FINAL REPORT

BUSINESS TAXATION STUDY COMMITTEE

Presented to the Legislative Council
and the Iowa General Assembly
February 1996

Prepared by the Legislative Service Bureau

Legislative Service Bureau

FINAL REPORT

Business Taxation Study Committee

February 1996

MEMBERS

Senator Tom Vilsack, Co-chairperson
Senator Tom Flynn
Senator Mary Lou Freeman
Senator William Palmer
Senator Donald Redfern

Representative Roger Halvorson, Co-chairperson
Representative Dwight Dinkla
Representative Chuck Larson
Representative Richard Myers
Representative Don Shoultz

Contents

Staff Contacts

Michael J. Goedert, Senior Legal Counsel
(515) 281-3922

Susan Crowley, Legal Counsel
(515) 281-3430

AUTHORIZATION AND APPOINTMENT

The Business Taxation Study Committee was established for the 1995 legislative interim by the Legislative Council and charged to "review taxation of all businesses in Iowa including sole proprietorships, partnerships, limited liability companies, Subchapter S corporations, and C-Corporations. Analyze tax equity, taxation incentives and disincentives for economic development and the long-term objectives of business taxation. The interim committee may spend up to $100,000 for a consultant. The Committee shall hold one meeting with the Nonbusiness Taxation Study Committee and make joint contributions."

1. Committee Proceedings.

The Study Committee was authorized four meeting days. The Study Committee completed its work without need for the fourth meeting day. The meetings were held at the State Capitol Building in Des Moines on October 12, 1995, November 17, 1995, and December 13, 1995. The October meeting was the joint meeting with the Nonbusiness State Taxation Study Committee.

2. October 12, 1995, Meeting.

The first of the three meetings of the Business Taxation Study Committee was held jointly with the Nonbusiness Taxation Study Committee on Thursday, October 12, 1995. The Committee heard testimony and had discussion on the following:

a. **Machinery & Equipment (M&E) Taxes.** David Lyons, Director, Department of Economic Development (DED), presented the status of the taxes on M&E as a result of Senate File 69, enacted in the 1995 Legislative Session. One concern involves the possibility of the base in tax increment financing (TIF) districts being reduced as a result of any reduction in M&E values. Language is being developed by interested parties to remedy this concern. Another concern relates to the method used in determining the amount of state replacement of lost taxes a result of reduction in M&E values.

b. **Rollback of Property Values.** Gene Eich, Department of Revenue and Finance (DoRF), and Ed Stachovic, Mayor of Cedar Falls, discussed the property tax rollback provisions. They focused on the limitation that agricultural property or residential property valuation does not increase by a higher percent than the increase in the other. They also discussed the effect this has on shifting the burden of property taxes and the possible side effect on economic development. The mayor emphasized the need to "uncouple" residential valuation increases from agricultural valuation increases.

c. **Federal Budget and Tax Law.** Lorin Knapp of DoRF stated that spending authority is likely to be enacted through an omnibus reconciliation bill. The Tax Simplification Act of 1995 is likely to be combined with the Revenue Reconciliation Act of 1995 and the Taxpayer Bill of Rights 2 as part of the omnibus reconciliation package. Some of the provisions of the two tax bills include: allowing for medical savings account deductions; corporation use of "excess" pension balance for limited purposes subject to an excise tax; restrictions on earned income tax credit; simplification of subchapter S corporation and partnership classification; simplification of pension plan requirements and restrictions; and extension of certain expiring tax credits or deductions.

d. **Property Tax Credits and Exemptions.** Will Ament, President, Iowa State Assessors Association, described a survey that was conducted on assessor views relating to property tax credits and exemptions. Mr. Marvin Diemer opined that property tax exemptions for nonprofit retirement homes which house high-income retirees are unfair.

e. **Tax Policy.** Both James Wengert, President, Iowa Federation of Labor, AFL-CIO, and Bill Smith, Iowa Tax Reform Action Coalition, stated that Iowa's tax policy is unfair because it is a regressive tax system. They identified changes that have been made which did not make the overall taxes less regressive and changes that have been proposed that would result in less progressivity.

f. **Franchise Tax.** John Sorensen, representing the Iowa Bankers Association, provided background on the state's franchise tax (a tax on financial institutions for doing business in the state) and provided a comparison of Iowa's tax to surrounding states. He also spoke of issues that would impact the future of financial services taxation, such as the use of automatic teller machines (ATMs), telephone and other home banking services, services being offered by INTERNET, and the elimination of restrictions on interstate banking and branch banking and the resulting fast pace of mergers and acquisitions.

