Leveling the Playing Field

How to Restore Fairness
to Iowa's Corporate Income Tax by Closing Loopholes

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By Peter S. Fisher

Most businesses that pay corporate income taxes in this state are Iowa-based firms, and every year they dutifully pay taxes on all their business income. But increasingly these Iowa firms have found themselves competing against large multistate corporations paying little Iowa tax. These larger firms often have teams of tax lawyers and accountants devising new and better ways to avoid paying taxes in Iowa. As these firms become ever more aggressive in exploiting loopholes in Iowa tax law, the state treasury loses revenue — possibly as much as $100 million per year — and everyone else, including all those Iowa-based firms, has to pick up the tab.

Why are large multistate firms able to avoid taxes that smaller Iowa firms cannot? The short answer is that they can use a variety of devices to shift their profits from Iowa to their operations in other states where that income is not taxable. If all your operations are in Iowa, you can't do that.

This profit-shifting can occur in Iowa because we have "separate entity" filing. By moving to "combined reporting," Iowa would join the 20 states that have already adopted this comprehensive approach to loophole closing, including Nebraska, Kansas, Minnesota and Illinois. Four of the 20 states joined the ranks in the past three years. Combined reporting would level the playing field for small Iowa firms and large multistate companies, and reverse the sharp decline in corporate income tax revenues in Iowa over the past 15 years.[1] Combined reporting would have produced an additional $100 million in corporate income tax revenue in 2002, and $65 million in 2003, almost all of it from non-Iowa corporations.[2]

How the Profit-Shifting Loophole Works

When a firm does business not as a single entity but as a group of affiliated firms and subsidiaries, Iowa law allows the business to consider each affiliate or subsidiary as a separate business. Only an affiliate that has tax "nexus" in Iowa (sufficient business presence to make it subject to state tax) need file an Iowa tax return. This allows a firm to avoid Iowa taxes in two steps. First, it splits its operations into many affiliates with headquarters and operations in different states. Second, it sets up artificial transactions that shift profits from Iowa operations to affiliate corporations that aren't taxable here, thereby avoiding Iowa tax on those profits.

Wal-Mart has drawn national attention recently for its use of profit shifting to avoid millions of dollars in state taxes across the country. Wal-Mart set up an affiliate firm, Wal-Mart Real Estate Business Trust (WMREBT) and transferred ownership of many (possibly most) Wal-Mart stores

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to WMREBT, including many in Iowa. A Wal-Mart store then leases the space from WMREBT. This rental expense is deducted from the store's income, reducing its state income taxes.

Why isn't the income of WMREBT taxable in Iowa, since that firm owns property in Iowa (giving it tax nexus)? Because it is a Real Estate Investment Trust, or REIT; Congress gave REITs a special exemption from federal income taxes, and states have followed suit. The rental income of REITs is exempt from federal and state corporate income taxes no matter where the REIT is located.

The Wal-Mart REIT then distributes its profits as dividends to the shareholders in the REIT, including about 100 Wal-Mart executives. The executives each own only one share in order for Wal-Mart to take advantage of the loophole: The tax exemption was intended to allow small investors to get into real estate, so the REIT must have over 100 members. The vast majority of the shares of WMREBT, however, are owned by a "shell" corporation, Wal-Mart Property, set up by Wal-Mart in Delaware. Delaware doesn't tax intangible income such as dividends received by corporations, so the funds remain tax free. Wal-Mart Property then pays dividends to Wal-Mart Stores East, another Delaware Corporation, which is a 100 percent subsidiary of Wal-Mart Stores Inc., headquartered in Bentonville, Arkansas. This dividend income received by Wal-Mart is also tax free because of another federal (and state) tax provision: Dividends from subsidiaries are exempt from taxation. The Delaware shell corporation is necessary because some states, and the federal government, do tax dividends received directly from REITs. Because Wal-Mart receives them indirectly, they look like regular dividends. It is highly likely that Wal-Mart is using this tax ruse in Iowa, because stores here are owned by WMREBT. [3]

By paying rent to itself, Wal-Mart is able to dodge its state tax responsibility. A portion of store profits that would normally accrue directly to Wal-Mart Stores Inc. in Arkansas is sent (in the guise of rent) on a detour through three shell corporations set up in Delaware. Profits are transformed into dividends received free of state taxes by the parent firm in Bentonville. The states are left with far less Wal-Mart profits to tax. According to a *Wall Street Journal* article, Wal-Mart escaped an estimated $350 million in state taxes over four years through the adoption of the REIT strategy.[4]

Wal-Mart is not the only firm to adopt this strategy, and the loss in state tax revenue has prompted a number of states to try to plug this loophole or pursue legal action to recover taxes owed. Maryland Comptroller Peter Franchot is quoted as saying, "It's an abuse that allows big companies to cheat on state taxes, and it's wrong, so we're going to begin to audit these companies. … These practices are going to no longer be permitted, and we're going to seek to level the playing field for all Maryland businesses."[5]

There are several other devices used to shift profits out of Iowa. To see how three of these work, imagine a manufacturing firm, Apex Corporation, that assembles garden tractors at a plant in Iowa. The engines are made by a subsidiary firm, Baker Co., in the state of Nevada, which has no corporate income tax. The parent corporation of both firms, Cutter Inc., is also located in Nevada.

