ISSUE REVIEW

Iowa Legislative Services Agency
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Iowa Corporate Income Tax Revenue

ISSUE

In FY 1999, the General Fund received $250.6 million in net corporate income tax revenue. For FY 2003, the total was $145.0 million. The current Revenue Estimating Conference (REC) estimate for FY 2004 net corporate income tax receipts is $61.7 million, a 75.4% reduction compared to the FY 1999 level. This ***Issue Review*** explores potential explanations for the revenue decrease.

BACKGROUND

Iowa's corporate tax laws are found in Chapter 422, Division III, Code of Iowa. Corporate tax credits can also be found in other portions of the Code of Iowa.[1] Major provisions of Iowa's current corporate tax laws include:

- Certain types of corporate structures, such as Subchapter S, partnerships, and limited liability companies are allowed to have the corporation income taxed as personal income.[2]
- To be subject to Iowa corporate tax, a company must have a sufficient connection (nexus) to the State of Iowa. A company that does not have a location (or other sufficient connection) in Iowa but does sell to Iowan's would not be subject to Iowa corporate tax.
- Corporations with nexus are only taxed on the portion of their income attributed to sales and other business activity in Iowa (single sales factor).[3] A company located in Iowa with all of its sales in Iowa computes their tax based on all revenue. A company located in Iowa with no sales in Iowa pays no Iowa corporate income tax. Other companies apportion their net revenue to Iowa based on their Iowa sales.

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[1] For instance, see Section 15.326 for the New Jobs and Income Program and Section 15E.196 for Enterprise Zone incentives.
[2] Tax revenue from corporate profits taxed as ordinary personal income is not included in the financial analysis contained in this ***Issue Review***.
[3] Other states use differing factors, including payroll and property owned within the state.

- Iowa does not require combined reporting for affiliated corporations. That is, a larger corporation made up of smaller companies would only be taxed on the Iowa revenue associated with each of the smaller companies with Iowa nexus.
- Iowa applies a graduated tax rate to a company's net income. The rate ranges from 6.0% of the first $25,000 of net income to 12.0% of net income over $250,000.
- Negative net income (net operating losses) from one tax year may be carried back two tax years and carried forward 20 tax years, or until exhausted.
- Tax liability can be reduced by tax credits. Significant corporate tax credits include:
  - Research Activities Credit: The research activities credit is equal to 6.5% of qualified research expenditures. The credit is allowed for the portion of the company's research expenditures that can be apportioned to Iowa. This tax credit is refundable in the year claimed, meaning companies receive tax refunds if tax liability does not exceed the value of the credit.
  - Bonus Research Activities Credit: Companies approved for the New Jobs and Income Program (NJIP), the Quality Jobs Zone (IPSCO), or located in an Enterprise Zone qualify for a second 6.5% credit in addition to the original credit. The entire 13.0% credit is refundable.
  - New Jobs Credit: Companies entering into an agreement with an Iowa community college under Chapter 260E, Code of Iowa, receive a one-time credit of 6.0% of a specified wage base for qualified, newly created positions. In 2003, the credit was equal to $1,152 per new job. The credit is not refundable but unused credits may carry forward up to 10 years.
  - Investment Tax Credit: Enterprise Zone and NJIP approved companies may receive a tax credit equal to 10.0% of the new investment related to job creation. The credit is not refundable but may be used over the next seven fiscal years.