3. November 12, 1995, Meeting.

The second of the three meeting of the Business Taxation Study Committee was held on Friday, November 17, 1995. The Committee heard testimony and had discussion on the following:

a. **Credit Unions.** Pat Jury, Vice President, Iowa Credit Union League, reviewed the tax status of credit unions, their makeup, and the difference between credit unions and banks.

b. **Alcoholic Beverages.** Claudia Brewington, Area Director, Distilled Spirits Council of the U.S., compared the retail price of alcoholic beverages sold in Iowa and surrounding states, speculated on the amount of purchases of the beverages outside of Iowa and the resulting loss in state revenues, and discussed what the effects would be if the amount of the state mandatory markup on alcoholic beverages were to be reduced.

c. **Telephone Companies.** Chris Zamora, Property Tax Manager, U.S. West, discussed the disadvantage and unfairness of the present method of assessing local telephone companies in comparison with the assessment method for other telecommunications companies. The emphasis was on the impact of the rapid change in the telecommunications industry and lack of corresponding change in the method of valuing property for property taxation.

d. **Unemployment Compensation.** Pat Sampson, Legislative Liaison, Department of Employment Services, updated the Committee on the positive fiscal status of Iowa's unemployment compensation fund.

e. **Machinery and Equipment Taxation.** David Lyons, Director, Department of Economic Development, distributed and commented briefly on proposed changes to Senate File 69 enacted in the 1995 Session, providing for full or partial exemption from property taxation of machinery, equipment and computers. The language changes were developed by the Departments of Economic Development and Revenue and Finance, bond counsels, and local units of government.

f. **Venture Capital.** Gregg Barcus, Iowa Seed Capital Corporation; Holmes Foster, representing a proposed qualified venture capital company; and Kent Sovern, Greater Des Moines Chamber of Commerce, discussed the need for venture capital in the state, especially for the early phases of a company's start, e.g., its inception and first two years. Comment was made on the workings of the Iowa Seed Capital Company and a qualified venture capital company as envisioned in Senate File 156 passed by the Senate in 1995 and now in the House Ways and Means Committee.

g. **Federal Changes.** Representatives of the Department of Revenue and Finance provided a federal tax update with emphasis on business tax changes, reported on the recent decline in franchise tax revenues, and reviewed subchapter S corporation changes proposed by the U.S. Congress.

h. **Subchapter S Corporations.** John Lisle, Lisle Corporation; Ike Leighty, Engineered Products Co.; Tom Seiders, McGladrey and Pullen; Dave Mulcahy, a private investor; and Fred Weitz, Des Moines Development Corp., individually discussed the disincentives and hardships that subchapter S companies located in Iowa incur. It was explained that the state taxes the shareholder's share of the profits, whether those profits are distributed to the shareholders or are invested in the company. It was suggested a better approach would be to apportion shareholder income subject to immediate tax the same as regular corporations. This would result in a deferral of state tax until the time the profits are actually distributed, provided the shareholder is still an Iowa resident.

4. December 13, 1995, Meeting.

The last of the three meetings of the Business Taxation Study Committee was held on Wednesday, December 13, 1995. The Committee heard from the following consultants and made recommendations:

a. **State Competitiveness.** Professor William Oakland, Department of Economics, Tulane University, made a presentation on a study in which he participated, which compares the business taxes of states in the Federal Reserve Board Seventh District, which includes Iowa. Professor Oakland explained the following criteria used in judging a business tax system:

(1) Neutrality among economic activities to avoid antidevelopment bias.

(2) Promotion of a sound expenditure policy.

(3) Tax cost spread fairly.

(4) Tax burden exported.

(5) Sharing of natural resource wealth promoted.

b. **Distribution of Business Taxes.** Professor Oakland stated that of all the business taxes imposed on businesses in Iowa, the property tax is the single most important tax, accounting for 55 percent of all business tax revenues. It was acknowledged that the figures used for the study were from 1992 and, therefore, do not reflect the phaseout of the property tax on industrial machinery, equipment, and computers enacted in Senate File 69 during the 1995 legislative session. In 1992, the distribution of Iowa business taxes by major tax source was as follows:

(1)	Sales tax	11 percent
(2)	Corporate income tax	11 percent
(3)	Property tax	55 percent
(4)	Unemployment tax	8 percent
(5)	Motor fuel taxes	7 percent
(6)	Other	8 percent

c. **Distribution Among Businesses.** Professor Oakland expressed concern that the corporate income tax burden may not be fairly distributed among corporations. In 1992, while 17,606 corporations had Iowa corporate income tax liability, 19,965 did not. Professor Oakland stated that he does not favor previously proposed changes to Iowa taxation of subchapter S corporation shareholders because the changes could negatively impact the personal income tax system.

d. **Business Payroll Tax.** During the course of his presentation, Professor Oakland recommended that Iowa enact a payroll tax on business. The effect of this, he said, would be to allow the state to more heavily tax the service industry, which is one of the fastest growing sectors of Iowa's economy and of the national economy, as well. A payroll tax rate as small as three-fourths of 1 percent would amount to a prodigious amount of revenue, Professor Oakland noted. Second, he proposed a repeal of sales taxes on business inputs. Taxing business purchases is not useful because the cost gets passed on to the consumer, anyway; and it prevents business from making some capital investments. Third, Professor Oakland recommended that the state provide businesses with some type of property tax relief.

