POLICY REPORT

The Iowa Policy Project — Child & Family Policy Center

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How to Balance the Budget by Cutting Tax Preferences

By Charles Bruner and Peter S. Fisher

Over time, Iowa has adopted a wide array of state tax preferences[1] — items of income or expense that are treated preferentially under Iowa's income or sales tax law. The Department of Revenue, in fact, has compiled a detailed list of 280 such tax preferences or "tax expenditures."[2]

At a time when Iowa is facing serious budget shortfalls, these tax preferences should be scrutinized closely. In this report, we examine six preference items we think warrant change or elimination, based upon their relationship to seven important tax principles (see box at right). Two (combined corporate reporting and taxing internet sales) have been recommended by Iowa Governor Tom Vilsack as part of the state's 2003 budget.

Altogether, changing or eliminating these six tax preferences could produce $150 to $200 million in tax revenue, while making the tax system fairer (from both an ability-to-pay and a horizontal tax fairness perspective). The changes would also strengthen and stabilize the state's tax base, and would eliminate incentives that serve no strong public purpose without adversely affecting the state's economic competitiveness.

These constitute only a start in reviewing tax preferences. Serious examination of all tax preferences and expenditures should be conducted by a balanced, blue-ribbon panel that could make such determinations outside of partisan politics.

Principles for Evaluating Iowa Taxes and Tax Proposals

1. Fairness

Taxes should be based on the ability to pay; those with similar ability to pay should have similar tax burdens. In general, tax fairness should be at the heart of tax deliberations and efforts should first be made to ensure that tax changes produce a fairer overall system.

2. Competitiveness

Iowa's overall tax system should allow the state to be competitive for business and for labor. The overall state and local tax system in Iowa is, in fact, about average both nationally and regionally. A tax system that meets the competition with tax levels that are near the average is a competitive system. Further cuts would imperil the public services that are the foundation for economic growth in the long run.

3. Public Benefit and Economic Efficiency

Tax incentives should promote some public purpose. Incentives that serve no public purpose can distort private economic decisions, making the Iowa economy less efficient.

4. Revenue Adequacy

Taxes must be capable of producing sufficient revenues to finance state and local public services.

5. Stability and Predictability

Other things equal, a tax base that is more stable and predictable over the business cycle is preferred.

6. Simplicity

The tax system should be easy for citizens to understand and taxpayers to comply with, and it should be easy for the government to collect the tax and audit compliance.

7. Accountability

Those who spend money should be accountable to those who provide the funds, through taxes or otherwise.

[1] The Iowa Policy Project and Child and Family Policy Center previously have reported upon a local tax preference, tax increment financing. IPP and CFPC believe that local tax preferences should be examined in the same manner as state tax preferences. See: www.iowapolicyproject.org.

[2] Iowa Department of Revenue and Finance, *Iowa Tax Expenditures 2000, Phase 1 Report*, July 2001.

1. Combined corporate reporting

One way for multistate corporations to reduce state taxable income is by paying royalty income to a "parent" company in a tax haven state. Other states have taken one of two tracks to eliminate such tax avoidance: requiring combined corporate reporting for the corporations or specifically disallowing a deduction for royalty income. Iowa has neither provision in place.

Under combined reporting, now in place in 16 of the states with corporate income taxes, a firm is required to combine the income of all of its related affiliate corporations prior to having that income apportioned. This is a very effective way of preventing a range of tax avoidance strategies that involve shifting profits from a corporation's operations in states where it is taxed to its affiliates in states where it is taxed lightly, or not at all.

One of the most common strategies, particularly among retailers, is to set up a shell corporation in Delaware or Nevada. There is even a firm, Delaware Corporate Management Inc., in Wilmington Delaware, that will facilitate the process. For a few thousand dollars, DCM will provide an address, office space, furniture, mail collection and forwarding, stationery, and telephone answering — everything, in other words, needed to give the appearance of an actual business operation.[3] Some 670 absentee corporations "occupy" DCM's Wilmington building. The shell corporation is incorporated in Delaware as a subsidiary of the parent corporation and then acquires the corporate logo or trademark. All retail stores are then required to pay royalties to the Delaware firm. The royalties are deductible as a business expense in the states where the firm actually does business, thus reducing the firm's taxable income in those states. Since Delaware does not tax royalty income, this scheme converts taxable income in states where the stores are located to tax-free income in Delaware.