CURRENT SITUATION

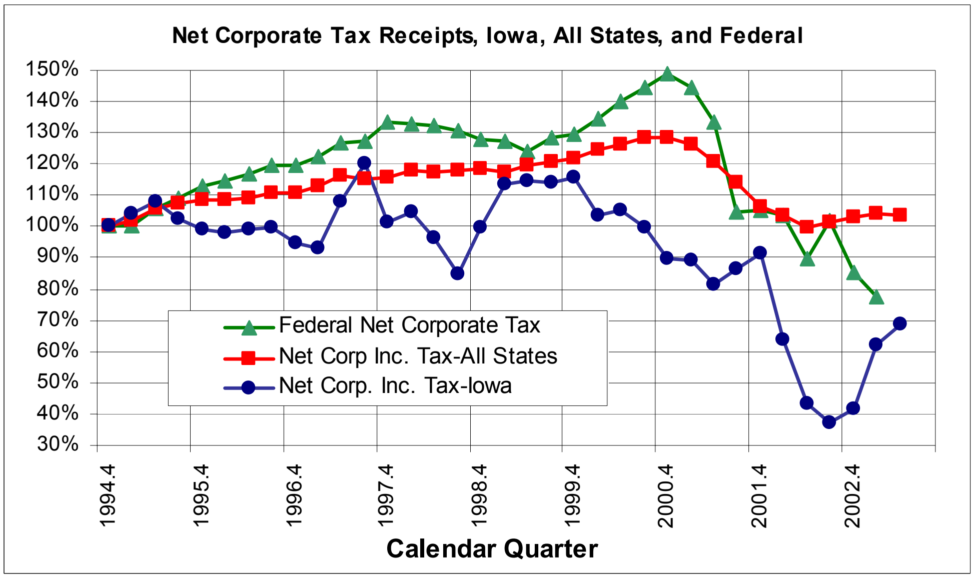
Net corporate income tax revenues have been decreasing since FY 1999 and the current REC estimate for FY 2004 is $188.9 million below the $250.6 million received in FY 1999. The following table provides the revenue history on a fiscal year basis.

Iowa Net Corporate Tax Revenue

Millions of Dollars

	Tax Receipts	Tax Refunds	Net Tax Revenue
FY 1996	$290.2	$55.5	$234.7
FY 1997	307.1	67.5	239.6
FY 1998	291.0	75.0	216.0
FY 1999	322.2	71.6	250.6
FY 2000	331.2	92.5	238.7
FY 2001	276.8	93.1	183.7
FY 2002	234.2	117.1	117.1
FY 2003	221.2	76.3	145.0
FY 2004 Est.	180.1	118.4	61.7

According to the National Bureau of Economic Research, the United States economy was in recession from March 2001 to November 2001. The recession contributed to the reduction in Iowa corporate taxes and loss carry-forward and carry-back provisions could also have contributed to revenue weakness since 2001. However, a revenue reduction due to reduced economic activity and the resulting fiscal "hangover" would not be Iowa specific; that is, national and other-state corporate tax revenue should also be impacted along with Iowa revenue. The following graph shows the change in corporate tax receipts over the last eight and one-half calendar years.[4] The graph is based on net revenue for the four quarters ending December 1994.



For each of the three data series, a line represents the percentage change in revenue compared to the January to December 1994 timeframe. For instance, federal net corporate tax revenue for the four quarters ending December 2000 was $211.4 billion, 149.0% of the amount ($141.9 billion) received during the four quarters ending December 1994. In comparison, state net corporate tax revenue for all states was 128.5% and Iowa net corporate tax revenue was 89.9% of the 1994 level.

The graph lines generally track together from the first quarter displayed (1994.4) through the fourth calendar quarter of 1999 (1999.4). Starting from that point:

- Federal tax revenue growth accelerated for one year (2000) and then exhibited softening in the first two quarters of 2001. A sharp drop in the third quarter of 2001 corresponds with the events of September 11, 2001. A significant drop in revenue after March 2002 is likely due to federal tax law changes related to new investment depreciation (bonus depreciation).
- Corporate tax revenue across all states also shows revenue acceleration in 2000 and a softening in 2001. The dip bottomed in June 2002 and there has been a small amount of growth since that time.
- Corporate tax revenues for Iowa fell noticeably in 2000, mildly in 2001, and significantly in 2002. The small increase shown at 2001.4 and the more significant growth shown over the

[4] The source for state tax data is the U.S. Census Bureau. The source for federal tax data is the U.S. Internal Revenue Service. The latest information is from the quarter ending June 2003.

final three quarters (ending June 2003) do not represent real growth, but instead are periods where few Iowa corporate tax refunds were issued.[5]

BUDGET IMPACT

Understanding the last five years of Iowa corporate tax revenue is a significant General Fund issue. If revenue has decreased due to transient economic conditions and other one-time factors, the annual revenue level could return to the $250.0 million range over the next few fiscal years. If, however, the long revenue slide is due to changes in how corporations allocate revenues and expenditures to the State of Iowa, or to how corporate tax credits are being utilized, the previous higher revenue levels may not return.

