POLICY REPORT

Executive Summary

The Iowa Policy Project Child & Family Policy Center

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How to Balance the Budget by Cutting Tax Preferences

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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 Page 2). 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, outside of partisan politics.

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, such as Delaware, that does not tax such income. Other states have two ways to eliminate such tax avoidance: requiring combined corporate reporting for the corporations or specifically disallowing a deduction for royalty income. Iowa has neither provision. 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 prevents a range of tax avoidance strategies that shift a corporation's profits in states where it is taxed to its affiliates in states where it is taxed lightly, or not at all.

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. Unlike most states, Iowa does not factor payroll and property into the equation. For example, if 20 percent of the firm's sales are destined for Iowa, then 20 percent of its profits are taxed in Iowa. But what happens if the sales from Iowa go to a state with no such taxes? The 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 that break and are taxed on all their income. Iowa could join 24 other states and implement a "throwback" provision, which would count those sales, and close a major loophole.

[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.

3. College savings account exclusion

Currently, Iowa tax filers can deposit up to $11,000 annually into an Iowa college savings account 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 – similar to an IRA. 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. Unlike IRAs, however, there is no income ceiling for the tax deduction. This means a deduction for high-income filers who already are in the best position to provide for their children's educational future. An income ceiling on the use of the deduction would better target this tax expenditure to those for whom it can make a real difference.

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. A major stated purpose for preferential tax treatment of such 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. 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 descendent who also materially engages in the business.

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). In addition to decoupling, there are options to create an Iowa estate tax that addresses concerns about estate taxes that does not phase out the estate tax entirely.

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 Internet sales taxes are more proportional to ability to pay than the sales tax generally.

Principles for evaluating Iowa taxes

1. Fairness
Taxes should be based on the ability to pay; those with similar ability to pay should have similar tax burdens. Tax fairness should be at the heart of tax deliberations.

2. Competitiveness
Iowa's overall tax system should allow the state to be competitive for business and for labor. A tax system with tax levels that are near the average is competitive.

3. Public Benefit and Economic Efficiency
Tax incentives should promote some public purpose.

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 to understand and to comply with; 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 providing funds, through taxes or other means.

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The full report is available to the public, free of charge, at www.iowapolicyproject.org.