Such tax avoidance schemes significantly impact Iowa Corporate Income tax revenue. Among the major U.S. firms that are known to use "intellectual property holding companies" to avoid paying state income taxes are the following businesses with a substantial presence in Iowa: American Greetings Corporation, Budget Rent-A-Car, Burger King, CompUSA, ConAgra Foods, Dress Barn, Gap, Home Depot, Honeywell International Inc. and Subsidiaries, Kmart, Kohl's, Long John Silver's, Marsh Village Pantries, Marsh Supermarkets, Payless Shoes, Radio Shack, Sherwin-Williams, The Limited Brands, Tyson Foods, Circuit City Stores, Staples, and Toys "R" Us.[4] The Iowa Department of Revenue estimates that combined reporting would generate $30 million in revenue in fiscal year 2004 and $40 million in 2005, taxes now being lost because of increasing exploitation of this loophole.

Adherence to Tax Principles: Combined Reporting

Fairness – Meets both components by treating like businesses equally and raising additional revenue from those with the most ability to pay
Competitiveness – Redresses a slight disparity in competitiveness for in-state businesses
Public Benefit/Economic Efficiency – Closes an incentive that serves no public purpose
Revenue Adequacy – Helps increase tax base
Stability and Predictability – Helps diversify tax base that has narrowed due to reduced corporate tax revenue
Simplicity – May complicate filing, but most corporations involved in establishing such subsidiaries already are multi-state entities that have to produce such filings in other states
Accountability – Eliminates an option to transfer liability away from where sales and profits occur
Overall – Strongly meets several principles and does not violate any principles

[3] Glenn Simpson, "A Tax Maneuver in Delaware Pust Squeeze on Other States," *Wall Street Journal*. August 9, 2002.
[4] Simpson, "Tax Maneuver…", Wall Street Journal (cited above).

Closing this loophole, as an increasing number of states are doing, would not affect Iowa's competitive attractiveness. Almost all of the firms on the above list are retail corporations. They locate stores where the market is, and are not going to be dissuaded from opening new Iowa outlets simply because Iowa decides to join the list of states plugging a tax avoidance loophole. Toys "R" Us cannot sell toys to Iowans from stores in Florida. Further, combined reporting would put all Iowa businesses on an equal footing, in particular by not giving an additional advantage to large multi-state retail organizations over in-state retailers who have no way to use this scheme or to other multi-state corporate citizens who have thus far not resorted to such tax avoidance strategies.

2. "Throwback sales" in corporate income tax apportionment

Any corporation doing business in Iowa and in other states is taxed only on the portion of its total income that is apportioned to Iowa. Iowa relies on "single-factor apportionment," meaning that the destination of the firm's sales is the only factor used in the apportionment formula (whereas most states rely on payroll and property as well). For example, if 20 percent of the firm's sales are destined for Iowa, then 20 percent of its profits are taxed in Iowa.

The majority of states with corporate income taxes (24 of 45) have a "throwback" provision. If Iowa were to adopt the throwback rule, a firm shipping goods from Iowa to another state where it has no tax nexus would have to count those sales as Iowa sales for purposes of apportionment; the sales are "thrown back" to the state of origin. Without the throwback provision, such sales are not counted by any state and the firm has tax-free "nowhere income." This creates an inequity when compared to comparable corporations without such "nowhere income," who are taxed on all their income. The absence of a throwback provision is a major loophole in a state such as Iowa, with single-factor apportionment. In other states, the payroll and property factors would result in some apportionment of such "nowhere income" since the goods are produced in-state.

