IOWA
TAX REFORM OPTIONS

BUILDING A TAX SYSTEM FOR THE 21ST CENTURY

TAX FOUNDATION

FUTURE of IOWA FOUNDATION

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BUILDING A TAX SYSTEM
FOR THE 21ST CENTURY

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INTRODUCTION AND EXECUTIVE SUMMARY

Introduction & Executive Summary

Iowa is strongly positioned for success. An Iowa businessman with whom we spoke put it best: while South Dakota's competitive advantage is its overall tax climate, and Nebraska's advantage is its generous credits, Iowa's competitive advantage is its people. Tax structures can be tweaked; building up human capital is far harder. The state boasts a dedicated and talented workforce. What remains is to implement a tax structure that can unleash the energy, creativity, and ambition of hard-working Iowans into a force to be reckoned with, in the region and across the country.

That is the theme of this book.

In the following pages, we examine Iowa's economy, detail the state's existing tax structure, and offer recommendations for reforming the tax code. We seek to identify what Iowa does well and to point out opportunities for improvement. Underlying our analysis is the goal of enhancing Iowa's competitive standing and a commitment to the principles of sound tax policy—that, to the greatest extent possible, taxes should be simple, transparent, neutral, and stable, and that the best tax structures are those with broad bases and low rates.

In the course of our research, we poured over Iowa's tax code, dusted off old tax studies, reviewed the economic literature, and examined successful reforms implemented by other states. First and foremost, however, we talked to Iowans—state and local government officials, business leaders, and everyday taxpayers alike. The insights and perspectives of those who actually interact with Iowa's tax system inform every page of this book.

In the following pages, we provide background on Iowa's economy and overall fiscal system (Chapter 1). We then review each major tax, outline concerns, and propose options for reform (Chapters 2, 3, 4, and 5). Chapter 6 examines additional tax considerations that fall outside of the four major tax types.

The Future of Iowa Foundation commissioned the Tax Foundation to prepare this review of the Iowa tax system and recommend possible solutions, and this book is the result. While they supported our study, they did not direct this or any of our recommendations. We offer our thanks to the many Iowans of all walks of life who met with us as we worked on this book.

A Menu of Tax Reform Solutions

Individual Income Tax

Our individual income tax solutions improve the tax code by broadening the tax base and reducing tax rates, making the state more competitive with its neighbors and rendering the system more neutral and fair. Iowa's present system of high, progressive taxation, partially countered by federal deductibility, is inefficient and inequitable, and the misleadingly high resultant rates hinder the state's ability to attract new residents. Each of our proposals address these concerns.

Enhancing tax neutrality. Iowa's individual income tax consistently fails to treat taxpayers evenhandedly. Our solutions for improving neutrality would:

- Double bracket widths for married filers, replacing the existing option for married couples to file separately on the same return.
- Repeal the alternative minimum tax, which imposes high compliance costs but only generated $9.9 million in tax year 2013.
- Adopt permanent conformity to federal Section 179 expensing levels to offer greater certainty for farmers and small business owners.

Rolling back business incentives. Pass-through businesses, which remit individual rather than corporate income taxes, claimed nearly $117 million in individual income tax credits in 2013, many of them pure preferences or business incentives. These credits erode the tax base while providing little economic benefit. Accordingly, our solutions would:

- Eliminate most or all business tax credits other than the S Corporation Apportionment Credit.
- Use the revenue associated with credit elimination to reduce individual income tax rates.

Lowering rates and repealing federal deductibility. Iowa's rates are anomalously high, creating "sticker shock." Federal deductibility introduces a range of unintended consequences which undermine the state's competitiveness. Consequently, we offer a menu of options for broad-based reform, all of which include, at minimum, the repeal of federal deductibility and the elimination of the alternative minimum tax:

- Repeal federal deductibility, offset on a revenue neutral basis by an across-the-board rate cut of 20 percent, yielding a new top marginal rate of 7.2 percent.
- Repeal federal deductibility and adopt a 5.8 percent flat tax coupled with a $10,000 standard deduction on a revenue neutral basis.
- Repeal federal deductibility and adopt a 5.3 percent flat tax on a revenue neutral basis.
- Repeal federal deductibility, eliminate all business credits, and adopt a 5.15 percent flat tax on a revenue neutral basis.

- Repeal federal deductibility, eliminate all business credits, and adopt a 4.0 percent flat tax, with an attendant reduction in revenue of about $200 million.
- Repeal federal deductibility, eliminate all business credits, adopt a 4.0 percent flat tax, and implement a $25,000 standard deduction, for a tax cut of $1.9 billion.
- Repeal federal deductibility, eliminate all business credits, modestly raise the standard deduction and personal exemption, and consolidate the existing nine-bracket system into two rates of 4.3 percent and 6.5 percent on a revenue neutral basis.

Corporate Income Tax

Iowa's 12 percent top marginal rate gives the state—at least on paper—the highest corporate income tax rate in the country. Our corporate income tax solutions would make Iowa more competitive by moving to a lower and flat rate. Our solutions also include base-broadening elements and help mitigate tax uncertainty for businesses.

Repealing federal deductibility. The 50 percent federal deduction eases the burden of Iowa's high, progressive corporate income tax rates, but increases complexity and introduces unintended distributional effects. We offer several options for the repeal of federal deductibility coupled with rate reductions:

- Repeal federal deductibility and adopt a 9.0 percent flat tax on a revenue neutral basis.
- Repeal federal deductibility and adopt a 6.5 percent flat tax at a tax cost of $100 million.
- Repeal federal deductibility and adopt a 4.0 percent flat tax for a $200 million tax cut.

Rolling back tax credits. In 2013, tax credits reduced corporate tax liability by $102.5 million. Evidence suggests that these tax credits provide minimal return to the state, and that a policy of picking winners and losers is ultimately counterproductive as well as inequitable. We propose that Iowa:

- Bring all existing tax credits under a unified cap and resist increasing the capped amount, or even impose a declining cap.
- Establish a standing tax expenditure committee charged with making and introducing legislative recommendations for the reform or repeal of ineffective tax credits.
- Substantially reduce or eliminate corporate income tax credits.

We also offer several options for pairing tax credit reductions with rate reform:

- Repeal federal deductibility, eliminate 50 percent of tax credits, and adopt a 7.7 percent flat rate on a revenue neutral basis.
- Repeal federal deductibility, eliminate 50 percent of tax credits, and adopt a 5.2 percent flat rate at a tax cost of $100 million.
- Repeal federal deductibility, eliminate all tax credits, and adopt a 6.5 percent flat rate on a revenue neutral basis.
- Repeal federal deductibility, eliminate all tax credits, and adopt a 3.9 percent flat rate at a tax cost of $100 million.

Improving tax structure. Iowa's corporate income tax code diverges from best practices in a number of ways which yield relatively little revenue while substantially increasing compliance costs and taxpayer uncertainty. Therefore, our solutions would:

- Eliminate the corporate alternative minimum tax, which only 1 percent of businesses pay but must be calculated by all businesses, and raises less than $6 million per year.
- Restore the three-year net operating loss carryback provision.

Sales Taxes

Iowa's sales tax is a critical source of both state and local revenue. Currently, however, many goods and services are unnecessarily exempted, while some business inputs are subject to tax, which can lead to multiple layers of taxation being imposed on the same final product at different points along the production process. Similarly, tax structure and administration is complex and introduces needless compliance costs. Our solutions strive to simplify the sales tax and include a range of base broadening options.

Modifying the sales tax base. A well-structured sales tax applies to all final consumer transactions, both goods and services, while exempting business to business transactions. While Iowa's tax base is broader than average, it still exempts many services. Similarly, while some strides have been made in excluding business inputs from the sales tax base, many remain. Accordingly, we offer a range of options for both service expansion and the exemption of business inputs. Any base broadening provides an opportunity to pay down reductions in the sales tax rate.

Our base broadening options are as follows:

- Modest expansion to personal services and entertainment products, like museum admissions, veterinary services, and amusements.
- Intermediate base broadening to also include final consumer purchases of professional services, including legal, accounting, and financial services.
- Broad base expansion to also include rental housing, health care services, and higher education expenses.

We also suggest the following options for excluding business inputs:

- Individual exemptions for goods and services likely to be business inputs, including business supplies and 25 enumerated services.
- Provision for all purchases made by businesses to be exempt from the sales tax, in much the same manner as nonprofits are often permitted to make tax exempt purchases.

Improving tax structure. Iowa's sales tax is rendered unnecessarily complex by a patchwork of local option sales tax rates and a series of dedications and diversions. Our solutions would:

- Eliminate the minuscule diversion into the Property Tax Equity and Relief Fund, which has seen revenues dip as low as $6.3 million.
- Modify the school infrastructure dedication to make it more responsive to future tax base changes.
- Provide for clearer regulations and published guidance on sales tax administration.

Property and Related Taxes

Property taxes account for the overwhelming majority of local revenue in Iowa. Base-narrowing exemptions, formula-driven adjustments, and divergent assessment ratios on different classes of property combine to produce a property tax structure that few understand, while an inheritance tax and real estate transfer tax impose substantial tax burdens on the transfer of property. Accordingly, our solutions would:

- Repeal the inheritance tax, which disadvantages some heirs more than others and leads to inefficient tax avoidance strategies.
- Limit further imbalances in Iowa's rollback structure by extending the 3 percent allowable growth factor to commercial and industrial property.
- Eliminate the "Ag Tie," an artificial restriction on the rate of assessment growth for residential property.
- Standardize filing and payment deadlines for local property taxes to reduce compliance costs for individuals and businesses with property in multiple localities.

Other Tax Considerations

We also consider several tax provisions which do not fit into the four major tax categories above, but which warrant their own separate consideration. Here, we offer a few options for consideration:

- Eliminate future authority for tax increment financing (TIF) for economic development purposes or, failing that, require a demonstration of how a proposed TIF will encourage development that would not have been realized otherwise.
- Index the motor fuel tax for inflation to avoid an erosion of revenue in real terms over time.

Comprehensive Reform

Were all of our major reforms adopted, in each case selecting the most significant revenue neutral option for rate reductions of major taxes, Iowa could move from 40th to 10th place on the *State Business Tax Climate Index*. Other reform packages, drawing from the options provided in this book, would also result in significant improvement on the Index. Several possible comprehensive reform options are reviewed below, each with a corresponding Index score. Throughout the book, Index scores are provided for each reform proposal individually as well.

In all of the options below, rate reduction options are revenue neutral, but other reforms, like the repeal of the inheritance tax, alternative minimum taxes, and the marriage penalty are not.

Option A

This approach, which incorporates the most significant revenue neutral rate reduction options for each tax category, is aggressive, but is provided to demonstrate the degree to which the reforms offered in this book, taken together, can enhance Iowa's tax code, and improve the state's competitiveness. Option A includes:

- A 5.15 percent flat individual income tax made possible by the repeal of federal deductibility and business tax credits, which also has the effect of eliminating the marriage penalty;
- The retention of the current standard deduction of $1,970 and the $40 personal exemption credit;
- The repeal of both individual and corporate alternative minimum taxes;
- A 6.5 percent flat corporate income tax with the repeal of federal deductibility and all business tax credits;
- The restoration of a three-year net operating loss carryback;
- The exclusion of business inputs from the sales tax base; and
- The repeal of the inheritance tax.

Option B

This option pairs a somewhat higher flat tax with a generous $10,000 standard deduction, providing a tax cut for taxpayers with taxable incomes below $40,000. This component and the flat-rate corporate income tax are designed to be revenue neutral, though other elements would involve modest revenue reductions. This option includes:

- A 5.8 percent flat individual income tax with a generous $10,000 standard deduction, made possible by the repeal of federal deductibility, while retaining all existing credits;
- The repeal of both individual and corporate alternative minimum taxes;
- A 6.5 percent flat corporate income tax with the repeal of federal deductibility and all business tax credits;
- The restoration of a three-year net operating loss carryback;
- The exclusion of business inputs from the sales tax base; and
- The repeal of the inheritance tax.

Option C

This option features a simplified two-rate individual income tax and retains existing business tax credits but otherwise follows Option A. This option includes:

- A two-bracket individual income tax with a top rate of 6.5 percent coupled with the repeal of federal deductibility;
- An increase in the standard deduction to $3,000, while raising the personal exemption credit to $60;
- Doubling of bracket widths for joint filers to eliminate the marriage penalty;
- A 6.5 percent flat corporate income tax with the repeal of federal deductibility and all business tax credits;
- The restoration of a three-year net operating loss carryback;
- The exclusion of business inputs from the sales tax base; and
- The repeal of the inheritance tax.

Option D

This option adopts a two-bracket individual income tax and single-rate corporate income tax while reducing corporate credits by 50 percent. It makes no changes to the sales tax base. This option includes:

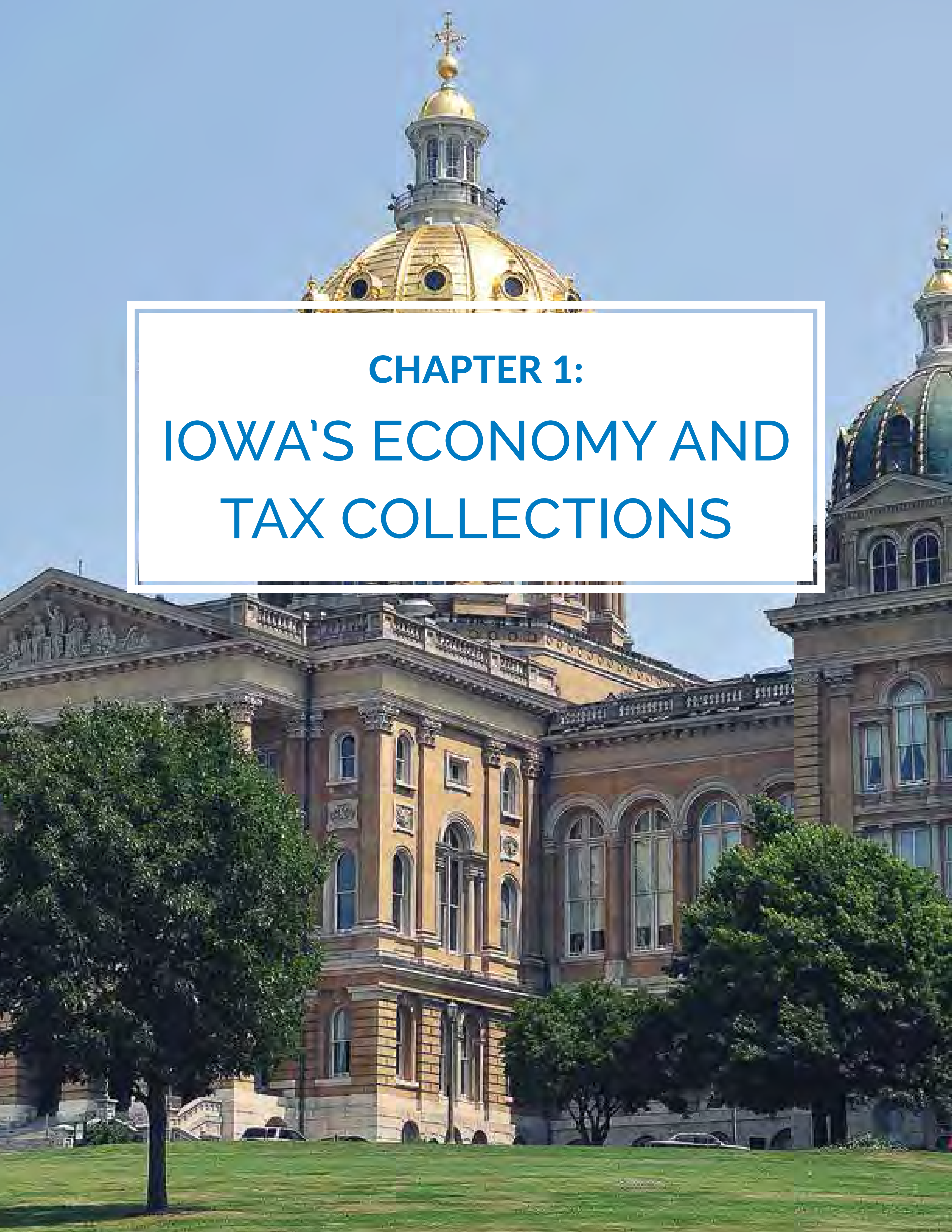
- A two-bracket individual income tax with a top rate of 6.5 percent coupled with the repeal of federal deductibility;
- An increase in the standard deduction to $3,000, while raising the personal exemption credit to $60;
- Doubling of bracket widths for joint filers to eliminate the marriage penalty;
- A 7.7 percent flat corporate income tax with the repeal of federal deductibility and a 50 percent reduction in corporate tax credits;
- The restoration of a three-year net operating loss carryback; and
- The repeal of the inheritance tax.

The above options would result in the following changes to Iowa's rankings in the *State Business Tax Climate Index*, compared to its current system.

	Overall	Corporate	Individual	Sales	Unemployment Insurance Tax	Property
Current System (2016)	40th	49th	32nd	24th	34th	40th
Option A	10th	3rd	14th	7th	34th	35th
Option B	10th	3rd	17th	7th	34th	35th
Option C	14th	3rd	20th	7th	34th	35th
Option D	24th	18th	20th	24th	34th	35th

CHAPTER 1:

IOWA'S ECONOMY AND TAX COLLECTIONS



Introduction

Iowa's economy has grown consistently in recent years, with per capita gross state product (GSP) pulling even with the national average and eclipsing the economies of regional competitor states. Among its neighbors, only Nebraska and South Dakota have seen more rapid per capita GSP growth over the past decade. After a prolonged period in which personal income trailed the national average by as much as 12 percent, the figure has been within 2.5 percent of the national average for the past four years. The state has found an avenue to average, but the means of distinguishing the state from its peers remains elusive.

Manufacturing, agriculture, finance, and insurance are the four pillars of Iowa's economy—four sectors on which the state relies far more than does the nation as a whole. Consequently, the state tax code tends to treat agriculture very favorably, while tax incentives offer attractive rates to manufacturers, and other features of Iowa's tax structure make the state at least competitive for the insurance and financial services industry.

These sectors are, of course, a crucial part of Iowa's economy and will continue to be. Unless great care is taken, however, a system of taxation can ossify around a particular industry mix, making the state comparatively less conducive to growth in other sectors. Iowa is at risk of this, and absent changes, the state's complicated and non-neutral tax structure has the potential to hold the economy back.

The illustrations in the following pages are meant to offer an overview of the Iowa economy and provide context to future chapters, giving readers a broad background on where the state has been economically and where it may be headed.