e. **Taxation of Business.** Professor Tom Pogue of the Department of Economics at the University of Iowa also made a presentation on Iowa's business tax system. Professor Pogue stated that the policy principle governing business taxation should be to collect business tax revenue with minimal impact on private sector efficiency. Decisions made by businesses should not be impacted by tax systems, he said. Businesses should be able to locate where they can operate most efficiently and at least cost. Professor Pogue also stated that taxes should not deter businesses from locating in Iowa when an Iowa location is the location where the business can operate most efficiently. Professor Pogue expressed concern that there is a bias in Iowa's property tax system because commercial property is taxed more heavily than other classes and that may be impacting adversely on decisions being made by Iowa businesses. When property taxes are lowered, the market value of the property tends to increase because there is a corresponding increase in the profit margin of the property. Professor Pogue also noted that the trend in Iowa has been to reduce the property tax burden of businesses.

f. **Tax Incentives for Businesses.** Professor Pogue also discouraged the use of tax incentives for businesses because they tend to encourage, through government subsidization, an inefficient means of production and inefficient business locations. He stated that government is not particularly adept at determining in what sector of the economy demand and profits will be. In general, he said, tax incentives tend to make more profitable a company that would have located in Iowa anyway.

g. **Taxation Trends.** Professor Pogue noted that Iowa's tax system is evolving into one that relies heavily on taxation of sales and wages, which reduces the opportunity for the state to export taxes. Also, more and more of the property tax is being paid by fewer people. These trends need to be reversed where possible, he said. He also recommended that Iowa must reduce its tax complexity and increase its stability and predictability because businesses are reluctant to make investments and other long-term commitments when tax laws are subject to frequent change.

5. Recommendations.

The Committee adopted the following recommendations:

a. Consider changes to Senate File 69, enacted during the 1995 session, relating to the property taxation of machinery and equipment (M&E) located in tax increment financing areas which were proffered to the Committee by the Department of Economic Development at an earlier meeting. The changes include clarifying the sales tax provision of the Code which exempts payment of sales tax on the purchase of M&E; requiring a business or employer as part of a new jobs training agreement to notify the assessor of what property will be affected; and clarifying the allocation of lost value in an urban renewal area due to the phase-out of the tax on M&E.

b. Consider increasing venture capital opportunities for Iowa small businesses.

c. Consider including in any subchapter S taxation revision the following: apportionment of losses in addition to gains, taxation of deferred income if the shareholder moves out-of-state, limitation on the amount of tax relief necessary until the state has more information about the costs of changes and about federal tax law changes, and limiting changes to those subchapter S corporations that are value-added concerns, rather than professional S corporations.

6. Materials Distributed to the Committee.

a. Procedural rules adopted by each Committee.

b. Memorandum submitted by Mr. Mike Ralston, Iowa Taxpayers Association.

c. Fact Sheet submitted by Mr. Kent Sovern, Greater Des Moines Chamber of Commerce.

d. *Mr. David Lyons - Machinery and Equipment Exemption Recommendations.*

e. Mr. Lorin Knapp - Status of Federal Tax Legislation.

f. Mr. Gene Eich - Property Tax Rollback.

g. Mayor Stachovic and the Iowa League of Cities - Written Testimony and Figures on Property Tax Rollback.

h. Mr. Marvin Diemer - Tax-Exempt Property Articles.

i. Mr. Jim Wengert - Written Testimony.

j. *Mr. John Sorensen - Written Testimony and Figures on Taxation of Financial Institutions.*

k. *Mr. Bill Smith - Written Testimony.*

l. Written testimony of Mr. Pat Jury, Iowa Credit Union League.

m. Illustrations re alcoholic beverage markup nationwide and in states surrounding Iowa -- Distilled Spirits Council of U.S.

n. Memorandum on "liquor leakage" from Iowa prepared by the Alcoholic Beverages Division of the Iowa Department of Commerce.

o. Written testimony of Mr. Chris Zamora, U.S. West Inc.

p. Summary report on the status of Iowa's Unemployment Compensation Fund for 1995 submitted by the Department of Employment Services.

q. Memorandum entitled "Venture Capital in Iowa" submitted by Mr. Holmes Foster.

r. Fact sheet on venture capital in Iowa submitted by the Greater Des Moines Chamber of Commerce Federation.

s. Summary of franchise tax receipts for calendar years 1992 to 1995 submitted by the Department of Revenue and Finance.

t. Summary of subchapter S corporation federal reform legislation submitted by the Department of Revenue and Finance.

u. Informational memorandum on subchapter S tax filings in Iowa submitted by the Department of Revenue and Finance.

v. Narrative of State Competitiveness Presentation. Submitted by Professor William Oakland, Department of Economics, Tulane University.

w. Chart Indicating Shares of State-Local Expenditures Attributable to Businesses and Households, FY 1992. Submitted by Professor William Oakland, Department of Economics, Tulane University.

x. Chart Indicating 1992 Business Tax Receipts by Type of Tax. Submitted by Professor William Oakland, Department of Economics, Tulane University.

y. Summary of Taxation of Business Presentation. Submitted by Professor Tom Pogue, Department of Economics, University of Iowa.

3074IC