The first profit-shifting device employed by Cutter relies on inter-company pricing. The engine manufacturer, Baker, sells its gas engines at prices well above market to the Apex garden tractor subsidiary in Iowa. This raises the costs of Apex Corporation, and lowers its reported Iowa profit and hence Iowa income tax. At the same time, the high prices make Baker Co. very profitable, but this firm is not taxable in Iowa and pays no income tax in Nevada. Thus the profits of Apex are transferred to Nevada tax-free through this internal pricing gimmick.

A similar strategy involves management fees. The parent corporation, Cutter, provides managerial consulting services to Apex, for which it charges very high fees. These fees are a deductible expense for Apex, once again lowering its Iowa profits and taxes, shifting them to the parent corporation, which pays no taxes on them in Nevada. The same result can be achieved through loans from the parent corporation to Apex. Apex is charged a high rate of interest on these loans, and that interest is a deductible expense, once again lowering its Iowa profits and Iowa tax, and shifting those profits to the parent firm where they go untaxed.

One of the most notorious devices for shifting profits involves the use of PICs (Passive Investment Companies). Toys 'R' Us stores, for example, set up a subsidiary firm in Delaware called Geoffrey Inc., a shell corporation that does nothing but own the trademark and license it to the retail stores. Geoffrey receives royalties from the stores for use of the name Toys 'R' Us, and these royalties are tax free because Delaware does not tax royalties or other intangible income. Meanwhile, the retail stores show smaller profits because they can deduct the royalty payments as an expense. This shifts profits from the states where the stores are located to Delaware, where they appear as tax free dividends. Numerous firms have used the PIC scheme to avoid millions in state taxes, including many with stores in Iowa (K-Mart, Home Depot, Burger King, Sherwin Williams, Staples, and others). There are thousands of Delaware PICs, and over 130,000 corporations in Nevada with no employees, many of which could be PICs.[6]

Closing the Loophole with Combined Reporting

In 16 states, none of these profit-shifting strategies have worked. These states have had combined reporting for many years. They include four states surrounding Iowa: Nebraska, Kansas, Minnesota and Illinois. Four more states have recently passed legislation to close these loopholes. Combined reporting became effective in Vermont for the 2006 tax year, and in Texas for 2008. West Virginia and New York adopted combined reporting this year, effective in 2009 and 2007, respectively. Bills have been introduced in Maryland and New Mexico in the current legislative sessions and the governors of Michigan, Massachusetts, Pennsylvania and North Carolina, as well as Iowa, have recommended adoption of combined reporting.

Instead of allowing separate-entity filing, these states require all corporations in an affiliated group to combine their income and expenses in calculating their corporate income tax. If Iowa were to adopt combined reporting, all of those profits shifted to the Wal-Mart Real Estate Business Trust or to Baker Corp. or to Geoffrey Inc. would be included, along with all the profits of the corporate affiliate with operations in the state. Then the combined profits would be apportioned to Iowa according to the percent of total company sales transacted in Iowa.[7] Thus inter-company pricing and lending, management fees, trademark leasing, and property renting through an REIT — none of these devices matter because the profits get counted by Iowa anyway.[8]

Combined reporting effectively closes all of these profit-shifting devices, and many future ones companies and their tax lawyers might invent. With combined reporting the state would also save money and staff time devoted to challenging tax returns and taking corporations to court; many of the issues the state ends up litigating would be resolved by combined reporting.

The Iowa Department of Revenue estimated in 1994 that there would have been a minimal gain in revenue in 1992 and 1993 if combined reporting had been in place. But the

department's most recent report shows that an additional $99 million in corporate income tax revenue would have been generated in tax year 2002 if combined reporting had been in effect, and $62 million in tax year 2003.[9] In both years, 99 percent of the increased revenue would have come from non-Iowa firms (that is, firms headquartered outside Iowa). In both years, 75 percent of businesses filing an Iowa corporate tax return would have been unaffected by combined reporting.

Objections to Combined Reporting

Some will argue that the shift to combined reporting amounts to a tax increase, and that higher business taxes will hinder economic development. There are several problems with this argument. First, combined reporting is more accurately described as a method of restoring tax levels to where they were before aggressive corporate "tax planning" began in earnest to erode revenues. The corporations whose tax liabilities will be affected the most are those who have been using profit shifting gimmicks to avoid Iowa taxes. The vast majority of firms filing an Iowa return are unaffected by combined reporting. In fact, local downtown businesses in Iowa that may have to compete with companies like Wal-Mart likely would benefit from combined reporting, since they would be on a more even playing field. Some firms will even pay less in taxes.[10]

Second, state corporate income taxes are a very small part of the cost of doing business in a state and have little to do with where businesses expand, as has been well-documented elsewhere.[11] Third, it hardly seems fair to the majority of corporate income-tax payers that must pay tax on all their income to promote an economic development strategy that amounts to posting signs at Iowa's borders saying, "Welcome, Multistate Corporations: Cheat on Your Taxes Here."

