Iowa Fiscal Partnership *policy brief*

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RESTORING FAIRNESS & REVENUE

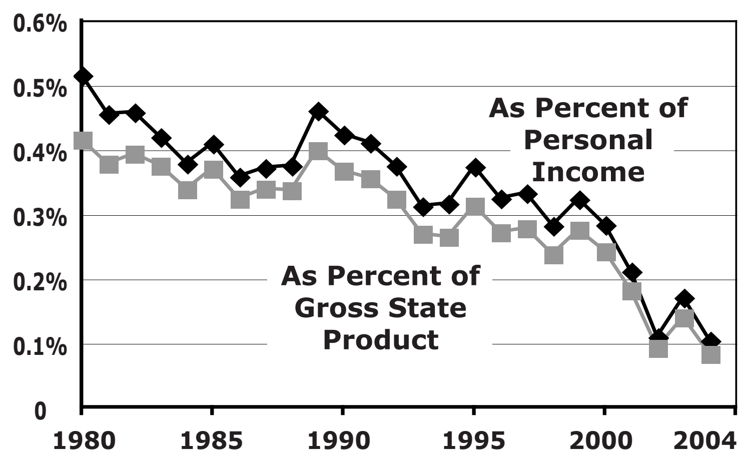
Reform Measures for Iowa's Corporate Income Tax

Legislators looking for answers to tight budget challenges could find a partial answer right in front of them: reviving the corporate income tax. Iowa's corporate income tax has 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? Are taxes among different types of business entities fairly equal or is there a problem with the basic fairness of the corporate tax system?

WHY HAVE CORPORATE TAX REVENUES FALLEN SO FAR?

There appear to be four principal reasons for the $146 million decline in state corporate income tax revenue in Iowa since the early 1980s:

- **Tax credits** cost the state about $36 million annually in the 2001-04 period. These tax credits, enacted since 1984, account for about one-fourth of the decline in revenue.
- **The increasingly aggressive use of tax avoidance strategies** has produced revenue losses in excess of $50 million every year.
- **Iowa's relatively slow population growth** may account for another $35 million drop in revenue because slow growth translates into a smaller share of the national market, and therefore less corporate income apportioned to Iowa.
- Based on national studies, it appears likely that the remaining lost revenue, around $25 million, is attributable to the **increasing use of pass-through entities** in place of traditional or C corporations. Subchapter S corporations, limited liability companies and partnerships pay taxes on their profits under the individual income tax, not the corporate income tax.



The decline in corporate tax revenue has been sharper in Iowa than in most states with a corporate tax. Other states' corporate tax systems are less subject to tax avoidance, and some states have recently adopted measures 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.** The public education system is responsible for educating workers and the children of company employees. State and local public services build and maintain the roads and water and sewer systems that businesses rely upon, and protect 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 public 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.

Cutting corporate income taxes has not brought 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 very expensive but only marginally effective tool for attracting business from one state to another. State and local taxes falling on businesses represent on average only about 1.2 percent of the total cost of doing business in the U.S. 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 corporate tax revenue as a percent of state personal income in 2001-02.

REVITALIZING IOWA'S CORPORATE INCOME TAX

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 corporate tax planning that exploits 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 that do not serve a public purpose and to ensure that corporate tax avoidance is minimized.**

A number of things can be done to curtail tax avoidance. The most important is the adoption of combined reporting, now mandatory in 17 states, including Kansas, Nebraska, Minnesota and Illinois. Vermont was the most recent state to adopt combined reporting (in 2004) and Texas will become the 18th state when combined reporting is phased in beginning next year. **Combined reporting renders ineffective a variety of loopholes and profit-shifting strategies** — whereby a firm shifts profits to subsidiaries that are not taxed, or taxed at a lower rate — because the profits of the parent firm and its subsidiaries must be combined before calculating state tax liability. Other measures to close corporate income tax loopholes include a better definition of tax nexus so that all firms doing business in Iowa are taxed, 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 versus non-business income.

By closing these tax loopholes that benefit only multi-state corporations, Iowa firms that do business only within the state would be able to compete on an equal footing with multi-state firms. Iowa also needs to disclose the beneficiaries of tax credits so that lawmakers can evaluate which tax breaks actually benefit the state. Without such reforms, revenues will continue to erode and in-state businesses will increasingly be at a competitive disadvantage. More and more firms may decide they can no longer afford to watch their competitors engage in "aggressive tax planning" with impunity, while they continue to pay their full share of the costs of doing business in the state.

This brief is based on the report **Revitalizing Iowa's Corporate Income Tax**, *by Peter Fisher, April 2006. The full report is available on the Iowa Fiscal Partnership web site at: http://www.iowafiscal.org/2006docs/060411-CIT-full.pdf*

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