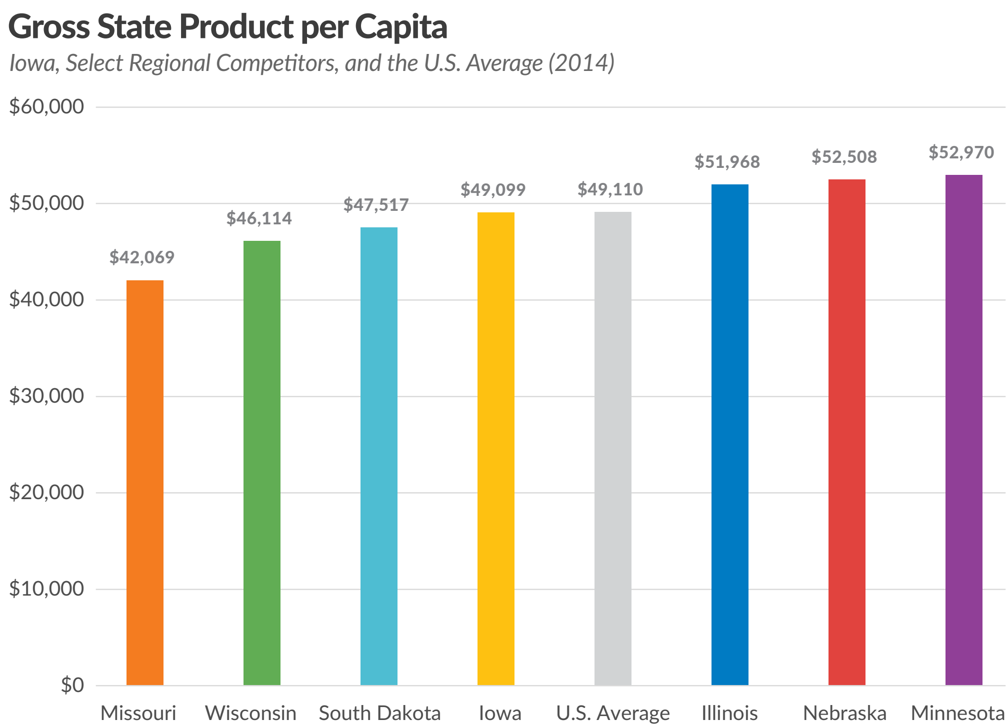
Iowa's Economy

Gross State Product

Iowa's economy ranked 30th in the nation in 2014 based on total production.[1] Compared to regional competitors, Iowa's economy is larger than those of Nebraska (35th) and South Dakota (47th), but substantially smaller than the economies of Illinois (5th), Minnesota (17th), Wisconsin (20th), and Missouri (22nd).[2] The comparative sizes of these economies are mainly driven by population; Illinois, for instance, is one of the most populous states in the nation, with a population four times larger than Iowa's.

Consequently, Iowa fares considerably better after adjusting for population. In 2014, Iowa's $49,099 per capita gross state product (GSP) tracked closely with the national average of $49,110, trailing per capita GSP in Minnesota, Nebraska, and Illinois, but exceeding per capita GSP in Missouri, Wisconsin, and South Dakota. See Figure 1a for a comparison of Iowa's real gross state product per capita to regional competitors and the U.S. average.

Figure 1a.



Source: Bureau of Economic Analysis, *Regional Economic Accounts*, "Gross Domestic Product (GDP) by State."

Figure 1b shows real GSP per person over time for these same states, along with the U.S. average.[3] Iowa has seen growth on this metric in recent years, catching up with a number of its regional competitors, though the state continues to trail Minnesota, Nebraska, and Illinois.

1 "Gross domestic product (GDP) by state (millions of current dollars)." Regional Economic Accounts, *Gross Domestic Product (GDP) by state*. Bureau of Economic Analysis.

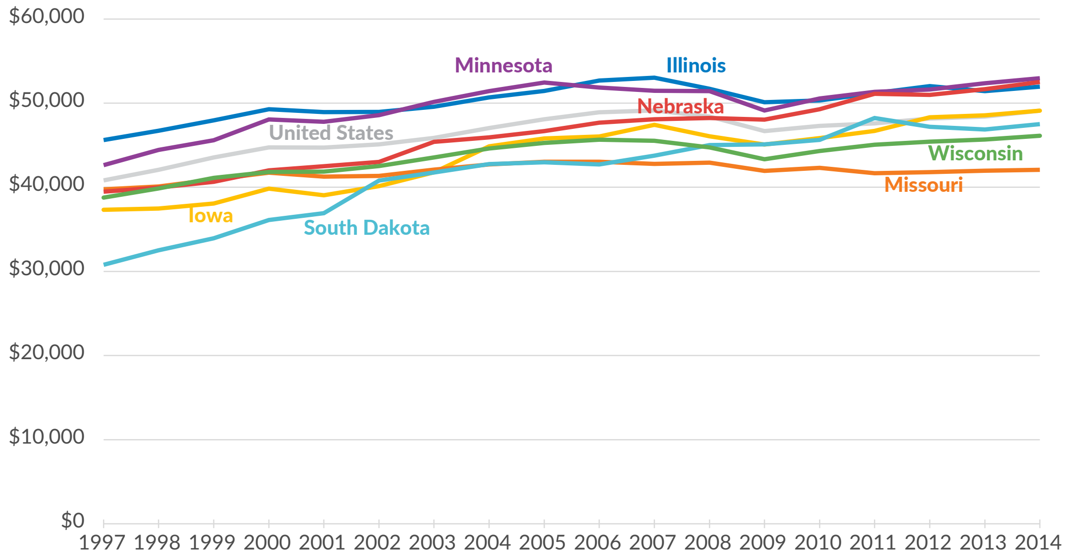
2 Id.

3 Id. Adjusted for inflation using Bureau of Labor Statistics, *Consumer Price Indexes*, "Consumer Price Index – All Urban Consumers" (not seasonally adjusted, U.S. city average, 1967=100).

Figure 1b.

Gross State Product per Capita over Time

Iowa and Regional Competitors (1997–2014, in 2014 Dollars)



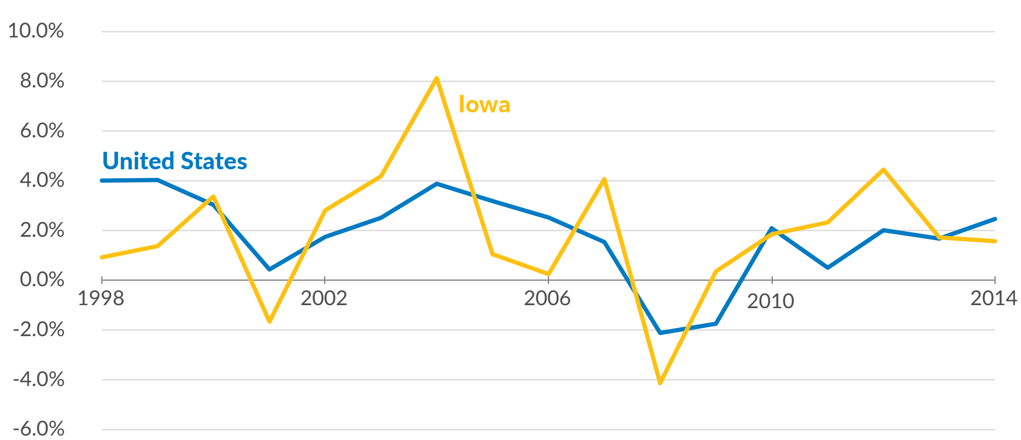
Source: Bureau of Economic Analysis, *Regional Economic Accounts*, Gross Domestic Product (GDP) by State.

Iowa's state economy has historically been more volatile than the U.S. economy as a whole. Iowa's output, at least since 1997, has fluctuated more severely during economic cycles than the national economy, as demonstrated by its higher peaks and lower troughs in Figure 1c.[4] Heavy reliance on a small number of industries can often contribute to such volatility. Notably, however, Iowa's economy fared better than the national economy during the Great Recession, due in part to the resilience—at least in this instance—of the agricultural sector.

Figure 1c.

Annual Percentage Change in Real GSP

Iowa and the U.S. (1998–2014)



Note: Dollar amounts were adjusted for inflation and expressed in 2014 dollars using the Consumer Price Index for All Urban Consumers (CPI-U) from the Bureau of Labor Statistics prior to calculating percentage changes.
Source: Bureau of Economic Analysis, *Regional Economic Accounts*, "Gross Domestic Product (GDP) by State"; Bureau of Labor Statistics, *Consumer Price Indexes* (All Urban Consumers).

4 Id., "Gross domestic product (GDP) by state (millions of current dollars)," Regional Economic Accounts, *Gross Domestic Product (GDP) by State*. Adjusted for inflation prior to calculating annual percentage changes using "Consumer Price Index – All Urban Consumers," Bureau of Labor Statistics, *Consumer Price Indexes* (not seasonally adjusted, U.S. city average, 1967=100).

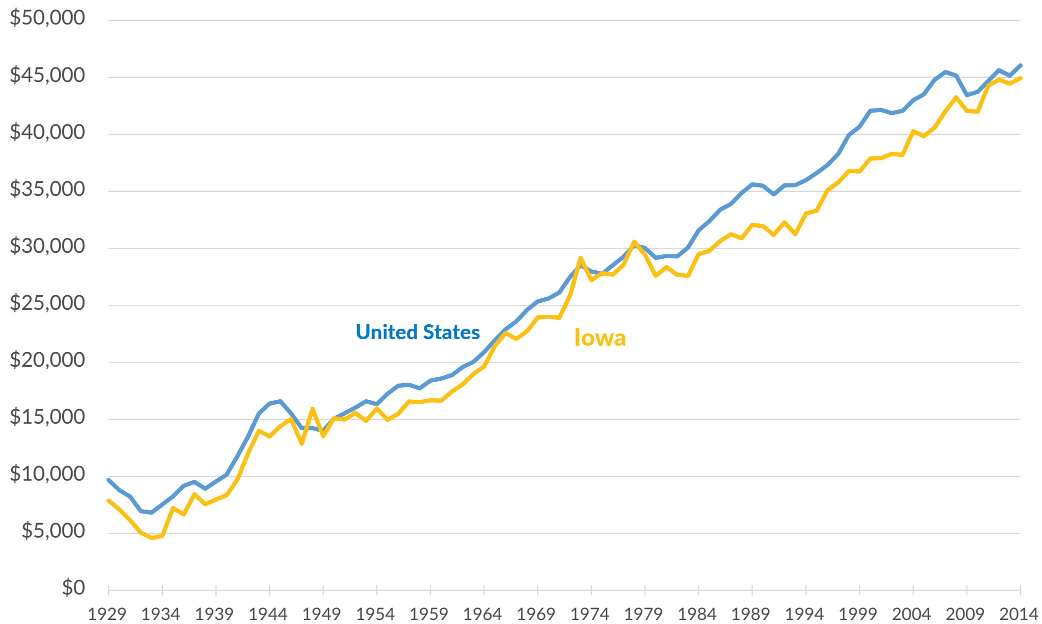
Personal Income

In 1929, the average inflation-adjusted personal income of an Iowa resident was $7,891, well below the U.S. average of $9,677. Both national and Iowa levels have risen significantly since that time, largely converging for several decades before a divergence in the 1980s which left Iowa again trailing the U.S. average until the end of the Great Recession, when Iowa and U.S. average personal income again intersected. Despite this extended decoupling, the two tend to follow the same pattern over time, dipping in the most recent recession and finally recovering to pre-recession highs in 2012.[5]

Figure 1d.

Personal Income per Capita

Iowa and the U.S. (1929–2014, in 2014 Dollars)



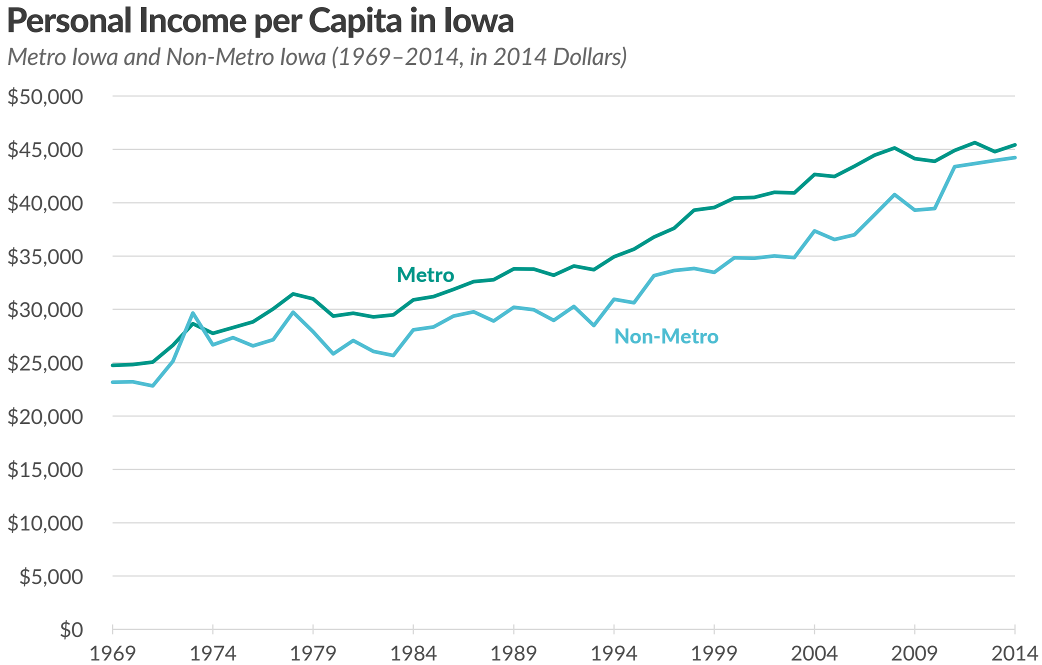
Note: Dollar amounts were adjusted for inflation and expressed in 2014 dollars using the Consumer Price Index for All Urban Consumers (CPI-U) from the Bureau of Labor Statistics prior to calculating percentage changes.
Source: Bureau of Economic Analysis, *Regional Economic Accounts*, Gross Domestic Product (GDP) by State; Bureau of Labor Statistics, *Consumer Price Indexes* (All Urban Consumers).

It can also be valuable to go beyond state-by-state comparisons to look at intrastate incomes, since different areas of a state tend to have differing economic composition. Non-metro per capita income tends to be lower than income in metro-area Iowa (see Figure 1e), but the disparity is currently much smaller than the one many states experience, and has been all but eliminated in recent years, with metro-area income stabilizing in the wake of the Great Recession while non-metro-area income experienced continued growth—again reflecting the current strength of agriculture. It is probable that, in time, metro-area income per capita will pull away again, but Iowa's economy is such that the chasm may never be as wide as is found in other states.[6]

5 Id., "Personal Income Summary: Personal Income, Population, Per Capita Personal Income" (Table SA1), Regional Economic Accounts, *Annual State Personal Income and Employment*. Adjusted for inflation using "Consumer Price Index – All Urban Consumers," Bureau of Labor Statistics, *Consumer Price Indexes* (not seasonally adjusted, U.S. city average, 1967=100).

6 Id., "Personal Income Summary: Personal Income, Population, Per Capita Personal Income" (Table CA1), Regional Economic Accounts, *Local Area Personal Income and Employment*. Adjusted for inflation using "Consumer Price Index – All Urban Consumers," Bureau of Labor Statistics, *Consumer Price Indexes* (not seasonally adjusted, U.S. city average, 1967=100, Series Id: CUUR0000AA0).

Figure 1e.



Note: Dollar amounts were adjusted for inflation and expressed in 2014 dollars using the Consumer Price Index for All Urban Consumers (CPI-U) from the Bureau of Labor Statistics prior to calculating percentage changes.
Source: Bureau of Economic Analysis, *Regional Economic Accounts*, Gross Domestic Product (GDP) by State; Bureau of Labor Statistics, *Consumer Price Indexes* (All Urban Consumers).

Major Industries

Iowa's industry mix differs markedly from the U.S. as a whole. Accommodations (2.1 percent), real estate (9.8 percent), and a range of technical and management sectors trail national averages, while manufacturing (18.7 percent), finance and insurance (9.9 percent), and agriculture (8.3 percent) are represented in Iowa at much higher rates than are experienced nationwide (see Figure 1f).[7]

Manufacturing is by far the largest sector in Iowa, though its share of the economy is in secular decline. It comprised 22.4 percent of the economy in 1997 but fell to 18.7 percent by 2013. The agriculture and finance and insurance sectors have experienced the most growth in recent years. Figure 1g shows Iowa's eight largest sectors' share of the total state economy since 1997.[8]

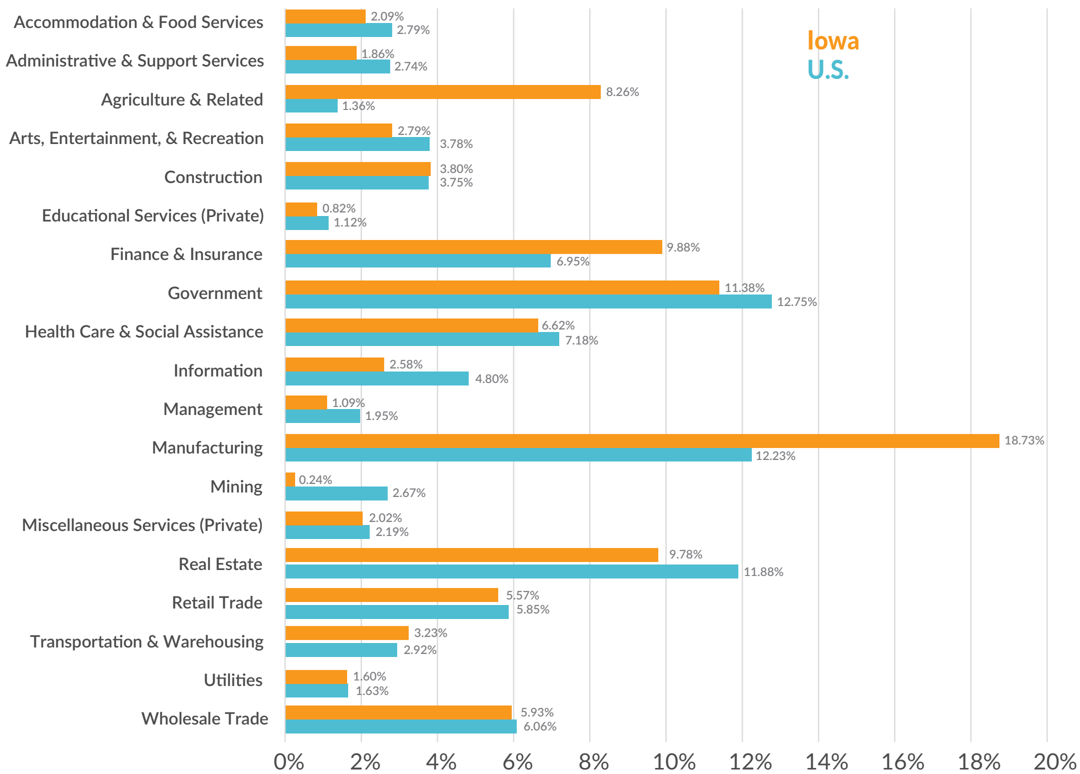
Goods-producing sectors are somewhat more prominent in Iowa than in the U.S. as a whole (the goods share of output in Iowa was 31 percent in 2013, compared to only 23 percent for the whole country) due to the state's large agricultural and manufacturing sectors. While the share of service-providing sectors has grown in the country as a whole over time, the increase in Iowa has been modest in recent decades, and there has even been a slight downtick over the past few years as the agricultural sector survived the recession relatively unscathed. Still, the general trend is toward a more service-oriented economy, and in the years to come, Iowa has every likelihood of catching up with other states.[9]

7 *Gross Domestic Product (GDP) by State, GDP in current dollars*. Regional Economic Accounts. Bureau of Labor Statistics, United States and Iowa (1997–2013).
8 Id.
9 Id.