Finally, combined-reporting states have, in fact, done well economically. California has the longest history with combined reporting (60 years), and an economic growth rate over that period that would be the envy of many states, including Iowa. If we look at states with a corporate income tax, only 10 of them have experienced positive growth in manufacturing employment over the past 15 years, and nine of those 10 were combined-reporting states.[12]

Opponents of combined reporting often argue that Florida adopted it, and then repealed it because it was economically harmful to the state. What they do not mention is that Florida's version of combined reporting was quite different from that adopted by all other states.[13] Furthermore, it was abandoned because of intense political pressure from the Reagan administration, and before it could have had any effects on the economy one way or the other.

Some argue that Iowa has a perception problem when it comes to the corporate income tax: We have the highest top tax rate in the country (12 percent). Despite this, the effective corporate rate is actually quite low because of federal deductibility and single-factor apportionment. Iowa ranks almost last among the states in corporate income taxes as a percent of state business activity.[14] A portion of the revenue gain from combined reporting could be used to lower the top rate, so that the perception of corporate tax levels in Iowa is brought into line with the reality – or it could be used to lower taxes on hard-working Iowa families who are much more in need of tax relief than multistate corporations.[15]

Conclusions

Combined reporting would level the playing field, taxing both the small Iowa firm and the large, multistate corporation on all income earned in Iowa. It would go a long way to restoring the corporate income tax in Iowa to its position as a significant revenue source, and would prevent further erosion of the tax as more and more companies aggressively pursue tax avoidance strategies. By discouraging such strategies, combined reporting also would enhance enforcement efforts by the Department of Revenue.

Governor Culver and Governor Vilsack before him both have recognized the need for corporate income tax reform and called for combined reporting. The General Assembly should consider making this part of its tax reform efforts.

[1] Peter Fisher, “Revitalizing Iowa’s Corporate Income Tax,” Iowa Fiscal Partnership, April 2006.
[2] Jay Munson, “Combined Reporting: An Option for Apportioning Iowa Corporate Income Tax,” Iowa Department of Revenue, March 2007.
[3] A spot check of county property tax records for 18 Iowa Wal-Mart stores found that all but two were listed as owned by Wal-Mart Real Estate Business Trust, with an address of 1301 SE 10th St., Bentonville, Arkansas. This is the principal place of business, even though the trust is incorporated in Delaware. The other two owners were listed as Wal-Mart Stores and Wal-Mart Realty Co, but with the same address as WMREBT (whereas Wal Mart Stores Inc., the corporate headquarters, is at 702 SW 8th St., Bentonville). At least one Wal-Mart store in Iowa, the supercenter in Oskaloosa, is operated by Wal-Mart Stores East, and probably most or even all are. It seems a safe presumption that Wal-Mart has transferred ownership of its Iowa properties to WMRBT for the purposes of avoiding state taxes.
[4] Jesse Drucker, “Wal-Mart Cuts Taxes by Paying Rent to Itself,” The Wall Street Journal, Feb. 5, 2007.
[5] Tricia Bishop, “Franchot to change policy on REIT rents,” Baltimore Sun, March 6, 2007.
[6] Michael Mazerov, “Growing Number of States Considering a Key Corporate Tax Reform.” Washington, D.C.: Center on Budget and Policy Priorities, April 5, 2007.
[7] Iowa, as do all states with a corporate income tax, uses a formula to apportion the income of a multistate business to Iowa, to determine the share of the firm’s total profit that is Iowa taxable income. Iowa apportions income entirely on the basis of sales. If 25 percent of a firm’s sales are destined to Iowa, then 25 percent of that firm’s profits are taxed in Iowa.
[8] If there are foreign affiliates in the group of firms, the dividends from the foreign affiliate would not be counted. Combined reporting as practiced by 17 U.S. states means “waters edge,” not worldwide, combined reporting.
[9] Jay Munson, “Combined Reporting: An Option for Apportioning Iowa Corporate Income Tax,” Iowa Department of Revenue, March, 2007.
[10] Corporations that have an out-of-state affiliate that is losing money could end up paying less Iowa tax if the affiliate must be included under combined reporting.
[11] See, for example, Peter Fisher and Elaine Ditsler, “Taxes and State Economic Growth: The Myths and the Reality,” Iowa Policy Project, May 2003; Robert Lynch, Rethinking Growth Strategies : How State and Local Taxes and Services Affect Economic Development, Economic Policy Institute, 2004.
[12] Michael Mazerov, “Growing Number of States Considering a Key Corporate Tax Reform.” Washington, D.C.: Center on Budget and Policy Priorities, April 5, 2007.
[13] Florida adopted worldwide combined reporting, not “waters edge” combined reporting that combines only U.S. affiliates.
[14] Peter Fisher, “Falling Below Average: Why Iowa Taxes Are Competitive,” Iowa Fiscal Partnership, February 2007.
[15] See the IFP backgrounder, “Next Piece of the Puzzle: After Minimum Wage, Iowa Looks at Earned Income Tax Credit,” March 2007.

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

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