Adherence to Tax Principles: Adopt "Throwback Sales" Rule

Fairness – Meets both components by treating like businesses equally and raising additional revenue from those with the most ability to pay
Competitiveness – Redresses a slight disparity in competitiveness for in-state businesses
Public Benefit/Economic Efficiency – Closes an incentive that serves no public purpose
Revenue Adequacy – Helps increase tax base
Stability and Predictability – Helps diversify tax base that has narrowed due to reduced corporate tax revenue
Simplicity – May complicate filing, but only for businesses with multi-state operations
Accountability – Neutral to accountability
Overall – Strongly meets several principles and does not violate other principles

3. College savings account exclusion

Currently, Iowa tax filers can deposit up to $11,000 annually into an Iowa college savings account, provided it is subsequently used to pay a child's higher education costs. The earnings accrued on these accounts are tax deferred at both the state and the federal level. In addition, Iowa allows a state income tax deduction for the amount that is deposited into each college savings account up to a limit of $2,180 per child per contributor for 2002. (A married couple with two children, for example, could deduct up to $8,720 each year.)

These accounts are similar to IRAs in providing both an immediate deduction and a deferral of taxation

on earnings. Unlike IRAs, however, there is no income ceiling that applies to the tax deduction for the amount that is deposited into the account. This means that tax filers with very high incomes receive this state income tax deduction, even though they are in the best position already to provide for their children's educational future. These accounts have been viewed as fairly substantial tax avoidance opportunities for wealthy families with children. For a very high income Iowa family placing $8,720 into such accounts, the first year state income tax reduction is over $700 alone, and $8,720 of principle is put into an account whose growth will be taxed lightly, if at all. Placing an income ceiling on the use of the state income tax deduction equivalent to that for IRAs would much better target this tax expenditure to those for whom it can make a real difference in funding their children's education.

Adherence to Tax Principles: College Savings Account Exclusion

Fairness – Better bases income tax system on ability to pay
Competitiveness – Has not been considered an incentive, so removal should not be disincentive
Public Benefit/Economic Efficiency – Any public benefit of making higher education more affordable is retained when eligibility is retained but simply means-tested
Revenue Adequacy – Helps increase tax base immediately
Stability and Predictability – Lowers likelihood of long-term, more significant state revenue erosion
Simplicity – Does not make significant difference in simplicity of tax filing
Accountability – Neutral or positive to accountability
Overall – Strongly meets several principles and does violate other principles

4. Capital gains tax treatment

Iowa provides a special exclusion from income for capital gains on the sale of selected types of property when the taxpayer "materially participated" for 10 years in the property and the property was held for a minimum of 10 years (422.7(21)(a).

One of the major stated purposes for preferential tax treatment of such capital gains (as opposed to other capital gains) was to avoid the forced liquidation of an asset, such as a family farm or family business, when it was sold or taken over by a lineal descendant. It was meant to distinguish between capital gains that represented passive investments (such as stock appreciation) and capital gains from a business that the taxpayer operated and was enacted as a tradeoff to adopting favorable tax treatment for all types of capital gains.

Even if preferential treatment is to be provided for this type of capital gain, however, it could be much less than a total exclusion. Fifty percent of such capital gains could be subject to taxation. If the concern remains that lineal descendants would be jeopardized, those gains could be deferred until a future sale in instances where the property is sold to a lineal descendant who also materially engages in the business.

Adherence to Tax Principles: Capital Gains Tax Treatment

Fairness – Strongly meets criteria of ability to pay
Competitiveness – Could make system somewhat less attractive to business start-ups, although coupling with federal tax treatment would make state competitive with other states in this respect
Public Benefit/Economic Efficiency – Rationale for providing incentives can largely be met through more focused qualifications
Revenue Adequacy – Helps increase tax base
Stability and Predictability – Provides at least as great stability and predictability
Simplicity – Depends on whether there is overall repeal and simple coupling with federal treatment (which would produce greater simplicity) or adapting to a new structure (which would retain a level of complexity)
Accountability – Neutral to accountability
Overall – Strongly meets several principles and does not violate other principles

5. Estate tax

While Iowa has an independent state inheritance tax, the Iowa estate tax is coupled to the federal estate tax. As a result, Iowa's estate tax is being phased out as the federal estate tax exemptions are increased and the estate tax credit is eliminated over the next several years, at a substantial cost to the state (increasing from $15.2 million in FY03 to $45.6 million for FY07).