Figure 1f.

Percent of Total State Gross Domestic Product by Industry

Iowa and the U.S. (2013)

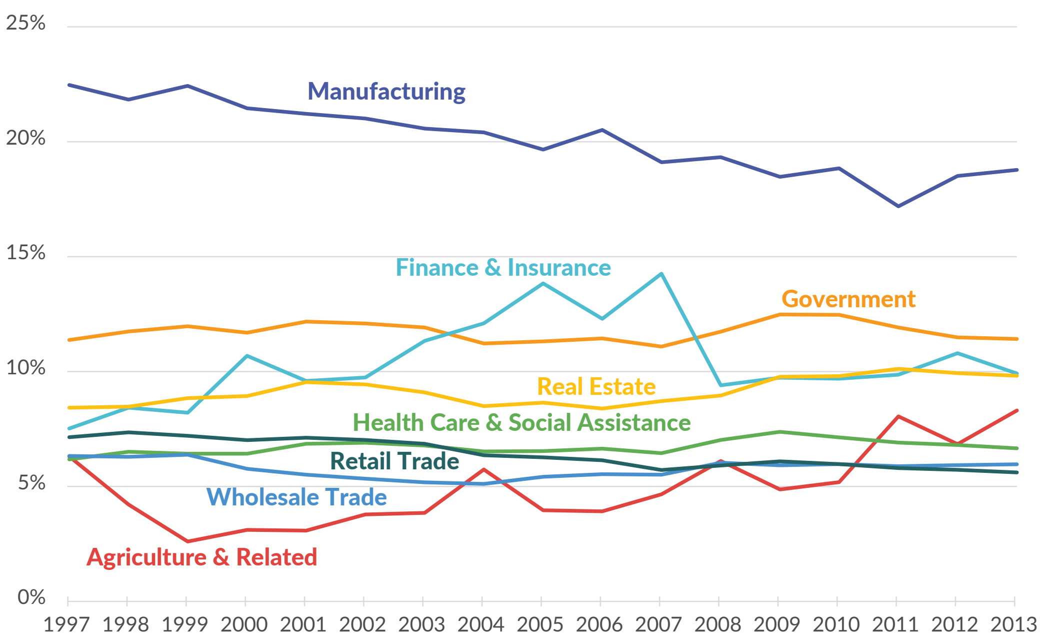


Source: Bureau of Economic Analysis, *Regional Economic Accounts*, Gross Domestic Product (GDP) by State.

Figure 1g.

Percent of Total State Gross Domestic Product by Industry over Time

Iowa's Eight Largest Sectors Based on Production in 2013 (1997–2013)



Source: Bureau of Economic Analysis, *Regional Economic Accounts*, Gross Domestic Product (GDP) by State.

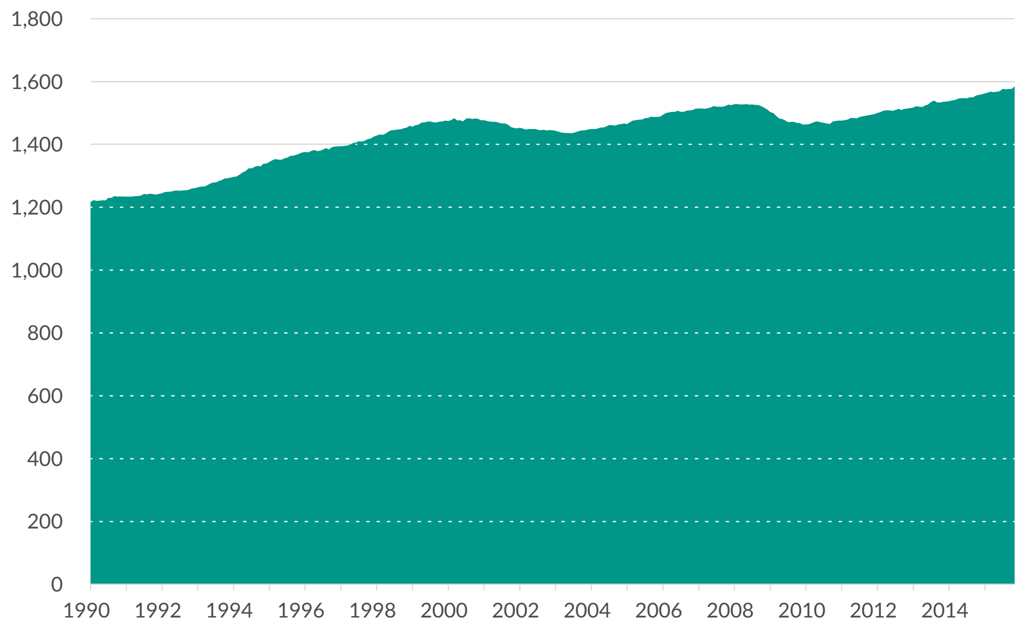
Employment

Employment in Iowa since 1990 has seen a slight upward growth trend, with employment in January 1990 sitting at 1,216,500 employees and increasing to 1,584,700 by October 2015 (an overall increase of 30.3 percent), as shown in Figure 1h. Employment loss in the state during the most recent recession was fairly moderate, with a loss of about 65,000 jobs in the late 2000s.[10] As of January 2016, Iowa's unemployment rate was the ninth lowest in the country at 3.5 percent. Among neighboring states, only South Dakota (2.8 percent) and Nebraska (3.0 percent) experienced lower unemployment. All other neighboring states had higher rates of unemployment, with the Illinois rate standing at 6.3 percent.[11]

Figure 1h.

Total Nonfarm Monthly Employment

Iowa, Seasonally Adjusted (January 1990–November 2015)



Source: Bureau of Labor Statistics, *State and Area Employment, Hours, and Earnings.*

The largest share of nonfarm employment in Iowa occurs in the trade, transportation, and utilities sector with 20.1 percent of total state nonfarm employment. Most of these jobs are in retail, as this category includes retail and wholesale trades. The next largest employment sector is government, employing 16.6 percent of total nonfarm employees in Iowa. Figure 1i shows the breakdown of nonfarm employment within the state, organized by broad sector categories provided by the Bureau of Labor Statistics.[12]

10 *State and Area Employment, Hours, and Earnings*. Total Nonfarm Employment (Iowa Statewide, All Employees, Seasonally Adjusted). Bureau of Labor Statistics.

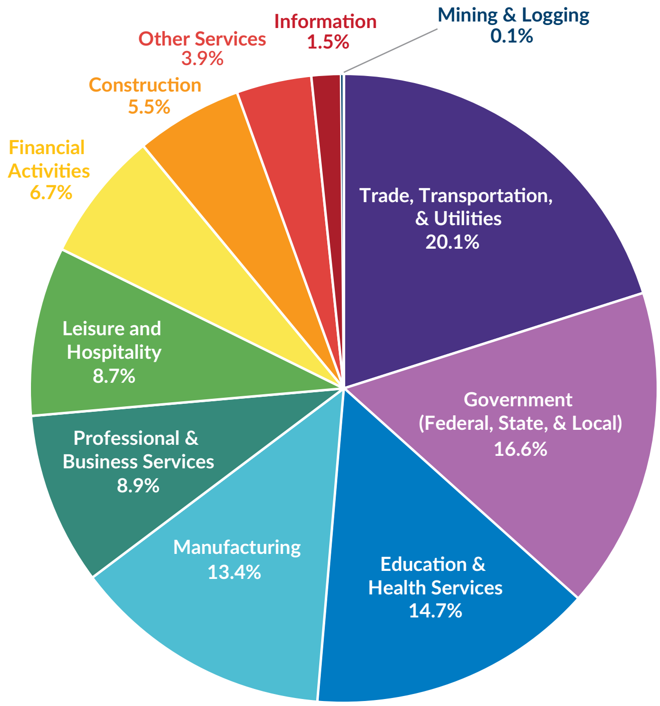
11 Local Area Unemployment Statistics, Unemployment Rates for States. Bureau of Labor Statistics. March 14, 2016. http://www.bls.gov/web/laus/laumstrk.htm.

12 *State and Area Employment, Hours, and Earnings*. Bureau of Labor Statistics. Data was queried for the following "supersectors," in addition to "Total Nonfarm Employment": "Mining & Logging," "Construction," "Manufacturing," "Trade, Transportation, & Utilities" (includes Retail Trade, Wholesale Trade, Transportation and Warehousing, and Utilities), "Financial Activities" (includes Real Estate), "Professional & Business Services" (includes Professional, Scientific, and Technical Services; Management; and Administrative and Support Services), "Education & Health Services," "Leisure & Hospitality" (includes Arts, Entertainment and Recreation and Accommodation and Food Services), "Other Services," and "Government" (includes Federal, State, and Local). Information was not explicitly reported by the Bureau of Labor Statistics and had to be extrapolated. All employment data is seasonally adjusted and corresponds to the entire state of Iowa.

Figure 1i.

Percent of Total Nonfarm Employment by Industry

Iowa, Seasonally Adjusted (2015)

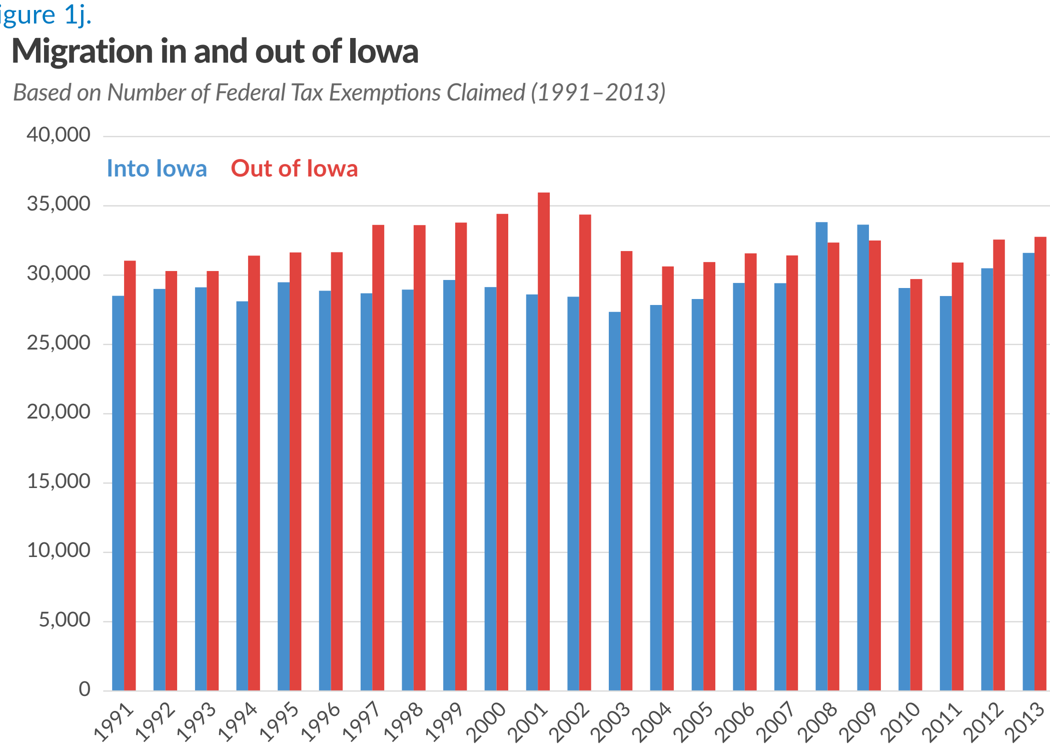


Note: Data for the information sector was extrapolated.
Source: Bureau of Labor Statistics, *State and Area Employment, Hours, and Earnings*.

Migration Patterns

Migration between states can be measured by tracking the movement of federal tax returns (and exemptions claimed on those tax returns) between states over time. Since the early 1990s, Iowa has seen a net of 63,194 people leave the state.[13] Out-migration has exceeded in-migration in all years except 2008 and 2009, when Iowa's economy—particularly the agricultural sector—proved more impervious to national trends than most states' economies. Figure 1k illustrates migration trends over time.

Figure 1j.



Source: Internal Revenue Service, *Statistics of Income Tax Stats – Migration Data.*

Although migration occurs for a variety of reasons, not all tax related, it is notable that over the past decade, Iowa has lost an average of 0.1 percent of its tax base a year to the nine states without a broad-based individual income tax, compared to a combined 0.7 percent to the other 41 states that tax wage income. Iowa actually loses somewhat more taxpayers to Minnesota than to South Dakota, but on the whole, states without individual income taxes have proven popular with Iowa residents. Over 19,000 taxpayers migrated from Iowa to Texas over the past decade, representing about 1.7 percent of Iowa's tax base.[14]

13 *Statistics of Income Tax Stats – Migration Data*. "U.S. Population Migration Data." Internal Revenue Service. http://www.irs.gov/uac/SOI-Tax-Stats-Migration-Data.

14 "Taxpayer Migration." Issue Review. Iowa Legislative Services Agency. February 22, 2016. https://www.legis.iowa.gov/docs/publications/IR/698823.pdf, 2.

A Brief Overview of Iowa's Tax System

Iowa's tax collections are competitive with most of its neighbors, though South Dakota's low-tax environment does bring pressure to bear. However, the existing tax *structure* is overly complex, its high nominal rates can make the state appear unattractive to those who might otherwise consider relocating, and its industry-specific focus will become increasingly unworkable as the state diversifies and new industries come to the fore.

Iowa's agricultural and manufacturing legacy is written into the pages of its tax code. These legacies are worth celebrating, and these industries will continue to play a vital role in Iowa's economic story, but a tax code built around them cannot keep up with the winds of economic change. Good tax structures are flexible and attractive to emerging industries and firms as well as those of long standing. Poor tax structures tend to ossify around a given industry mix, holding back economic growth.

Lawmakers should look for ways to simplify Iowa's tax code, enhancing neutrality across industries and business models and reducing the uncertainty and high compliance costs which too often characterize the present structure. Tax reform is necessary to help position the state for future growth, and positive solutions will involve broadening tax bases, lowering rates, and taking a step back from the business of picking winners and losers in the state economy.

A modern tax code for the state of Iowa would continue to be attractive to the traditional cornerstones of the state's economy, but would emphasize simplicity and neutrality, making it more attractive to other individuals and industries—from the state's thriving financial and insurance sector to businesses that have yet to be imagined—and ensuring that Iowa's fields of opportunity beckon all comers.

To address these goals, this book will provide a menu of options for legislators that address separate parts of the tax system as well as a comprehensive option that addresses the system as a whole, with both revenue neutral and revenue positive options for each.

This chapter provides a very brief overview of the Iowa tax system, including how collections have behaved over time. Subsequent chapters will explain certain taxes in depth while providing reform options.

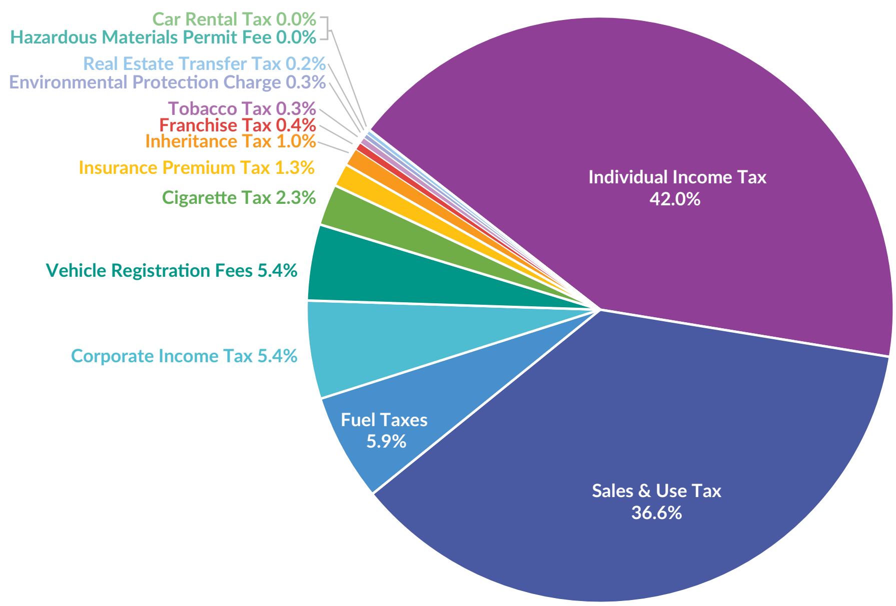
Structure and Revenues

Iowa's individual income tax has nine brackets, while its corporate income tax has four. Both taxes feature high top marginal rates, of 8.98 and 12.0 percent respectively. Effective rates are mitigated somewhat by the ability to deduct federal taxes paid. In all of these respects—number of brackets, top marginal rates, and use of federal deductibility—Iowa's tax structure is atypical.

The state's sales tax is imposed at 6 percent, with a possible further 1 percent local option sales tax. The base is broader than average, but much narrower than that of neighboring South Dakota. Property taxes, meanwhile, are the most reflective of Iowa's agricultural heritage, with rollbacks and linkages intended to keep levies on agricultural and, to a lesser extent, residential property in check. The result, however, is a highly complex system that undermines predictability and shifts costs to commercial and industrial properties, particularly those unable to secure tax increment financing options.