ANALYSIS

The 2001 recession no doubt played a large part in the significant drop in Iowa corporate income tax revenue. But as the previous graph depicts, the drop in Iowa revenue started one year prior to the drop in federal and all-state corporate tax receipts and the Iowa drop came when the other two showed sizable increases. It is quite possible other factors have been working to lower Iowa corporate tax revenue. Some of those factors include:

- Greater use of corporate tax credits: In the past several years, Iowa has created an additional economic development program called Enterprise Zones. Enterprise Zones provide enhanced tax benefits to companies that locate within designated areas of the state. The benefits include a bonus 6.5% refundable research activities credit and a 10.0% investment tax credit.
- Incorrect Fiscal Note assumptions: Since tax year 1994, Fiscal Notes have identified roughly $20.0 to $40.0 million in annual corporate tax credit costs associated with enacted legislation. It is possible the estimate process did not properly identify all of the costs associated with the tax law changes.
- Iowa population: Census Bureau estimates show Iowa's population, while growing, is lagging in percent growth when compared to the national average. Since Iowa and most other states use sales within the state as a factor in determining corporate tax liability, Iowa's slow population growth could result in lower corporate tax growth when compared to the rest of the states.
- Out-of-state purchases: As technologies such as the Internet expand, Iowans have more opportunities to purchase goods and services from out-of-state providers. Those providers may not have a tax nexus to Iowa, so the net income from those sales would not generate corporate tax revenue for the state.
- Corporate tax structure changes: New corporations may not be forming as the traditional "C-corporation" but may be forming instead as "S-Corporations," limited liability companies, etc., where the corporate profits are taxed as individual income. Additionally, previously existing C-corporations may be switching to another tax status.

[5] Over the past several years, there have been several periods when little or no corporate tax refunds were issued, followed by a period of significant refunds. The Net Corporate Tax Receipts graph ends with June 2003. Significant refunds have been issued since that time and a graph including the two quarters ending December 2003 will show a significant downturn in the Iowa line.

- Corporate accounting changes. Corporations may have developed more sophisticated corporate structures designed to shield company profits from state corporate income tax. For instance, one company within a larger corporation may hold the licensing and patent assets of the corporate group and may charge the retail entity of the corporation a large fee for using these assets. The retail organization may operate in all states, but the asset-holding company is located in a state without corporate taxes. The asset fee essentially makes the retail portion of the larger corporation unprofitable, and therefore, not taxable by the individual states.
- Corporate acquisitions: Out-of-state corporations may acquire traditionally profitable Iowa companies and the combined corporate structure may be such as to produce little or no net corporate taxable income. If there is no net taxable income, the fact that significant sales are made in Iowa will still not produce tax liability.

RECOMMENDATIONS

To properly understand the economic and demographic forces working to decrease Iowa corporate income tax, the General Assembly may wish to:

- Request that the Department of Revenue complete an in-depth analysis of the various factors influencing corporate tax revenue.
- Ensure through legislative action or through the Comprehensive Annual Financial Report (CAFR) process that the Department of Revenue issue all refund checks in a timely manner and in compliance with proper accounting principles.
- Establish a formal procedure to track and report tax credits awarded as business and development incentives by various state agencies. There is currently no mechanism for tracking the award and use of most corporate tax incentives.

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http://staffweb.legis.state.ia.us/lfb/ireview/ireview.htm
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