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Loopholes Cheat Iowa Out of Millions Each Year

By Peter S. Fisher

Most businesses that pay corporate income taxes in Iowa are smaller, Iowa-based firms that every year dutifully pay taxes on all their business income. But increasingly these firms find themselves competing against large, multi-state corporations paying little Iowa tax.

As large corporations become ever more aggressive in exploiting loopholes in Iowa tax law, the state loses revenue - \$50 million to \$100 million per year - and everyone else, including thousands of smaller Iowa firms, has to pick up the tab.

Multi-state firms can avoid taxes through a variety of devices that shift profits from Iowa to states where that income is not taxable. If all your operations are in Iowa, you can't do that.

Wal-Mart has drawn national attention recently for its use of profit shifting to avoid millions of dollars in state taxes across the country by creating a Real Estate Investment Trust, or REIT.

Wal-Mart is not the only firm to adopt this device, and the loss of tax revenue has prompted a number of states to try to plug this loophole or pursue legal action to recover taxes owed.

Several other devices are used to shift profits out of Iowa. One of the most notorious involves the use of passive investment companies.

In that strategy, a shell corporation is set up in Delaware to own a trademark or store name. The Iowa stores pay the passive investment company a royalty for use of the name, then deduct the royalty as a business expense and reduce their Iowa tax. The royalties are not taxed in Delaware.

In 16 states, none of these profit-shifting strategies work because these states require "combined reporting." All corporations in an affiliated group must combine their income and expenses in calculating their income tax.

In one form or another, all the profits of the various affiliates end up as part of the corporate group's profits. Then a share of the combined profits is assigned to the state according to the percent of total company business conducted in that state.

Four of the 16 combined-reporting states are Iowa neighbors: Nebraska, Kansas, Minnesota and Illinois. Four more states will soon close these loopholes as well: Vermont, Texas, West Virginia and New York. It is time for Iowa to join these states.

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The Iowa Department of Revenue has found this change would boost revenues and not harm Iowa-based businesses:

- 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.

- In both years, 99 percent of the increased revenue would have come from firms headquartered outside the state.

Combined reporting would level the playing field, taxing both the small Iowa firm and the 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.

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