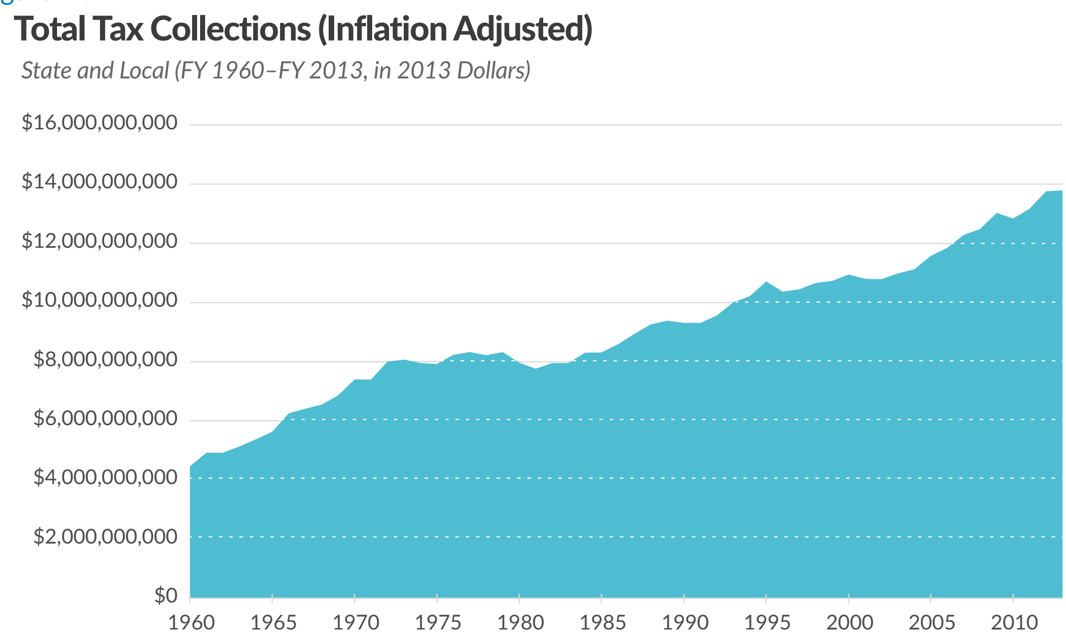
Figure 1k.

State and Local Tax Revenue Sources (FY 2015)



On the whole, Iowa's tax revenues have been relatively stable, and did not fall precipitously during the Great Recession. Similarly notable, however, is that the increase in Iowa tax revenues has been relatively gradual, not rising as quickly as the nation as a whole pre-recession. The state has, however, been susceptible to changes in the federal tax code due to the deduction for federal taxes paid. Avoiding the introduction of additional volatility should be a goal of any tax reform plan.

Figure 1l.



Measures of State Tax Competitiveness

Tax reform can accomplish many things. It can, for instance, make budgeting easier and more consistent, and reduce compliance costs for individuals and businesses. One of the most important goals of tax reform, however, is to improve state competitiveness.

Two annual Tax Foundation publications, our *State-Local Tax Burden Rankings* and *State Business Tax Climate Index*, provide measures of tax competitiveness that matter for taxpayers. Both of these measures have a different story to tell. The *State-Local Tax Burden Rankings* report answers the very first question that most taxpayers ask: "How much do residents in my state pay in taxes?" The *State Business Tax Climate Index*, by contrast, answers the question, "How well is my state tax system structured?"

State and Local Tax Burdens

Many people are familiar with tax collections measures, which tally the amount of taxes collected by state and local governments. Tax burdens, by contrast, measure the impact of those collections on taxpayers.

In the Tax Foundation's *State-Local Tax Burden Rankings*, collections data are adjusted for tax importation and tax exportation, resulting in a full picture of the taxes Americans remit in their home states and across the country. In fiscal year 2012, New Yorkers paid the most in state and local taxes (12.7 percent of total state income), while Alaskans paid the least (6.5 percent).[15]

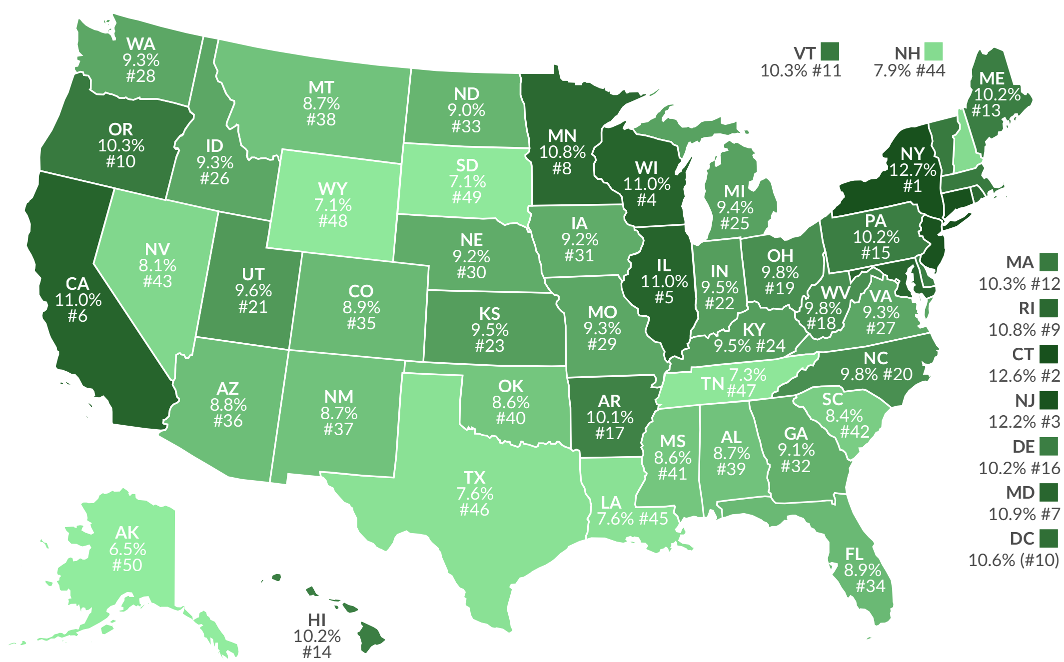
15 Malm, Liz, Gerald Prante, and Nicole Kaeding. *State-Local Tax Burden Rankings FY 2012*. Tax Foundation. January 20, 2016. http://taxfoundation.org/article/state-local-tax-burden-rankings-fy-2012.

Iowans experience modestly below-average state and local tax burdens, ranking 31st highest nationally. In fiscal year 2012, residents of the state paid $4,037 per capita in all state and local taxes (including $1,161 in taxes to other states), amounting to an effective rate of 9.2 percent of total state income.[16] Figure 2e shows the total state and local tax burden of each state in the 2012 fiscal year. Of note, among neighboring states, only South Dakota (49th highest) boasts lower burdens. Missouri's rate is almost identical to Iowa's, while residents of Illinois, Minnesota, Nebraska, and Wisconsin all pay more in state and local taxes than Iowans.

Figure 1m.

State-Local Tax Burdens by State

State-Local Tax Burdens as a Percentage of State Income (FY 2012)



Note: As a unique state-local entity, Washington, DC is not included in rankings, but the figure in parentheses shows where it would rank.
Source: Tax Foundation calculations; U.S. Census Bureau; Rockefeller Institute; Bureau of Economic Analysis; Council on State Taxation; Travel Industry Association.

State-Local Tax Burden as a Percentage of State Income

Lower — Higher

While how much is paid in taxes each year is an important consideration for competitiveness, equally important is *how* those taxes are paid. Taxes vary significantly, with certain levies being more harmful to growth, and others creating additional compliance costs.

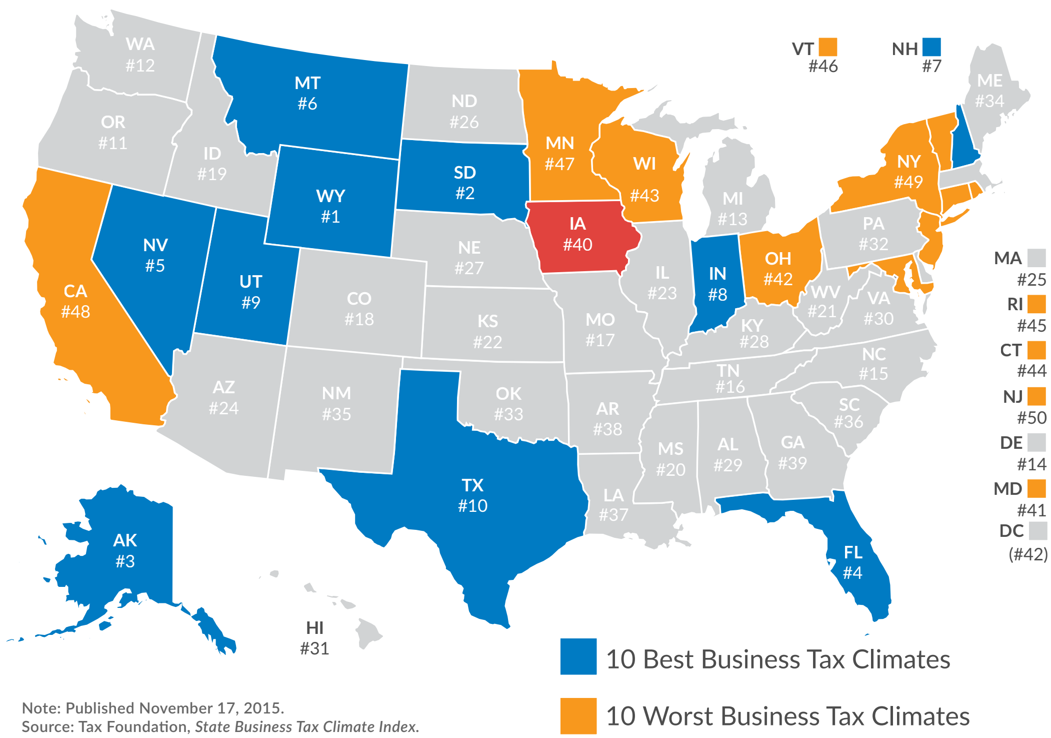
Each year, the Tax Foundation produces the *State Business Tax Climate Index* to enable business leaders, state policymakers, and taxpayers to gauge how these structural elements compare.[17] The *Index* examines over 100 variables in individual income tax, corporate income tax, sales tax, unemployment insurance tax, and property tax categories to reduce these many complex considerations into a ranking.

16 Id.
17 Walczak, Jared, Scott Drenkard, and Joseph Henchman. *2016 State Business Tax Climate Index*. Tax Foundation. http://taxfoundation.org/article/2016-state-business-tax-climate-index.

In the most recent report (see Figure 1o), which gauges states as of July 1, 2015, the states with the best tax systems are Wyoming, South Dakota, Alaska, Florida, Nevada, Montana, New Hampshire, Indiana, Utah, and Texas. The states with the worst tax systems are New Jersey, New York, California, Minnesota, Vermont, Rhode Island, Connecticut, Wisconsin, Ohio, and Maryland.

Figure 1n.

2016 State Business Tax Climate Index



Note: Published November 17, 2015.
Source: Tax Foundation, *State Business Tax Climate Index.*

Table 1a.

Iowa's *State Business Tax Climate Index* Overall & Subcomponent Rankings

Overall	40th
Corporate Income Tax	49th
Individual Income Tax	32nd
Sales Tax	24th
Unemployment Insurance Tax	34th
Property Tax	40th

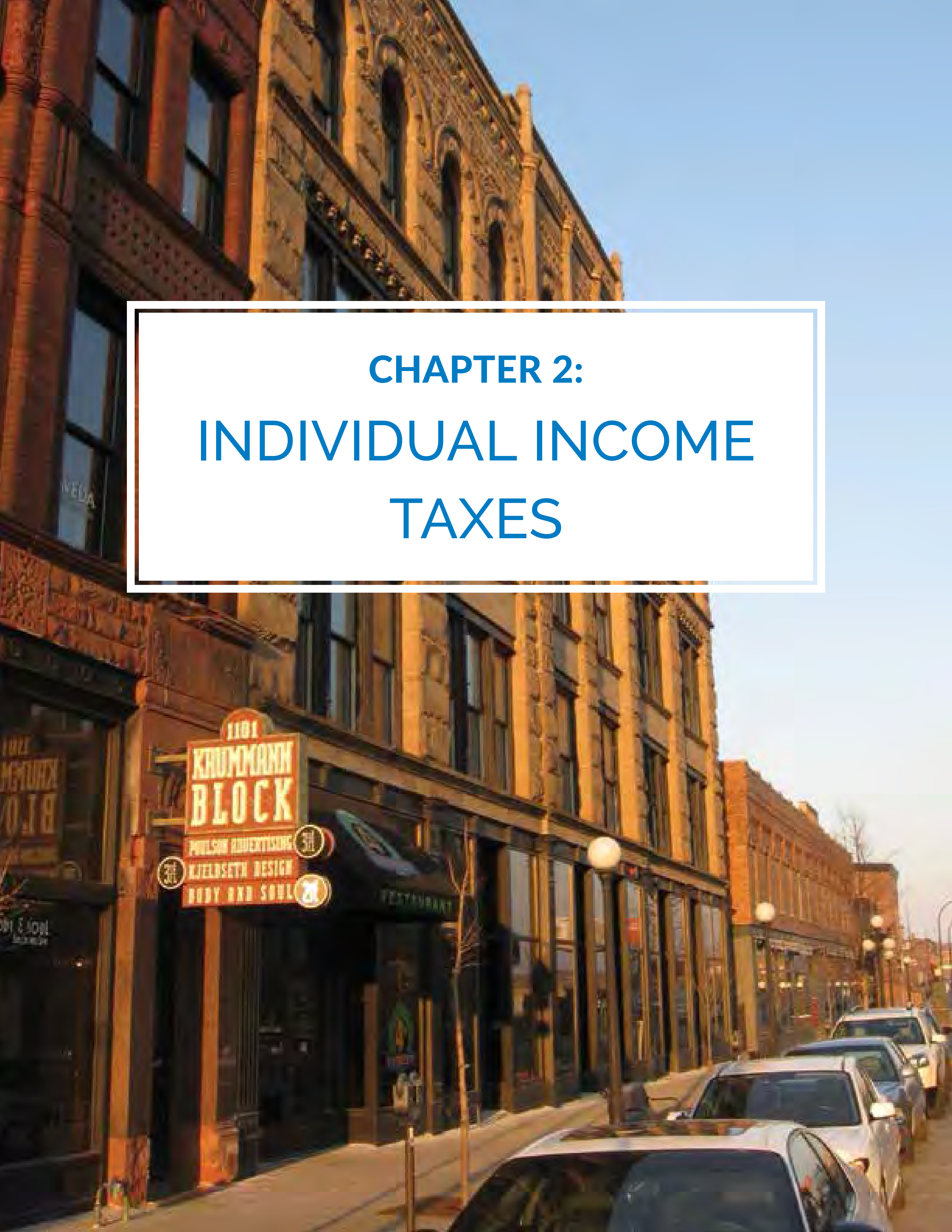
Even though Iowa's tax burden is not far from the national average, its tax structure leaves much to be desired, ranking toward the bottom of the pack at 40th nationally, just missing the bottom 10. The most poorly ranked element of the state's tax system is the corporate income tax component, which ranks 49th in the country. Iowa's top marginal corporate income tax rate is the highest in the nation, driven in part by federal deductibility, and the base is heavily eroded by tax incentives (discussed further in Chapter 3).

Other components that contribute to Iowa's poor *Index* rankings are the top statutory individual income tax rate of 8.98 percent, the imposition of inheritance and real estate transfer taxes, and the inclusion of many business inputs in the sales tax.

Fundamental tax reform is about improving these shortcomings so that Iowa can collect the revenue necessary for government services while maintaining a competitive position which allows Iowa to attract new businesses and individuals and grow opportunity in the state. By broadening tax bases and lowering tax rates, the state can have a meaningful impact on the quality of life for Iowans.

Throughout this book, we will use the *State Tax Business Climate Index* as a way to compare Iowa's taxes to regional competitor states and the country as a whole. The states we have chosen for comparison are the bordering states of Illinois, Minnesota, Missouri, Nebraska, South Dakota, and Wisconsin.

CHAPTER 2:
INDIVIDUAL INCOME TAXES



Introduction

Iowa's individual income tax has a nine bracket graduated-rate structure. The top marginal rate of 8.98 percent is the fourth highest nationally, after California, Oregon, and Minnesota, though the ability to deduct federal income taxes paid reduces overall liability. The state's bracket count is also anomalously high, with only three states having as many or more brackets (Hawaii—9, California—10, and Missouri—10).[18] Most states have far fewer brackets, and eight states impose flat (single-rate) individual income taxes.[19] A range of tax expenditures significantly shrink the base, contributing to Iowa's high nominal rates.

Iowans with whom we spoke frequently emphasized that the statutory income tax rates only tell half the story due to federal deductibility, but also expressed concern that these rates—very high on paper—complicate efforts to attract new talent to the state, since many outsiders may not take the time to determine their effective tax burden were they to relocate to Iowa.

It is important to bear in mind, moreover, that individual income taxes are not exclusively of interest to individual taxpayers, as many businesses (S Corporations, LLCs, partnerships, and sole proprietorships) pay individual income taxes as well. Since these taxes impact Iowa employers, it is important to consider businesses as well as individual payers when contemplating changes to the individual tax code. Finally, Iowa's individual income tax system provides for local surtaxes, a fairly atypical approach in local government finance.

In this chapter we provide a broad overview of the state's individual income tax, outline issues with the current system, and discuss potential reform options. We conclude with *State Business Tax Climate Index* rankings for each proposed solution.

18 California imposes nine statutory tax brackets plus a "millionaire's tax" which functionally creates a tenth 10th bracket.
19 Kaeding, Nicole. "State Individual Income Tax Rates and Brackets for 2016." Tax Foundation. February 8, 2016. http://taxfoundation.org/article/state-individual-income-tax-rates-and-brackets-2016, 2–4.

A Short History of the Individual Income Tax

State individual income taxes came into their own during the Great Depression, and Iowa's 1934 adoption of a five-bracket individual income tax fits neatly into that broader trend. States had imposed income taxes before, but these taxes tended to fall exclusively on a small number of high earners and were often short-lived. Confronted with a steep decline in property tax assessments (and, consequently, property tax collections) during the Depression, states increasingly sought to diversify tax collections, and income taxes proved a popular option.[20] These taxes did not, however, immediately take their role as the largest driver of state tax collections; as late as 1940, tobacco and liquor taxes brought in more than state individual income taxes across the nation.[21]

From the beginning, Iowa's income tax incorporated a deduction for federal taxes paid, in the form of an allowable deduction to gross income for most other taxes paid to the federal government, state or territorial governments, or foreign governments.[22] The income tax was imposed on all income after deductions—a break from many states' pre-Depression approach of taxing only high incomes—at rates ranging from 1 percent (on taxable income up to $1,000) to 5 percent (on the amount of taxable income in excess of $5,000).[23]

Over the years, Iowa's rates and brackets have been adjusted many times, including four income tax cuts (one due to the sunset of a temporary tax increase). From 1975 through 1987, the state imposed the tax across thirteen brackets with a top marginal rate of 13 percent. The most recent substantial change to the individual income tax code, adopted in 1998, was a 10 percent across the board rate cut. [24][25]

Table 2a.

