tax filers in terms of incomes.

Many of the details of how the QBID will operate are still in question, as the legislation is complex and there are uncertainties of how it will be administered or used. There are substantial concerns that its complexity will give rise to its use well beyond what was intended as it will generate incentives for high-income individuals to reclassify their salaries as pass-through income to take advantage of the deduction. There are also a number of issues related to its fairness (the tax treatment of similar income being treated similarly) have been raised.

One rationale for its adoption at the federal level was that other changes — reducing corporate income tax rates to a top rate of 21 percent, while individual income tax rates remained above 35 percent — meant that business income now was being taxed at substantially different rates on the individual income tax side than on the corporate side. This tenuous rationale clearly does not hold for Iowa taxes as the corporate rate is higher, not substantially lower, than the individual rate.

Multiple types of entities that will receive a tax benefit from this provision at the federal level operate in the state of Iowa. Several are described, for illustrative purposes, below:

1. A smaller manufacturing firm with four partners who own the business, with a payroll of $6 million (80 employees), gross sales of $60,000,000 and net income (profit) of $4 million. Each of the partners, two from Iowa and two from out-of-state, are working owners and

receive $200,000 in salary. For the year, the firm distributes $1 million of profit to each of the four partners. Under the QBID, the $200,000 in salary is considered as income, but the $1 million is discounted to $800,000 through the QBID.

2. The QBID has some provisions to serve as guardrails against some businesses — such as attorney and accounting businesses — qualifying, but there also can be ways around this. A law practice owns its own office and real estate, and it now pays its attorneys an average of $400,000 in salaries. While the practice may not be able to convert these salaries into profits qualifying for the QBID tax break, the practice could set up a real estate partnership, with the attorneys as its owners, and charge rent to the practice. That rent, then, could be returned to the attorneys, as owners, in the form of a payment that would qualify under the QBID. If the rental income averaged $100,000 per attorney, the attorneys could receive $300,000 in salaries and $100,000 in a distribution from the real estate partnership. They would have the same $400,000 in compensation overall, but their taxable income reduced from $400,000 to $380,000 if the value of the building were sufficiently high.
3. A lobbyist received contracts from eight different organizations that are provided as payments and not salary, totaling $280,000. If that person is married and has a total income under $315,000, the entire $280,000 can be treated as a QBID. That means, instead of being taxed on $280,000, 20 percent is exempted from taxation and that person is taxed on only $224,000.
4. The third example generally also raises the issue of tax fairness for similar taxpayers with similar incomes. In a fourth example, two plumbers do essentially the same job. One plumber works on a salaried basis for a small company and makes $120,000. The other plumber works for himself and, after deducting all expenses, also makes $120,000. The first plumber is taxed on $120,000; the second plumber is taxed on $96,000.

Questions for Iowa

The questions for Iowa before adopting the QBID in any form are basic: How much does it cost? Who benefits? Does it treat similar people fairly? And, does it serve any public purpose?

For Iowa, the answer to the question of costs is, with a 20 percent reduction, $100+ million annually. The answer to the question of who benefits is very disproportionately those with the highest incomes. The answer to the question of its fairness compared with the treatment of other income is, looking at the examples above, no. Finally, with the question of whether it serves any other public purpose, such as stimulating new forms of economic activity, is that all evidence (particularly for such a piggy-back provision in Iowa) is no; it simply creates new avenues to avoid taxes.

Charles Bruner is a former state senator and former executive director of the Child and Family Policy Center, which is part of the Iowa Fiscal Partnership.

See also in our Iowa Fiscal Partnership 2018 Tax Policy Kit:

- ***Passing through a special break for wealthiest filers:*** http://www.iowafiscal.org/wp/wp-content/uploads/2018/03/180319-IFP-qbid.pdf
- ***Plugging tax loopholes could boost revenue:*** http://www.iowafiscal.org/plugging-loopholes-could-boost-revenue/