Two major arguments often are presented for reducing the estate tax: (1) it represents a second tax on income that has been previously taxed, and (2) where business property is involved, it can require selling that property rather than enabling lineal descendents to manage the business (e.g. retain a family farm).

On the first argument, however, inheritances often involve unrealized capital gains, appreciations in underlying value that have never been taxed. On the second argument, tax obligations could be further deferred until the business was no longer being actively run by the offspring. Iowa's estate tax could be decoupled simply by basing the tax on the amount of the maximum federal credit as of January 2001.

In addition to decoupling, there are options to create an Iowa estate tax that addresses the concerns in the above two arguments that does not phase out the estate tax entirely. This could include:

- Indexing the amount exempt from taxation, to account for inflation.
- Providing a deferral of any assessment and tax liability, when the inheritor(s) are materially engaged in the business, until such time as they no longer are materially engaged.
- Allowing the estate the option of selecting the current exemption amount or foregoing the exemption but having the estate tax liability only on that portion of the estate which constitutes unrealized capital gains.

These would be ways of addressing the arguments most often raised against the estate tax without simply phasing it out.

Adherence to Tax Principles: Estate tax

Fairness – Strongly meets ability to pay criteria
Competitiveness – Consistent with many other state approaches and generally not considered an economic competitiveness issue
Public Benefit/Economic Efficiency – Alternatives exist to address proposed public benefit that would not result in current revenue loss
Revenue Adequacy – Helps increase tax base
Stability and Predictability – Diversifies tax base
Simplicity – Does not produce necessarily greater simplicity and may be somewhat difficult to audit, but affects only a very small percentage of all estates (likely less than 3 percent), which are generally complex to administer and involve individualized expertise that can handle any new complexities as a matter of course
Accountability – Helps ensure that those who have received benefits from services and economic opportunity contribute, with a significant portion of taxes paid by current nonresidents
Overall – Strongly meets several principles and causes complications in terms of simplicity for only a tiny percentage of the population.

6. Sales tax on Internet sales

Currently, state sales taxes on products sold through the Internet are not collected, while sales taxes on identical products from downtown and other retail establishments are collected. There is the potential for collecting sales tax from Internet sales, provided the state adopts some uniform definitions for what is subject to sales tax collections. Customers on the Internet tend to have higher incomes than customers at

retail establishments generally, meaning that the sales tax collected on Internet sales is more proportional to ability to pay than that of the sales tax on goods and products generally. Iowa should take action to join with other states in ratifying the Streamlined Sales and Use Tax Agreement, which makes voluntary imposition of such taxes possible. Iowa should also monitor developments that might enable the state to expand its capacity to collect sales tax on Internet and catalog sales.

Adherence to Tax Principles: Tax on Internet Sales

Fairness – Provides for much greater horizontal equity, and is likely to be fairly proportional in overall ability to pay
Competitiveness – Should make in-state retail establishments slightly more competitive
Public Benefit/Economic Efficiency – Eliminates a negative incentive to economic development for retail operations in the state
Revenue Adequacy – Helps increase tax base
Stability and Predictability – Helps stabilize sales tax base, which has been eroding through increased Internet sales
Simplicity – Adoption of definitions should not affect simplicity of tax collection
Accountability – Makes those who benefit from sales more accountable for paying for the costs of services than otherwise would be the case
Overall – Strongly meets several principles and does not violate any principles

Conclusion

These six tax preferences constitute only a tiny proportion of existing tax preference items in the Iowa tax system, some established many years ago in very different times and some established as Iowa "coupled" with federal personal and corporate income tax provisions, often without any substantial review or discussion of their particular merits in Iowa. Further, their tax impacts often are poorly recognized or estimated as they are started, and they often grow dramatically over time, as their tax avoidance benefits are discovered and expanded upon.

Many tax preferences do serve valid public purposes in Iowa. Those that do not, however, should be eliminated. Failing to do so puts a strain on more general taxing sources, diminishes public confidence in the tax system, and erodes the ability of the state to maintain the tax base it needs.

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This report, and a two-page summary, are available to the public, free of charge, at www.iowapolicyproject.org.