Iowa Individual Income Tax Rate History

Year	# of Brackets	Top Bracket	Lowest Rate	Highest Rate
1934	5	$4,000	1.00%	5.00%
1953	5	$5,000	0.75%	3.75%
1955	5	$4,000	0.80%	4.00%[24]
1957	5	$4,000	0.75%	3.75%
1965	6	$9,000	0.75%	4.50%
1967	7	$9,000	0.75%	5.25%[24]
1971	7	$9,000	0.75%	7.00%
1975	13	$75,000	0.50%	13.00%
1987	9	$45,000	0.40%	9.98%
1998	9	$51,660[25]	0.36%	8.98%

Source: Iowa Department of Revenue, "Iowa Tax Rate History."

20 Snell, Ronald. "State Finance in the Great Depression." National Conference of State Legislatures. March 2009. http://www.ncsl.org/print/fiscal/statefinancegreatdepression.pdf, 3.

21 Id., 5.

22 Inheritance, estate, and local property taxes could not be deducted. See Iowa Code of 1935, §6943-f9, https://www.legis.iowa.gov/docs/shelves/code/ocr/1935%20Iowa%20Code.pdf, 1002.

23 Id., §6943-f5. At the time, per capita income was about $464.50.

24 The top marginal rates for 1955 and 1967 include temporary surtaxes. See Iowa Legislative Services Agency, "Iowa Income Tax," Fiscal Topics, January 2014, https://www.legis.iowa.gov/docs/publications/FT/24495.pdf, 2.

25 Iowa adopted annual inflation indexing in 1996. The top bracket kick in of $51,660 represents $45,000 adjusted for inflation. As of 2016, the top bracket begins at $69,930. See Table 2d.

Comparing Iowa's Individual Income Taxes Regionally and Nationally

Compared to other state individual income tax systems, Iowa's is somewhat below average on the *State Business Tax Climate Index*. Table 2b shows Iowa's individual income tax component ranking on the *Index*, in addition to select regional competitor states' rankings. The *Index* provides a measure of a state's tax structure, not its collections, where Iowa is closer to the middle of the pack, with the 21st highest collections per capita in the country.

Table 2b.
***State Business Tax Climate Index* Individual Income Tax Component Rankings**
Iowa and Regional Competitors (2016)

State	Component Ranking
Iowa	32nd
Illinois	10th
Minnesota	46th
Missouri	28th
Nebraska	24th
South Dakota	1st
Wisconsin	43rd

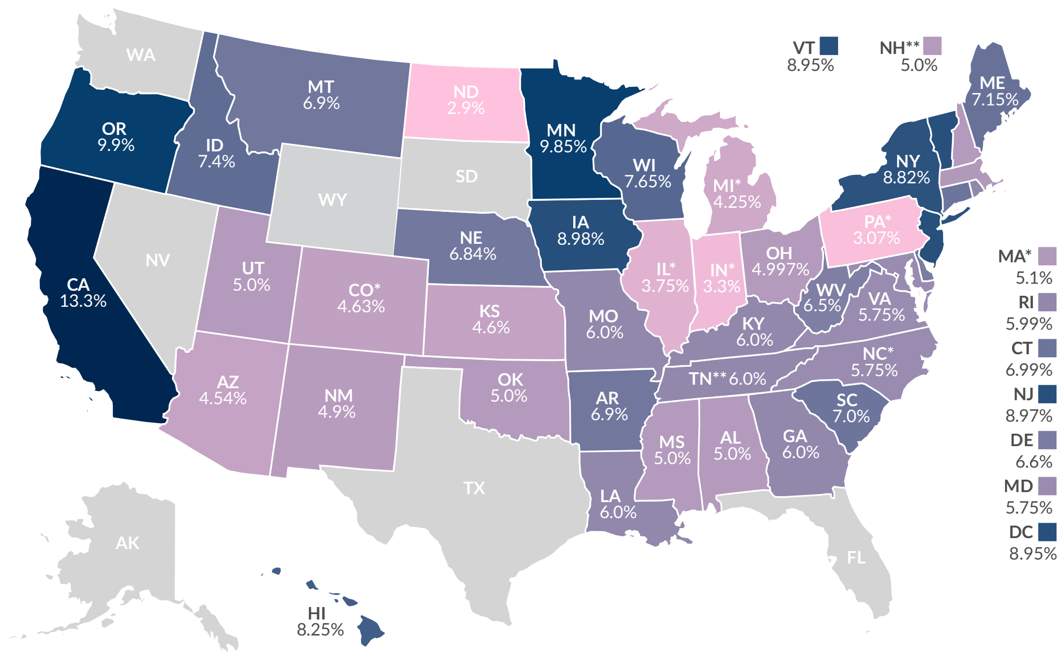
Source: Tax Foundation, 2016 *State Business Tax Climate Index.*

Iowa's top marginal rate is the fourth highest in the nation, and exceeds the top marginal rates of all of its regional competitors except Minnesota, which imposes a top rate of 9.85 percent on income in excess of $155,650.[26] In the wake of a recent sunset, Illinois' individual income tax is a flat rate of 3.75 percent of federal taxable income, while Missouri (top rate of 6.0 percent), Nebraska (6.84 percent), and Wisconsin (7.65 percent) all impose graduated income taxes with top rates below Iowa's top marginal rate. South Dakota does not impose an individual income tax. Figure 2a shows top marginal income tax rates for all states.[27]

26 Kaeding, Nicole. "State Individual Income Tax Rates and Brackets for 2016," 4.
27 Id., 2.

Figure 2a.

Top State Marginal Individual Income Tax Rates in 2016



Note: (*) State has a flat income tax. (**) State also only taxes interest and dividends income. Map shows top marginal rates: the maximum statutory rate in each state. It is not an effective marginal tax rate, which would include the effects of phase-outs of various tax preferences. Local income taxes are not included.

Source: State tax forms and instructions.

Excessive taxes on income are generally less desirable than taxes on consumption because they discourage wealth creation. In a comprehensive review of international econometric tax studies, Arnold et al. (2011) found that individual income taxes are among the most detrimental to economic growth, outstripped only by corporate income taxes. The authors found that consumption and property taxes are the least harmful.[28]

The economic literature on graduated-rate income taxes is particularly unfavorable.[29] The Arnold et al. study concluded that reductions in top marginal rates would be beneficial to long-term growth, and Mullen and Williams (1994) found that higher marginal tax rates reduce gross state product growth. This finding even adjusts for the overall tax burden of the state, lending credence to the precept of broad bases and low rates.[30]

28 Arnold, Jens, Bert Brys, Christopher Heady, Åsa Johannsson, Cyrille Schwellnus, and Laura Vartia. "Tax Policy for Economic Recovery and Growth." *The Economic Journal* 121, no. 550 (February 2011).

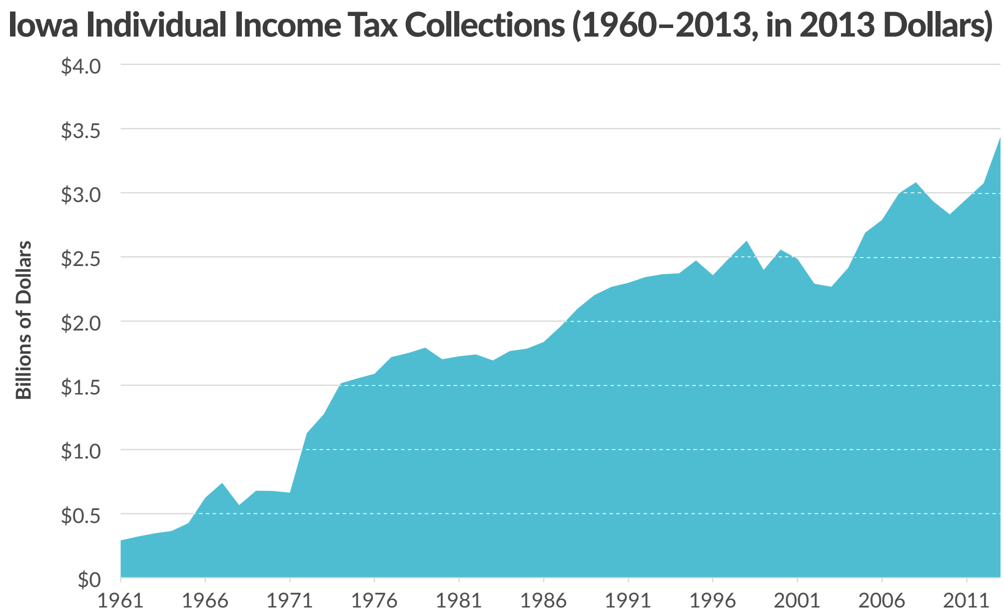
29 See, e.g., William McBride, "What is the Evidence on Taxes and Growth?" Tax Foundation, December 2012, http://taxfoundation.org/article/what-evidence-taxes-and-growth.

30 Mullen, John, and Martin Williams. "Marginal Tax Rates and State Economic Growth." *Regional Science and Urban Economics* 24, no. 6 (1994).

Individual Income Tax Collections

Individual income tax collections have grown significantly through the years, but have seen sizable swings, dipping notably during recessionary periods.

Figure 2b.



Note: Dollar amounts are inflation adjusted based on the annual average Consumer Price Index for All Urban Consumers (CPI-U) with a 2013 base year.
Source: Census Bureau, *State and Local Government Finances*; Bureau of Labor Statistics, *Consumer Price Indexes* (All Urban Consumers).

Individual income taxes accounted for 42 percent of state tax collections in 2013, representing the largest single source of state tax revenue.[31] Distributionally, income under $20,000 is minimally taxed, income between $20,000 and $50,000 is taxed proportionally, income from $50,000 to $1 million is taxed at above-average effective rates, and proportionality returns above $1 million—the curious result of federal deductibility working against progressivity, as explained below. The Earned Income Tax Credit also contributes to the low share of tax liability on income under $20,000.[32]

Table 2c.

Share of AGI and Tax Liability by Income Group for Resident Taxpayers (2013)

AGI Class	Share of AGI	Share of Tax Liability
$1 – 19,999	8%	1%
$20,000 – $49,999	32%	31%
$50,000 – $74,999	20%	22%
$75,000 – $124,999	15%	19%
$125,000 – $249,999	10%	13%
$250,000 – $999,999	9%	12%
$1,000,000 +	5%	5%

Source: Anthony Girardi, "2013 Iowa Individual Income Tax Annual Statistical Report,"14.

31 "State and Local Government Finance, FY 2013." Census Bureau. http://www.census.gov/govs/local/.
32 Girardi, Anthony. "2013 Iowa Individual Income Tax Annual Statistical Report," 14.

Structural Elements

With the exception of continued indexation of brackets, Iowa's income tax structure remains essentially unchanged since 1998. The state currently offers a standard deduction of $1,970 ($4,860 for married filers), with personal exemption credits of $40 per person.[33] Many proposals to eliminate federal deductibility have been contemplated in recent decades, but for now, at least, the deduction remains.

Table 2d.

Iowa's Current Income Tax Rates Schedule (2016)

Rate		Bracket
0.36%	>	$0
0.72%	>	$1,554
2.43%	>	$3,108
4.50%	>	$6,216
6.12%	>	$13,896
6.48%	>	$23,310
6.80%	>	$31,080
7.92%	>	$46,620
8.98%	>	$69,930

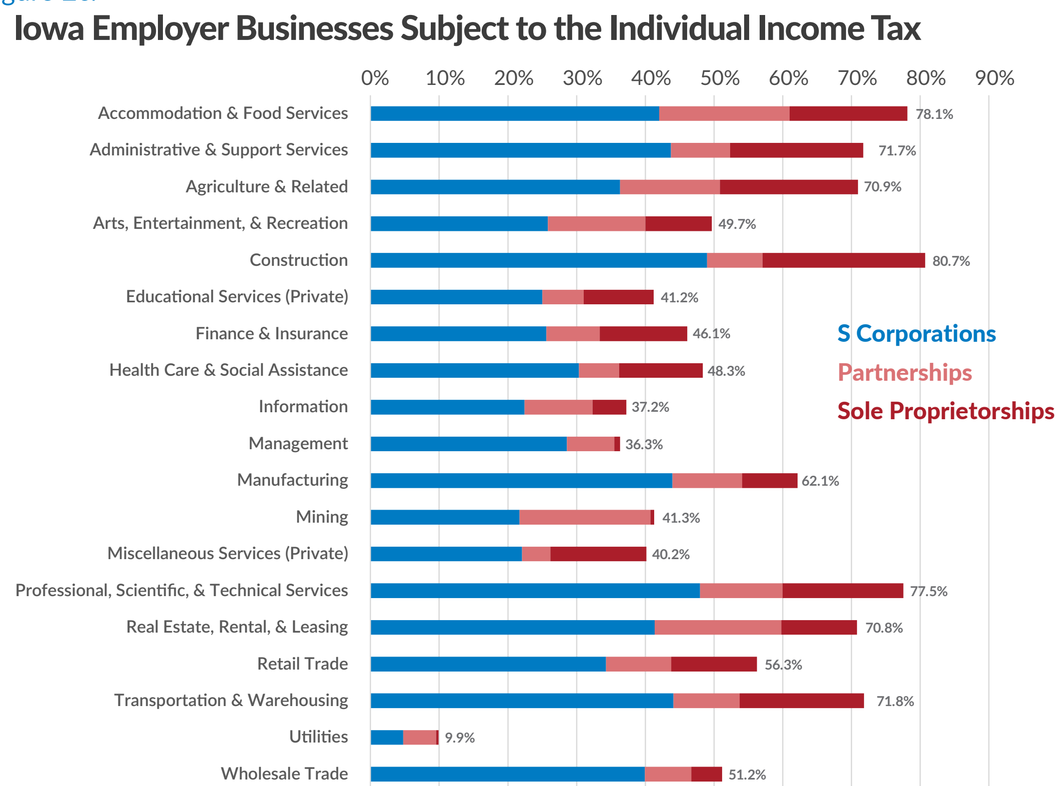
In conversations we had with Iowa taxpayers, the complexity of the individual income tax was a frequent concern. Iowans are often uncertain of what their tax liability will be, given the interaction of federal deductibility, income surtaxes, married filing separately on a combined return, and a plethora of additions and subtractions (additional detail on the following pages). Even the length of the state income tax form came up in conversations: the 2015 Iowa 1040 has 76 lines,[34] compared to 35 lines in Minnesota,[35] 40 in Illinois,[36] 44 in Nebraska,[37] 50 in Missouri,[38] and 56 lines on the Wisconsin return.[39] Iowa's other neighbor, South Dakota, does not impose an individual income tax. The Iowa return is only three lines shorter than the federal Form 1040.[40]

33 Kaeding, Nicole. "State Individual Income Tax Rates and Brackets for 2016," 4.
34 "2015 IA 1040 Iowa Individual Income Tax Form." Iowa Department of Revenue 2015. https://tax.iowa.gov/sites/files/idr/forms1/2015IA1040%2841001%29_0.pdf.
35 "M1 Individual Income Tax 2015." Minnesota Revenue. 2015. http://www.revenue.state.mn.us/Forms_and_Instructions/m1_15.pdf.
36 "2015 Form IL-1040." Illinois Department of Revenue, Individual Income Tax Return. December 2015. http://www.revenue.state.il.us/taxforms/IncmCurrentYear/Individual/IL-1040.pdf.
37 "Nebraska Individual Income Tax Return." Nebraska Department of Revenue. 2015. http://www.revenue.nebraska.gov/tax/15forms/f_1040n.pdf.
38 "Individual Income Tax Return—Long Form." Missouri Department of Revenue. 2015. http://dor.mo.gov/forms/MO-1040%20Print%20Only_2015.pdf.
39 "Wisconsin Income Tax Form 1." Wisconsin Department of Revenue. 2015. https://www.revenue.wi.gov/forms/2015/Form1.pdf.
40 "Form 1040, U.S. Individual Income Tax Return." Internal Revenue Service. 2015. https://www.irs.gov/pub/irs-pdf/f1040.pdf.

Impact of the Individual Income Tax on Iowa Businesses

Individual income taxes are of considerable importance to pass-through entities, businesses that pay the individual income tax in lieu of the corporate income tax because the earnings "pass through" to the income tax form of the owners or shareholders rather than being remitted by the business entity itself. Because S corporations, partnerships, sole proprietorships, and limited liability corporations (LLCs) remit their income tax payments through the individual income tax, the individual code is a significant policy issue for the majority of Iowa businesses. Figure 2c shows the share of employer firms in each sector that pay individual income taxes in Iowa (separated by type).[41]

Figure 2c.



Note: This does not include non-employer firms.
Source: Census Bureau, *County Business Patterns*.

Traditional C corporations care about individual income tax rates as well, since high rates can impede their ability to attract and retain talented employees. In conversations with corporate leaders in Iowa, individual income taxes were a recurring theme, with many expressing the belief that Iowa's high statutory individual income tax rates often keep potential employees from even considering Iowa, despite the fact that federal deductibility brings the overall individual income tax burden more in line with national averages.

41 "County Business Patterns, Geographic Area Series: County Business Patterns by Legal Form of Organization." Census Bureau. 2013.

Marriage Penalty

Because the individual income tax brackets are identical for single and joint filers, Iowa's income tax contains a "marriage penalty," with married couples paying more in taxes when filing jointly than they would if they filed separately. This can have serious business ramifications. The top 20 percent of income earners is dominated (85 percent) by married couples, and this same 20 percent also has the highest concentration of business owners of all income groups.[42] Therefore, marriage penalties have the potential to affect a significant share of pass-through businesses. Iowa is one of 24 states to impose a marriage penalty, and—unlike some other states—makes no attempt to abate it through tax credits or expansion of brackets short of doubling.[43]

Married couples can limit the adverse impact of this penalty by choosing to file separately on the same return. Typically, filers must select the same filing status at the federal and state level, but Iowa permits married couples to file separately on the same return even if they filed jointly at the federal level.[44] The majority of married filers take advantage of this option, which frequently reduces, but does not altogether eliminate, the marriage penalty.

Table 2e.
Tax Filers and Tax Liability by Filing Status

Filing Status	% of Filers	% of Tax Liability
Single	34.2%	20.7%
Head of Household	7.7%	3.7%
Married Filing Jointly	11.6%	13.4%
Married Filing Separately on Combined Return	45.6%	61.3%
Married Filing Separate Returns	0.9%	0.9%

Source: Anthony Girardi, "2013 Iowa Individual Income Tax Annual Statistical Report," Iowa Department of Revenue, June 2015, 8.

Alternative Minimum and Maximum Taxes

Iowa's income tax code includes both an alternative minimum and alternative maximum tax, bounding tax liability on both sides. In practice, relatively few Iowa taxpayers see their liability adjusted by either provision.

