Executive Summary

Revitalizing Iowa's Corporate Income Tax

Peter S. Fisher

April 2006

Iowa Fiscal Partnership
www.iowafiscal.org

The Iowa Policy Project
318 2nd Ave. N
Mount Vernon, IA 52314
(319) 338-0773 • www.iowapolicyproject.org

Child & Family Policy Center
1021 Fleming Building • 218 Sixth Ave.
Des Moines, IA 50309
(515) 280-9027 • www.cfpciowa.org

Iowa Fiscal Partnership

Executive Summary

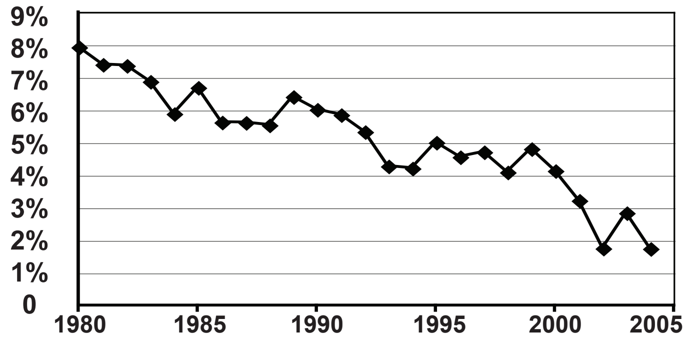
April 2006

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.

Corporate Income Tax Revenue as Percent of State Tax Revenue in Iowa, FY1980-2004



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 Multistate 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 multistate 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

---

Peter S. Fisher is research director of the Iowa Policy Project, a nonprofit, nonpartisan research organization based in Mount Vernon. He is a Professor in the Graduate Program in Urban and Regional Planning at the University of Iowa.

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 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. 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.

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 on the web at http://www.iowafiscal.org.