Iowa is one of only six states which imposes an alternative minimum tax (AMT) on individual income, though two of those—Minnesota and Wisconsin—are neighboring states. Only three states (including Iowa) impose an AMT on both individuals and corporations.[45]

42 Hodge, Scott. "Married Couples File Less than Half of All Tax Returns, But Pay 74 Percent of All Income Taxes." Tax Foundation. March 2003, http://taxfoundation.org/article/married-couples-file-less-half-all-tax-returns-pay-74-percent-all-income-taxes; Id., "Own a Business? You May Be Rich: Two-Thirds of Taxpayers Hit by Highest Tax Rate Have Business Income," Tax Foundation, May 2003, http://taxfoundation.org/article/own-business-you-may-be-rich-two-thirds-taxpayers-hit-highest-tax-rate-have-business-income.

43 Walczak, Jared, Scott Drenkard, and Joseph Henchman. *2016 State Business Tax Climate Index*. Tax Foundation. November 17, 2015. http://taxfoundation.org/article/2016-state-business-tax-climate-index, 69.

44 "Filing Status." Iowa Department of Revenue. https://tax.iowa.gov/expanded-instructions/filing-status.

45 Gullickson, Angela. "Iowa's Alternative Minimum Tax Credit." Iowa Department of Revenue, Tax Credits Program Evaluation Study. December 2015. https://tax.iowa.gov/sites/files/idr/Minimum%20Tax%20Credit%20Evaluation%20Study.pdf, 6-7.

The state's alternative maximum tax (generally called the Iowa Alternate Tax) chiefly, but not exclusively, benefits senior citizens. Maximum individual income tax liability is determined as follows:

1. Calculate the sum of net income and any pension exclusion taken or Social Security benefits received;
2. Subtract $13,500 from this total if under the age of 65, or $32,500 if 65 or older;
3. Multiply the difference by 8.98 percent, the top marginal tax rate, to yield an alternate tax; and
4. Calculate the tax on regular taxable income using the standard tax tables and remit the lesser of the two amounts.[46]

Conversely, the alternative minimum tax is designed to limit the amount of tax savings that high earners (and trusts and estates) can realize. Effectively, the alternative minimum tax guarantees a tax rate (neglecting the federal deduction) of at least 6.74 percent, which is 75 percent of the top marginal rate.[47]

1. Calculate the sum of net income and preferences and adjustments required under the federal alternative minimum tax rules;
2. Calculate an exemption of $17,500 for married individuals filing separately, $26,000 for single filers, and $35,000 for married couples, reduced by 25 percent of the amount by which alternative minimum taxable income (prior to the exemption) exceeds $75,000, $112,500, or $150,000 for each filing status respectively; and
3. Subtract the exemption from the sum of income, and multiply the difference by 8.98 percent, the top marginal rate, to yield the alternative minimum tax.[48]

Alternative minimum taxes are sometimes triggered due to unique, non-recurring financial activities. In these cases, where an alternative minimum tax is owed one year but not the next, Iowa allows the taxpayer to recoup the additional tax paid under the AMT by means of a credit taken in the subsequent year. Of the six states with AMTs on individual income, only Wisconsin does not offer such a credit.[49] Iowa's alternative minimum tax raised $9.9 million from 26,524 taxpayers in 2013.[50]

46 "Iowa Alternate Tax Worksheet." Iowa Department of Revenue. 2014. https://tax.iowa.gov/sites/files/idr/forms1/2014Alt%20tax(41145)14.pdf.
47 Whipple, Tom, Susan Crowley, and Mike Goedert. "Legislative Guide to State Taxation in Iowa." Iowa Legislative Services Agency. December 2008. https://www.legis.iowa.gov/docs/publications/LG/9463.pdf, 24.
48 I.C.A. § 422.5(1)(k).
49 Gullickson, Angela. "Iowa's Alternative Minimum Tax Credit," 6.
50 Girardi, Anthony. "2013 Iowa Individual Income Tax Annual Statistical Report," 10.

Internal Revenue Code Conformity

For reasons of administrative simplicity, states frequently seek to conform many, though rarely all, elements of their state tax codes to the federal tax code. This harmonization of definitions and policies reduces compliance costs for individuals and businesses with liability in multiple states and limits the potential for double taxation of income.[51] No state conforms to the federal code in all respects, and not all provisions of the federal code make for good tax policy, but greater conformity substantially reduces tax complexity and has significant value.

In Iowa, as in 28 other states, the income tax base begins with federal adjusted gross income,[52] though some adjustments (e.g., pension and retirement income, Social Security benefits, and most significantly, federal deductibility) diverge from the federal treatment of income.[53] Perhaps most disadvantageous to filers, though, is when the determination to couple with select federal provisions is made on a year-to-year basis, and frequently after economic decisions that might have been predicated on those provisions having already been made.

In 2016, legislators only belatedly coupled with the current federal Section 179 deduction allowance, by which small businesses—including many farms—may deduct certain business expenses immediately, rather than deducting them over time according to a depreciation schedule. In late 2015, the federal government adopted a permanent expensing allowance of $500,000,[54] but the prospects of conformity for the 2015 tax year remained uncertain until March 2016, requiring the Department of Revenue to postpone filing deadlines. This debate will take place again for the 2016 tax year, since the legislature declined to resolve the issue on a permanent basis.[55]

This means that, should the state ever fail to couple with the new federal allowance, small businesses would only be able to deduct $25,000 worth of business expenses in the first year at the state level. This uncertainty was a chief concern of farmers and other small business owners with whom we spoke. When decisions on conformity are made after the fact, businesses (to the extent that their decisions are predicated on tax policy) are forced to act on assumptions about future legislative decisions, leading to worse economic decision-making than would be anticipated if this source of uncertainty were removed.

51 Mason, Ruth. "Delegating Up: State Conformity with the Federal Tax Base." *Duke Law Journal* 62, no. 7 (April 2013): 1269–1270.
52 Another six states begin with federal taxable income. See id., 1276.
53 Olin, Rick. "Individual Income Tax Provisions in the States." Wisconsin Legislative Fiscal Bureau. July 2012. https://www.wmc.org/wp-content/uploads/LFB-paper-on-Individual-Income-Tax-Provisions-in-the-States.pdf, 26.
54 Walczak, Jared. "States Lag Behind Federal Government on Small Business Expensing." Tax Foundation. December 22, 2015. http://taxfoundation.org/blog/states-lag-behind-federal-government-small-business-expensing; and see generally, id., "Consistent and Predictable Business Deductions: State Conformity with Section 179 Deductions," Tax Foundation, January 28, 2015, http://taxfoundation.org/article/consistent-and-predictable-business-deductions-state-conformity-section-179-deductions.
55 Patane, Matthew. "'Tax Coupling' Delay Could Cost Iowans Thousands of Dollars." *Des Moines Register*. March 4, 2016. http://www.desmoinesregister.com/story/money/business/2016/03/04/tax-coupling-delay-could-cost-iowans-thousands-dollars/81206468/.

Local Income Surtaxes

In Iowa, school districts can fund certain programs through local property taxes or a combination of property taxes and income surtaxes; the latter route is frequently taken in an effort to keep property tax rates in check. Counties may also, with the assent of the public at an election, impose an emergency medical services income surtax, though only one county (Appanoose County) has ever done so.[56]

Surtaxes differ from local income taxes as found in other states inasmuch as they are not a supplemental tax on additional percentages of taxable income, but rather a tax on some percentage of base tax liability. That means, in general terms, that if a taxpayer owes $2,000 in Iowa individual income taxes and lives in a school district with a 7 percent school surtax, she would owe $140 in surtaxes. Technically, however, the surtax base is "equal to Iowa individual income tax liability after the application of nonrefundable Iowa tax credits but prior to the application of other refundable credits,"[57] and since 2014 (responsive to the U.S. Supreme Court's decision in *Comptroller of the Treasury of Maryland v. Wynne*), it takes into account tax credits for income taxes paid to other states.[58]

Fifty-three school districts forgo an income surtax (about 15 percent of all school districts), while at the opposite extreme, the West Liberty school district imposes one at 17 percent.[59] The maximum allowable surtax is 20 percent, though no school division presently imposes one at that rate.[60]

Since 1991, the school district surtax has drawn from two discretionary programs, the Instructional Support Program and the Educational Improvement Program. Both programs can be funded through school district-levied property taxes or by a combination of such property taxes and an income surtax, but not by an income surtax standing alone.[61] The former may not comprise more than 10 percent of the school district's program costs, and the latter is only available to school districts with per pupil costs of at least 110 percent of the average state cost per pupil, or which are grandfathered in due to heavy reliance on the prior funding scheme.

56 Whipple, Tom, Susan Crowley, and Mike Goedert. "Legislative Guide to State Taxation in Iowa," 25.

57 Girardi, Anthony. "2014 Iowa Individual Income Tax School District Report." 2015. https://tax.iowa.gov/sites/files/idr/14sklrep.pdf, 2.

58 In response to the ruling, Iowa issued refunds to about 32,000 households, but raised surtaxes in most school districts to make up the revenue gap. See William Petroski, "Court ruling gives 32,000 Iowa households tax refunds," *Des Moines Register*, October 20, 2015, http://www.desmoinesregister.com/story/news/politics/2015/10/20/court-ruling-gives-32000-iowa-households-tax-refunds/74262170/.

59 "Iowa Counties, School District Numbers, Surtax Rates for 2015." Iowa Department of Revenue. 2015. https://tax.iowa.gov/sites/files/idr/forms1/2015Surtax_Rates.pdf.

60 "Income Surtaxes." Iowa Legislative Services Agency, Issue Review. https://www.legis.iowa.gov/docs/publications/IR/8916.pdf, 2–3.

61 The Instructional Support Program also draws state aid funding.

An income surtax of up to 20 percent can be imposed in aggregate for these two programs, in any combination. These surtaxes must be approved by the voters in an election,[62] and while the surtax is collected on state individual income tax returns, the revenues are then remitted by the state to the local school district.[63] In practice, school districts rely almost exclusively on the Instructional Support Program, with *de minimis* revenue raised through the Educational Improvement Program. Income surtaxes for education raised $92.2 million in 2015.[64]

Deductions, Exemptions, and Credits

Federal Deductibility

Iowa is one of only three states (along with Alabama and Louisiana) to provide a 100 percent deduction for federal individual income taxes paid. Another three states allow a limited deduction. (Iowa also provides a 50 percent deduction against corporate income taxes; see Chapter 3.)

Because the federal income tax code is highly progressive, the federal deduction provides greater relief to high income taxpayers, partially offsetting the effects of Iowa's graduated rate structure. Deductibility can also have other effects, often unintentional. When income receives preferential treatment at the federal level, it consequentially receives less preferential treatment under the Iowa tax code, since the deduction will be smaller.

For instance, capital gains income—because it is taxed at a lower level under the federal income tax—yields a smaller deduction in calculating Iowa income tax liability. A similar effect is experienced when taxpayers take advantage of federal child tax credits, the mortgage interest deduction, or other federal preferences which reduce liability. Because federal income tax liability will tend to be multiples of Iowa liability, these federal tax expenditures still provide a net benefit for Iowa taxpayers, but the distributional effects of federal deductibility cut against them, in the same way that it cuts against the progressivity of Iowa's rates and brackets.

62 "Income Surtaxes." Iowa Legislative Services Agency, 2.
63 Whipple, Tom, Susan Crowley, and Mike Goedert. "Legislative Guide to State Taxation in Iowa," 25.
64 "Financing Public Education in Iowa." Iowa Department of Education. October 2015. https://www.educateiowa.gov/sites/files/ed/documents/Financing%20Public%20Education%20in%20Iowa%20Oct%202015.pdf, 19–20.

Federal deductibility moderates the impact of Iowa's nine-bracket graduated tax structure, so any effort to eliminate federal deductibility would have to be paired with rate reductions and a less progressive structure to avoid imposing a substantial tax increase. The degree to which federal deductibility flattens effective rates is illustrated by the examples in the table below.

Table 2f.
Effective Rates on Taxable Income with and without Federal Deductibility

Taxable Income	$25,000	$50,000	$100,000	$250,000	$1,000,000
Iowa PIT Liability					
without deductibility	$1,127	$2,851	$7,137	$20,607	$89,957
with deductibility	$919	$2,245	$5,248	$14,679	$56,332
Effective Rate on Taxable Income					
without deductibility	4.51%	5.70%	7.14%	8.24%	8.80%
with deductibility	3.68%	4.49%	5.25%	5.87%	5.63%

Source: Author's calculations.

After taking the federal deduction, a taxpayer with $1 million in taxable income actually experiences a lower effective rate on taxable income than does a similarly situated taxpayer with $250,000 in taxable income. Our hypothetical taxpayer at the $25,000 level sees an 18.5 percent reduction in liability due to the federal deduction, while the individual with $1 million in taxable income sees a 40 percent savings.

It is important to note that, for the sake of simplicity, the above table only considers taxable income. The effective tax rates of most taxpayers will be significantly lower than these effective rates, because not all net income is taxable due to a range of credits, deductions, and exemptions at the state and federal level. All things being equal, high income individuals eligible for fewer tax preferences at the federal level gain the most from federal deductibility, because they have a larger federal tax liability to deduct in calculating state taxes.

Pass-Through Entity Credits and Exclusions

Part of the standard tax treatment of traditional C corporations is the ability to "apportion" business income among the states, to avoid having all of the company's income taxed in each state in which the company does business (see Chapter 3 for details). S corporations can also take advantage of apportionment, but the privilege is often more narrow, applying exclusively to non-resident shareholder income. A resident shareholder, in such cases, would be able to deduct income taxes paid to other states, but this will differ from using apportionment and—in a single sales factor apportionment state— frequently be less generous.

Since 1998, Iowa resident shareholders have been able to elect to use the provisions available to nonresidents using a credit which approximates single sales factor apportionment.[65] The credit is designed to tax S corporations "on the greater of income attributable to Iowa under the single sales factor or actual distributions by the S corporation less federal income tax."[66] The credit, however, has limitations, most notably that it is unavailable to S corporations that distribute all of their taxable income to shareholders.[67] This approach is unusual; most states simply rely on the ability of the owners of pass-through businesses to deduct taxes paid to other states from their own taxable income.

Pass-through businesses, including farms, may also be able to take advantage of a capital gains deduction commonly known as the "ten-and-ten" deduction. These businesses may deduct capital gains on the sale of business assets, or their business as a whole, provided that they have owned the asset for at least 10 years and materially participated in the business for the past 10 years at the time of sale.[68] Generally speaking, the sale of stocks or bonds does not qualify for the deduction; the exception is a deduction for 50 percent of the gain from the sale or exchange of employer securities of an Iowa corporation to a qualified Iowa employee stock ownership plan (ESOP).[69]

Other Business Incentives

Most of the credits available to C corporations are also available to pass-through businesses paying through the individual income tax system. Not including the S Corporation Apportionment Credit, which was itself worth $37.3 million, pass-through entities claimed $79.5 million in business tax credits in tax year 2013.[70]

Taxpayers Trust Fund Credit

Iowa's Taxpayers Trust Fund, created in 2013, exists to return surplus General Fund revenue to taxpayers, operating somewhat like a modestly structured "taxpayer bill of rights" (TABOR). The surplus is transferred to the Taxpayers Trust Fund, and taxpayers filing in a timely manner may claim a nonrefundable Taxpayers Trust Fund Tax Credit against their liability. The amount of each year's credit is determined by dividing the fund's balance by the number of eligible individuals for the immediately preceding tax year. Any remaining balance gets carried into the next year. Individual filers, however, may not carry forward any excess credit.[71]

65 Whipple, Tom, Susan Crowley, and Mike Goedert. "Legislative Guide to State Taxation in Iowa," 32.
66 "Other Nonrefundable Iowa Credits." Iowa Department of Revenue. https://tax.iowa.gov/expanded-instructions/other-nonrefundable-iowa-credits-1#j.
67 Kristan, Joe. "How Iowans Report S Corporation Income From Non-Iowa Sales." July 21, 2009. http://www.rothcpa.com/archives/004960.php.
68 I.C.A. §422.7(21).
69 "Iowa Capital Gain Deduction for Certain Business/Farm Assets/ESOP Stock Only." Iowa Department of Revenue. 2014. https://tax.iowa.gov/expanded-instructions/iowa-capital-gain-deduction-certain-businessfarm-assetsesop-stock-only-0.
70 Derived from data provided to the author by the Iowa Department of Revenue.
71 Id., "Iowa Taxpayers Trust Fund Tax Credit Preliminary Report," June 6, 2014, https://tax.iowa.gov/sites/files/idr/PrelimTY13taxCreditReport.pdf, 1-5.

Over one million households, representing nearly three-quarters of all Iowa filers, claimed a Taxpayers Trust Fund Credit in the first year of eligibility. Many of those who did not claim the credit had zero or negative tax liability, frequently due to the state's Earned Income Tax Credit.[72] The Taxpayers Trust Fund Credit was $54 for single filers in 2013, but $15 in 2014 and $0 in 2015.[73]

Earned Income and Other Personal Tax Credits

Many of the tax credits available against the individual income tax are intended primarily for pass-through businesses—credits ranging from the S Corporation Apportionment Credit to investment and redevelopment incentives. Other credits, however, are available to individual filers whether or not they have pass-through income. These include, most notably, the Earned Income Tax Credit, as well as tuition and textbook credits and child and dependent care credits. In some years, the aforementioned Taxpayers Trust Fund Credit can provide a sizable reduction in taxable income (as it did in 2013, the most recent year for which claims data are available for all tax credits), but in other years its impact may be limited or even nonexistent, whereas other personal credits tend to be more predictable.

The Earned Income Tax Credit eliminates all tax liability for some low income filers, which is one of the primary reasons why the elimination of federal deductibility has little effect on the lowest income taxpayers, who frequently owe no income tax with or without federal deductibility.

Table 2g.

Most-Claimed Credits against Individual Income Tax Liability, 2013

Tax Credit	Personal?	2013 Amount
Taxpayers Trust Fund Tax Credit	✓	$88,258,180
Earned Income Tax Credit	✓	$65,570,550
S Corporation Apportionment Tax Credit		$37,283,837
Franchise Tax Credit		$16,947,137
Tuition and Textbook Tax Credit	✓	$15,168,557
Iowa Alternative Minimum Tax Credit	✓[74]	$9,063,961
Biodiesel Blended Fuel Tax Credit		$8,952,982
School Tuition Organization Tax Credit		$7,959,472
Investment Tax Credit		$6,398,910
Research Activities Tax Credit		$6,198,938
Endow Iowa Tax Credit		$5,148,980
Child & Dependent Care Tax Credit	✓	$3,813,708
Enterprise Zone Housing Investment Tax Credit		$3,383,880
Agricultural Assets Transfer Tax Credit		$3,017,880
Historic Preservation and Cultural and Entertainment District Tax Credit		$2,568,523
Geothermal Heat Pump Tax Credit		$2,004,953
Ethanol Promotion Tax Credit		$1,448,930
E85 Gasoline Promotion Tax Credit		$1,205,087
Redevelopment Tax Credit		$1,063,459
Renewable Energy Tax Credit		$1,019,227

Source: Data provided to the author by the Iowa Department of Revenue. For prior year published data, see generally, Angela Gullickson, "Iowa's 2012 Tax Credit Claims," Iowa Department of Revenue, July 2015.

72 Petroski, William. "Iowa's Taxpayers Trust Fund helps 1 million households." *Des Moines Register*. June 9, 2014. http://www.desmoinesregister.com/story/news/politics/iowa-politics-insider/2014/06/09/iowa-taxes-fund-legislature/10242021/.

73 "Taxpayers Trust Fund Tax Credit." Iowa Department of Revenue, Expanded Instructions. Multiple years. https://tax.iowa.gov/individuals.

74 Liability under the alternative minimum tax is almost entirely attributable to non-wage income, whether that be pass-through income or a windfall from the sale of an asset. Eligibility for the credit requires no AMT liability in the subsequent year. Many of those claiming the AMT credits on individual income tax returns are likely to be small business owners, but the credit sufficiently benefits other taxpayers as well that we have chosen to designate it as a "personal" credit.

Individual Income Tax Reform Solutions

Our individual income tax solutions would enhance Iowa's competitiveness by simplifying the current nine-bracket system, making the treatment of married filers more equitable, and limiting or eliminating state tax policies which pick winners and losers. These solutions will make Iowa more attractive to individuals looking to relocate, while helping to retain taxpayers who might otherwise be tempted to move to a state with a lower tax environment.

Reduce Disparate Treatment in the Income Tax Code

Iowa never intended to penalize households with two earners, but a tax system designed around the assumption of a single breadwinner is increasingly anachronistic. The ability to file separately on the same return for Iowa purposes while filing jointly at the federal level ameliorates the marriage penalty but does not eliminate it. If Iowa retains a graduated income tax, policymakers should end the disparate treatment of two-earner families by doubling bracket widths for joint filers. The marriage penalty is also eliminated by default should Iowa adopt a single-rate individual income tax.

Similarly, the alternative minimum tax treats some taxpayers differently from others and imposes compliance costs disproportionate to the small share of revenue actually generated. The AMT credit substantially offsets revenues, making the case for retaining the AMT even more tenuous. Collections were a mere $9.9 million in tax year 2013. That revenue is not worth the administrative and compliance costs associated with both the tax and associated credit. Iowa policymakers should repeal the AMT.

Finally, Iowa should conform to the new federal Section 179 expensing provisions on a permanent basis, giving farmers and small business owners greater certainty about the tax implications of their investment decisions.

Were Iowa to adopt these changes while retaining its current rate structure, the state would only improve one place (from 32nd to 31st) on the *State Business Tax Climate Index*'s individual income tax component, but the impact of these changes would be magnified if paired with other reforms. These policies would also help to reduce filing complexity.

Roll Back Business Incentives

Credits available to small businesses reduced individual income tax collections by $116.8 million in 2013, or $79.5 million if the S Corporation Apportionment Credit (which attempts to facilitate a more consistent definition across S and C Corporations) is excluded from the tally. For reasons discussed at greater length in Chapter 3, there is little reason to believe that these credits induce significant investment or promote meaningful economic growth. Benefits accrue to industries and activities favored by the legislature, a state of affairs which is likely to encourage economic decision-making different from the choices that would be made under a more neutral regime.

Iowa policymakers should eliminate most or all of these business credits, using them to pay down rate reductions which benefit Iowans more broadly. Such a policy is included in some of the rate reduction options scored below. Our recommendations extend exclusively to tax credits for businesses, like the Redevelopment Tax Credit or the New Jobs Tax Credit, and not to credits for Iowa wage earners and low-income taxpayers, like the Earned Income Tax Credit or the Child and Dependent Care Tax Credit.

Lower Rates and Repeal Federal Deductibility

On paper, Iowa's rates are anomalously high, and the resultant "sticker shock" is an impediment to growth. The "perception, not consistent with the comparative tax statistics, that Iowa is a very high tax state" has long been a concern of state policymakers.[75]

Iowa has the opportunity to lower rates and repeal federal deductibility at the same time, and indeed these efforts should be paired. Moreover, Iowa legislators should work to provide assurances that the repeal of federal deductibility will not pave the way for future tax increases. One way to do this would be to cut rates below the point of revenue neutrality, underscoring a commitment to reducing Iowans' tax burdens. Another option would be to adopt a program of revenue triggers concurrently with rate and base reform, dedicating a portion of future revenue growth to subsequent rate reductions. These options are both discussed further in Chapter 3.

75 "Final Report." Iowa Tax Fairness and Equity Interim Study Committee. February 1993. https://www.legis.iowa.gov/docs/publications/IP/257034.pdf, vii.

Ideally, Iowa would adopt a single-rate individual income tax (a proposal deemed to have "real merit" by the 1985 Tax Study Committee[76] and subsequent state-commissioned reviews of Iowa tax policy), possibly paired with a generous increase in the standard deduction to ensure that tax burdens do not increase for lower-income taxpayers. Failing that, Iowa policymakers should consider a consolidation of Iowa's nine brackets into a more manageable two or three. Any such effort should be accompanied by the repeal of federal deductibility and, preferably, a reduction in business credits as well. If the state moves to consolidate tax brackets, an increase in the standard deduction and personal exemption credit can ensure that benefits accrue to lower-income taxpayers. Several options, with revenue projections and Index scores (both overall and on the individual income tax component), are listed below.

Table 2h.

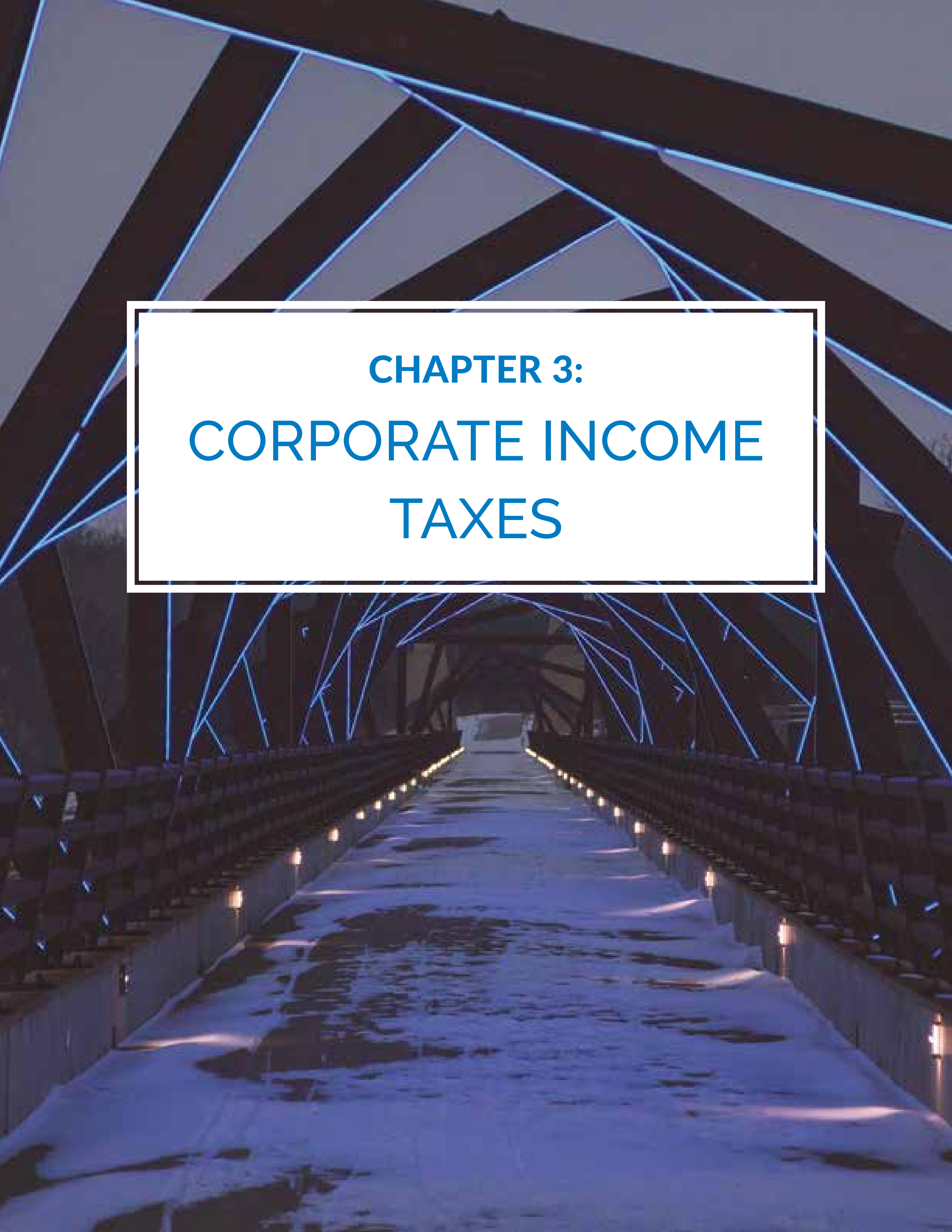
Rate Reduction Options

All options except the status quo also assume the repeal of federal deductibility and repeal of the AMT.

		Resulting *Index* Ranking	
Reform Option	Revenue Impact	Overall	Component
Current System	Revenue Neutral	40th	32nd
20% Across-the-Board Rate Cut (e.g., top rate of 7.2%)	Revenue Neutral	38th	29th
4.3% > $0, 6.5% > $48,120 $3,000 Std. Deduction, $60 PE Credit, Repeal Business Credits	Revenue Neutral	36th	20th
5.8% Flat Tax, $10,000 Std. Deduction	Revenue Neutral	29th	17th
5.3% Flat Tax	Revenue Neutral	28th	14th
5.15% Flat Tax, Repeal Business Credits	Revenue Neutral	28th	14th
4.8% Flat Tax, Repeal Business Credits	- $250 million	27th	14th
4.0% Flat Tax, $25,000 Std. Deduction, Repeal Business Credits	- $1.9 billion	26th	12th

Source: Iowa Department of Revenue; author's calculations.

76 "Report of the Tax Study Committee: A Study of State and Local Taxes in Iowa." Iowa Legislative Services Bureau. 1985. https://www.legis.iowa.gov/docs/publications/IP/256370.pdf, 5, 59–62. The retained consultants proposed such an option, but the committee concluded the issue was not yet ripe, considering the possibility that the federal government might act first.



CHAPTER 3:
CORPORATE INCOME TAXES

Introduction

With a top marginal rate of 12 percent, Iowa finds itself in the unenviable position of imposing the highest top corporate income tax rate in the country (and, including the top federal rate, the highest combined rate in the industrialized world), driven in part by the state's 50 percent deduction for federal corporate income taxes paid. The state's corporate tax structure is progressive, with four brackets, and relies heavily on credits to reduce tax liability for targeted industries.

In this chapter, we provide a broad overview of Iowa's corporate income tax, outline issues to consider regarding the current system, and provide options for reform. Accompanying these solutions are projected *State Business Tax Climate Index* rankings for each recommended reform.

Overview of Iowa Corporate Income Taxation

The earliest taxes in what would become the state of Iowa were territorial taxes levied on merchants, traders, tavern keepers, and peddlers,[77] but the first hints of the present system of corporate taxation emerged with the corporation tax of 1851. Initially restricted to railroads, the tax was soon broadened to encompass a range of industries. The tax was first assessed as a capital stock tax, and soon shifted to a tax on gross earnings. It morphed into a gross receipts tax in 1896, when a tax of 1 percent was imposed upon the entire receipts of business conducted in the state.[78]

In 1934, Iowa became the 27th state to adopt a modern corporate income tax,[79] originally imposed at a flat rate of 2 percent of net income.[80] The rate was adjusted multiple times, but remained a flat tax until 1967, when a three-bracket graduated structure was adopted. The current structure, consisting of four brackets and a top rate of 12 percent, dates back to 1981.[81] The brackets are not indexed for inflation, meaning that over time, a greater share of corporate income is subjected to taxation in the higher brackets.

Table 3a.
Historical Rates and Brackets

Year	Rates and Brackets
1934	Flat rate of 2.0%
1955	Flat rate of 3.0%
1957	Flat rate of 2.0%
1959	Flat rate of 3.0%
1965	Flat rate of 4.0%
1967	Up to $25,000 – 4.0% $25,000 to $100,000 – 6.0% Over $100,000 – 8.0%
1971	Up to $25,000 – 6.0% $25,000 to $100,000 – 8.0% Over $100,000 – 10.0%
1981	Up to $25,000 – 6.0% $25,000 to $100,000 – 8.0% $100,000 to $250,000 – 10.0% Over $250,000 – 12.0%

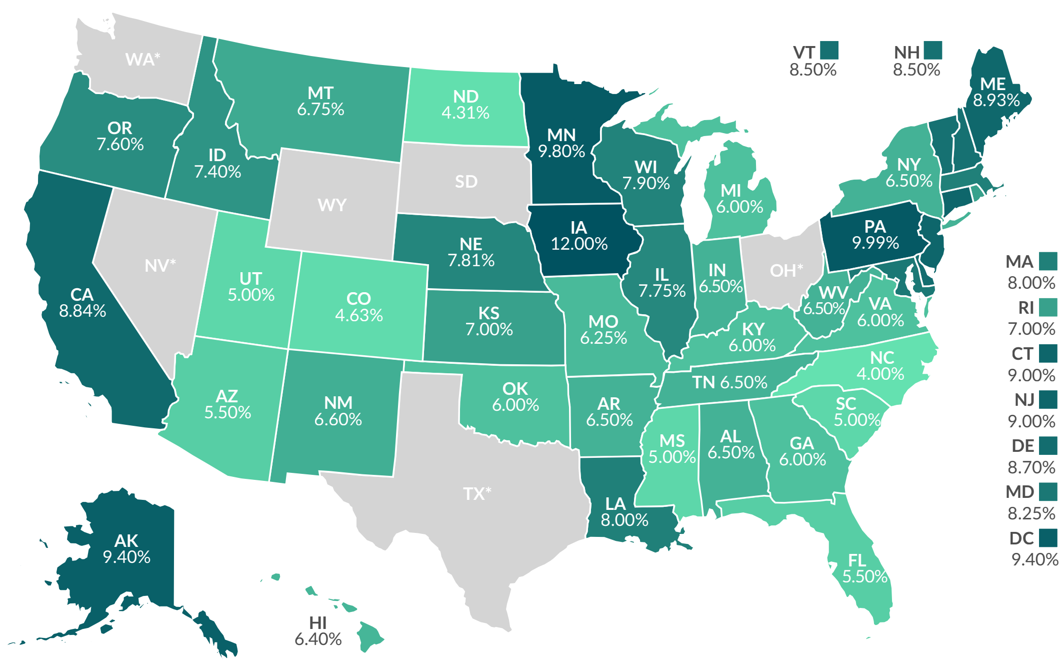
77 Noble, F.H. *Taxation in Iowa: Historical Sketch, Present Status, and Suggested Reforms*. New York: Philip Cowen, 1897, 11–12.
78 Herriott, Frank L. *An Introduction to the History of Corporation Taxes in Iowa.* Des Moines: Plain Talk Printing House, 1902, 17. Gross receipts taxes were once a common form of corporate taxation in the states, but largely fell into obsolescence as the economic shortcomings of gross receipts taxes become more apparent, and alternative forms of corporate taxation grew more feasible.
79 "Dates of Adoption of Major State Taxes." Tax Foundation. January 1, 2005. http://taxfoundation.org/article/dates-adoption-major-state-taxes. Despite a range of earlier corporate taxes, the first modern state corporate income tax was imposed by Wisconsin in 1911. See 1911 Wis. Sess. Laws 989.
80 Iowa 45th G.A., Extraord.Sess. ch. 82, § 28.
81 "Iowa Tax Rate History." Iowa Department of Revenue. https://tax.iowa.gov/iowa-tax-rate-history#corporation.

Iowa is one of only three states which allows a significant deduction for federal income taxes paid, along with Alabama and Louisiana. The state's 50 percent deduction, which entails higher statutory tax rates than would otherwise be necessary, reduces liability for many but not all businesses and subjects state revenue collections to the vicissitudes of the federal tax code. (A federal deduction also applies to the individual income tax, as discussed in Chapter 2.) Iowa's corporate tax code, moreover, is one that provides substantial incentives for select businesses—sometimes to the point of offering them an actual subsidy through the tax code—rather than lower rates across the board.

Among bordering states, only Nebraska imposes a graduated rate corporate income tax, a two-bracket tax with a top rate of 7.81 percent. Missouri, Illinois, Wisconsin, and Minnesota impose single-rate corporate income taxes at rates ranging from 6.25 percent in Missouri to 9.8 percent in Minnesota, while South Dakota foregoes a corporate income tax altogether. Figure 3a shows top marginal corporate income tax rates for all 50 states and the District of Columbia.

Figure 3a.

Top State Marginal Corporate Income Tax Rates in 2016



Note: Connecticut's rate includes a 20 percent surtax. Illinois' rate includes two separate corporate income tax rates. Delaware, Ohio, Texas, Virginia, and Washington have gross receipts taxes with rates not strictly comparable to corporate income taxes.
Source: Tax Foundation, "State Corporate Income Tax Rates and Brackets for 2016".

Forty-four states levy a corporate income tax, and of those, Iowa is one of 17 to adopt a graduated rate system. Single-rate systems are more consistent with the principles of simplicity and neutrality. In contrast to the individual income tax, there is no meaningful “ability to pay” concept in corporate taxation. Jeffery Kwall, a professor at Loyola University Chicago School of Law, notes that

> graduated corporate rates are inequitable—that is, the size of a corporation bears no necessary relation to the income levels of the owners. Indeed, low-income corporations may be owned by individuals with high incomes, and high-income corporations may be owned by individuals with low incomes.[82]

A single-rate system minimizes the incentive for firms to engage in expensive, counterproductive tax planning to mitigate the damage of higher marginal tax rates that some states levy as taxable income rises. Iowa’s graduated rate structure, by contrast, in tandem with the complexity introduced by federal deductibility, encourages businesses to engage in tax arbitrage, which is economically unproductive and introduces additional compliance costs.

Since 2008, 15 states and the District of Columbia have cut corporate income taxes, and Michigan shifted from a gross receipts tax to a traditional corporate income tax.[83] In Iowa, by contrast, corporate income taxes have only been cut once—in 1957—and the current rates and brackets have remained unchanged since 1981.

Reductions in corporate rates elsewhere reflect a trend toward decreased reliance on a highly volatile tax imposed on a declining amount of taxable income, and, in some instances, an effort to simplify the tax structure by broadening the base and lowering the rate. Corporate income tax revenue is in decline across the country as more businesses choose to structure as S corporations and limited liability corporations (LLCs), single sales factor apportionment schemes become more common, and states give away more of their tax base in special credits and deductions.

Corporate income taxes also tend to be complex and impose substantial administrative burdens for both payers and the government, and this complexity has not abated as the tax base has eroded. Finally, revenue volatility necessarily follows from the nature of the tax, since in periods of economic distress, many companies may post losses and thus lack exposure to a corporate income tax.

82 Kwall, Jeffrey L. “The Repeal of Graduated Corporate Tax Rates.” Tax Notes (June 27, 2011): 1395.

83 See, e.g., Henchman, Joseph, “Trend #3: Corporate Tax Reductions, Top 10 State Tax Trends in Recession and Recovery, 2008 to 2012,” Tax Foundation, June 13, 2012, http://taxfoundation.org/article/trend-3-corporate-tax-reductions; *Facts & Figures: How Does Your State Compare?* Tax Foundation, multiple years.

Comparing Iowa's Corporate Income Taxes Regionally and Nationally

Iowa has the second worst corporate income tax structure in the nation according to our *2016 State Business Tax Climate Index*, owing to the state's high and progressive rates, the lack of a carryback provision, heavy reliance on tax incentives, a lack of indexing, and the imposition of a corporate alternative minimum tax. Two of Iowa's regional competitors—South Dakota and Missouri—rank in the top three on the corporate tax component of the *Index*, rendering Iowa's corporate income tax structure uniquely uncompetitive in the region. It must be emphasized that the *Index* measures structure, not collections, where Iowa is firmly middle-of-the-pack.

Table 3b.

***State Business Tax Climate Index* Corporate Income Tax Component Rankings**

Iowa and Regional Competitors (2016)

State	Component Ranking
Iowa	49th
Illinois	36th
Minnesota	46th
Missouri	3rd
Nebraska	31st
South Dakota	1st
Wisconsin	32nd

Source: Tax Foundation, *2016 State Business Tax Climate Index.*

Corporate Income Tax Collections

Corporate income taxes are among the most volatile sources of state revenue, since many companies may generate little or no net income during economic downturns. While practically all revenue streams are cyclical, with collections lower during periods of economic distress, corporate income taxes experience particularly deep troughs. Property values may decline during a recession, but they are rarely wiped out, limiting how low property tax collections can go. Similarly, consumption patterns may decline, leading to lower sales tax revenues than when the economy is booming, but sales can only drop so far. Many companies' net income, by contrast, can bottom out or even go into negative territory. As such, collections tend to be highly volatile, spiking sharply in good years and collapsing in bad ones.

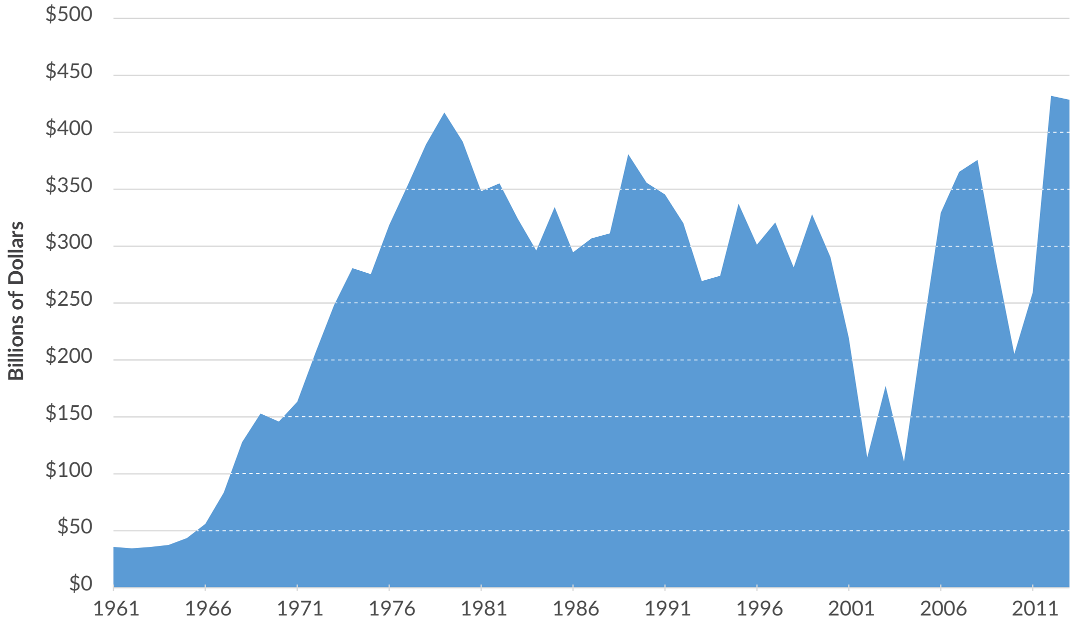
As demonstrated in Figure 3b, corporate income tax collections took a significant hit during the Great Recession, just at the time when Iowa most needed revenue stability. In fiscal year 2015, the corporate income tax brought in $459.7 million,[84] accounting for 5.4 percent of

84 "Annual Report FY 2015." Iowa Department of Revenue. https://tax.iowa.gov/sites/files/idr/IDR%20Annual%20Report%20FY2015.pdf, 6.

state tax collections and 2.1 percent of state expenditures.[85] Iowa's corporate income tax collections per capita were decidedly middle-of-the-pack, with the 26th highest collections in the nation in fiscal year 2014.[86]

Figure 3b.

Iowa Corporate Income Tax Collections (1960–2013, in 2013 Dollars)



Note: Dollar amounts are inflation adjusted based on the annual average Consumer Price Index for All Urban Consumers (CPI-U) with a 2013 base year.
Source: Census Bureau, *State and Local Government Finances*; Bureau of Labor Statistics, *Consumer Price Indexes* (All Urban Consumers).

Corporate Income Tax Expenditures

Iowa offers a range of deductions, exemptions, and credits against corporate income tax liability. By far the most significant of these is the 50 percent deduction for federal income taxes paid (federal deductibility). This deduction is available to all firms, though it does not benefit all companies equally. Many other state tax expenditures function as incentives for select industries or favored business activities.

Incentives can be effective, but they are not efficient. By lowering tax costs for targeted industries or rewarding particular business activities, they can yield higher employment or greater investment in those sectors. Unfortunately, the cost of these incentives must be borne by other, non-favored businesses which bear a correspondingly higher tax burden. Ultimately, incentives involve picking winners and losers, and seek to guide the economy in keeping with policymakers' (often competing) visions. A well-structured tax code with a broader base—eliminating many of the incentives—and a lower rate would do far more to encourage job creation and economic growth.

85 State expenditures ran $21.8 billion in FY 2015. The difference between state expenditures and state tax collections is largely accounted for by intergovernmental transfers, but also includes fees and miscellaneous other revenue sources. See National Association of State Budget Officers, *State Expenditure Report: Examining Fiscal 2013-2015 State Spending*, 2015, http://www.nasbo.org/sites/default/files/State%20Expenditure%20Report%20%28Fiscal%202013-2015%29S.pdf, 8.

86 Kaeding, Nicole. *Facts & Figures 2016: How Does Your State Compare?* Tax Foundation. http://taxfoundation.org/article/facts-figures-2016-how-does-your-state-compare, Table 16.

All states rely on incentives to some degree, but Iowa relies particularly heavily on targeted incentives to help offset the state's high tax rates. Federal deductibility is largely predictable, and can be taken into account by corporations making location decisions. Credits, however, are different: in many cases, companies must navigate an application process to be approved for such credits, and of course, some companies fail to qualify. This uncertainty can make Iowa less attractive than a state with a lower overall rate but fewer incentives, even though firms that do decide to locate in Iowa may obtain approval for a number of credits and other incentives which reduce their overall tax burden.

Deductions, exemptions, and credits all serve to reduce tax liability, but they do so in distinct ways that are important to bear in mind while attempting any comparison. Deductions reduce taxable income by a given amount, whereas credits are a subtraction against tax liability. Imagine, for instance, a corporate taxpayer with $50,000 in Iowa corporate income tax liability. A $5,000 credit will reduce tax liability to $45,000, whereas a $5,000 deduction would reduce tax liability by less than $500, as the reduction in liability will be equal to the tax on that $5,000.[87] An exemption, meanwhile, excludes certain revenue from the tax rolls altogether.

Federal Deductibility

The 50 percent deduction for federal taxes paid—similar to the 100 percent deduction on the individual income tax—is the most notable feature of Iowa's corporate tax structure. Only two other states (Alabama and Louisiana) offer deductions against the entirety of corporate income tax liability; another three states allow a limited deduction up to a capped amount.

Because federal corporate income tax liability necessarily diverges from state liability due to variations in rate distributions and differences in the availability of exemptions, deductions, and credits, this tax deduction has distributional effects which favor companies with greater exposure to corporate income taxes and subjects state revenue collections to the effects of changes in the federal tax code. A revenue neutral coupling of the deduction's repeal with an offsetting rate reduction would increase the neutrality of the tax code and reduce revenue volatility. Notably, federal deductibility is statutory, not constitutional, rendering it easier to phase out or repeal.[88]

Federal deductibility serves to ease the burden of Iowa's high, and highly progressive, corporate income tax rates, with a top rate of 12 percent on taxable income over $250,000. Any effort to eliminate federal deductibility must be paired with rate reductions and some attenuation, if not the elimination, of the corporate income tax's progressivity to avoid a substantial increase in corporate tax burdens. As currently instituted, the federal deduction serves to limit not only the effective rate of taxation that corporations experience, but also the degree to which that effective rate increases with higher net corporate income, as the following table illustrates.

87 The precise amount cannot be ascertained without further details which would complicate the example, given the role of federal deductibility.

88 I.C.A. §422.35(4).

Table 3c.

Effective Rates on Taxable Income with and without Federal Deductibility

Taxable Income	$50,000	$100,000	$500,000	$5,000,000	$10,000,000
Iowa CIT Liability					
without deductibility	$3,500	$7,500	$52,500	$592,500	$1,192,500
with deductibility	$3,200	$6,610	$4,230	$490,500	$988,500
Effective Rate on Taxable Income					
without deductibility	7.00%	7.50%	10.50%	11.85%	11.93%
with deductibility	6.40%	6.61%	8.46%	9.81%	9.89%

Not only does federal deductibility reduce overall liability, it actually cuts against progressivity. A company with $50,000 in taxable income pays 91.4 percent of the tax burden it would have experienced without the deduction, whereas a corporation with ten times as much taxable income pays 80.6 percent of its pre-deduction liability. The percentage can creep back up slightly at higher net income levels, e.g., 82.9 percent for $10 million in taxable income. In other words, due to federal deductibility, the actual burden within every corporate income tax bracket is lower than the statutory tax rate would indicate, but this feature is more pronounced at higher income levels, a reflection of the progressivity of the federal corporate income tax.

As with the table for individual income tax comparisons (see Chapter 2, Table 2f), it is important to note that for the sake of simplicity, the above table only considers taxable income. The effective tax rates of most corporations will be significantly lower than these effective rates, because not all net income is taxable due to a range of credits, deductions, and exemptions at the state and federal levels. All things being equal, corporations with limited access to tax preferences at the federal level gain the most from federal deductibility, because they have a larger federal tax liability to deduct in calculating state taxes.

Tax Credits

In tax year 2013, the most recent year for which a full accounting of tax credits has been made, $102.5 million was claimed in credits against the corporate income tax.[89] This is not the sum of the state's outstanding tax credit liability, nor the amount of tax credits made available in a given year, but rather the amount actually claimed.

89 Figures supplied to the author by Iowa Department of Revenue. For published 2012 statistics, see "Tax Credits Contingent Liabilities Report," Iowa Department of Revenue, December 10, 2015, https://tax.iowa.gov/sites/files/idr/Contingent%20Liabilities%20Report%201215.pdf, 7.

In broad terms, Iowa's tax credits can be divided into two categories: refundable and non-refundable. A refundable credit may be claimed in excess of a firm's corporate income tax liability. If, for instance, a firm owed $100,000 in corporate income taxes but claimed $150,000 in refundable credits, the firm would actually receive a net payment of $50,000 from the Department of Revenue. Non-refundable credits, by contrast, cannot exceed actual tax liability, though they can be carried forward to future years and may be transferable, meaning that they can be sold (inevitably at a discount) to others seeking to reduce their own tax liability. In 2012, refundable tax credits accounted for over 63 percent of all tax credit claims in Iowa.[90]

Other dichotomies exist as well. Some credits are automatic, meaning that any eligible taxpayer may claim them, while others are awarded, requiring that an application for the credit be approved. Some credits are transferable, meaning that they can be transferred or sold to a third party—which is particularly valuable when a company has insufficient tax liability to utilize a non-refundable credit fully—while others are not. And some credits are capped, meaning that there is a maximum amount allocated for a given credit (awards can be prorated among filers if the cap is reached), while others are uncapped, available in full to all eligible claimants.[91]

A few recent tax credits are under a unified (umbrella) cap. In theory, including most or all tax credits under a unified cap would serve to limit the growth of tax expenditures by forcing them to compete against each other, requiring legislators to set priorities within a budget amount. In practice, the aggregate cap has been raised as new credits are added, limiting its utility.

The Research Activities Credit (RAC) was responsible for by far the largest share of refundable credits claims, at $50.4 million in 2015. Actual refunds, which are always less than the amount of credits claimed, ran $38.5 million in 2015.[92] This particular credit is chiefly claimed by a small number of large manufacturing firms in the state; in 2015, the top three claimants combined for $27.1 million in claims, representing 53.7 percent of all claims made that year.[93] A Supplemental Research Activities Tax Credit accounted for another $6.8 million in claims and $6.0 million in awards.[94]

90 Gullickson, Angela. "Iowa's 2012 Tax Credit Claims." Iowa Department of Revenue. July 2015. https://tax.iowa.gov/sites/files/idr/2012%20Tax%20Credit%20Claim%20Report.pdf, 35.

91 "Tax Credit Contingent Liabilities Report." Iowa Department of Revenue. October 14, 2014. https://tax.iowa.gov/sites/files/idr/1014RECReport.pdf, 2.

92 More recent figures are only available for select tax credits. See "Research Activities Tax Credit Annual Report For the Period January 1 – December 31, 2015," Iowa Department of Revenue, https://tax.iowa.gov/sites/files/idr/RAC%20Annual%20Report%202015.pdf, 3–4.

93 Id., 5.

94 Id., 3–4.

In 2011, an Iowa Department of Revenue study held that it is "reasonable to believe that the RAC does not impact companies' research decisions on the margin."[95] Although structured as a research and development incentive, the state's own study concluded that the credit functions like a more typical employment incentive, designed to attract or retain businesses and create jobs. The analysis "did not show that those companies [receiving the credit] pay higher average wages to employees compared to companies in the same industry with no credit claims," and further noted that the credit is "not heavily utilized by start-up companies."[96]

The Department of Revenue's findings were equally critical of other credits. A New Jobs Tax Credit, designed to incentivize job creation, fails to live up to its billing, with the Department concluding that "the New Jobs Tax Credit has not served as an incentive for claimants to create additional jobs," and noting that two-thirds of firms eligible for the credit did not even claim it, possibly deciding that "the administrative cost of making a claim exceeded the benefits."[97]

The historic preservation tax credit, the economic impact of which is held to be largely felt in employment growth in the construction sector, is estimated to yield between 5 and 21 jobs for every million dollars' worth of tax credits. The upper bound figure is based on the unrealistic assumption that none of the rehabilitation projects would have been undertaken absent the credits, and none of the private funds dedicated to those projects would have gone to other construction projects instead.[98] At the lower bound, each job created would cost $200,000 in tax credits.

Other significant credits include an investment tax credit (non-refundable), a venture capital tax credit (non-refundable), and a biodiesel blended fuel credit (refundable). These credits help limit—and in some cases eliminate—corporate tax liability for some firms, but do so at the expense of neutrality, requiring less advantaged firms to shoulder a larger tax burden to facilitate these carve-outs.

Although the value of some credits is known for 2015, the last year for which complete data are available is 2013, when tax credits reduced corporate income tax liability $102.5 million, cutting corporate income tax receipts by about 20 percent. Table 3d lists the ten largest credits in tax year 2013.

95 Gullickson, Angela, Amy Harris, Zhong Jin. "Iowa's Research Activities Tax Credit." Iowa Department of Revenue, Tax Credits Program Evaluation Study. December 2011. https://tax.iowa.gov/sites/files/idr/RAC2011.pdf, 26.

96 Id., 37–38.

97 Jin, Zhong. "The Iowa New Jobs Tax Credit." Iowa Department of Revenue, Tax Credits Program Evaluation Study. December 2015. https://tax.iowa.gov/sites/files/idr/New%20Jobs%20Tax%20Credit%20Evaluation%20Study.pdf, 6.

98 Id., "Iowa's Historic Preservation and Cultural and Entertainment District Tax Credit," Iowa Department of Revenue, Tax Credits Program Evaluation Study, December 2014, https://tax.iowa.gov/sites/files/idr/Historic%20Preservation%20Tax%20Credit%20Evaluation%20Study.pdf, 32–33.

Table 3d.

Most-Claimed Credits against Corporate Income Tax Liability (2013)

Tax Credit	Refundable?	Transferable?	Cap?	2013 Amount
Research Activities Tax Credit	✓			$44,214,450
Investment Tax Credit				$24,261,328
Iowa Alternative Minimum Tax Credit				$7,935,933
Biodiesel Blended Fuel Tax Credit	✓			$6,750,412
Supplemental Research Activities Tax Credit	✓			$6,368,629
Historic Preservation and Cultural and Entertainment District Tax Credit	✓	✓	✓	$5,938,703
Renewable Energy Tax Credit		✓		$1,512,655
New Jobs Tax Credit				$1,477,869
Ethanol Promotion Tax Credit	✓			$889,243
Enterprise Zone Housing Investment Tax Credit		✓	✓	$874,383

Source: Data provided to the author by the Iowa Department of Revenue. For prior year published data, see generally, Angela Gullickson, "Iowa's 2012 Tax Credit Claims."

Other Deductions and Exemptions

Like all states, Iowa offers a range of deductions and exemptions against the corporate income tax. For instance, Iowa businesses can deduct the value of any federal Work Opportunity Credits or claim additional deductions above actual compensation for certain employment actions. Exemptions or exclusions of income exist for employer-paid contributions to Employment Stock Ownership Plans (ESOPs), insurance payouts, like-kind exchanges, and interest on government bonds. Some deductions and exemptions are designed as incentive programs, while others are intended to facilitate the arrival at a proper definition of income (i.e., one that does not lead to double taxation).

Structural Elements

Net Operating Loss Carrybacks and Carryforwards

The corporate income tax is designed to tax only the profits of a corporation. However, a yearly profit snapshot may not fully capture a corporation's true profitability. For example, a corporation in a highly cyclical industry may look very profitable during boom years but post substantial losses during bust years. When examined over the entire business cycle, the corporation may actually have an average profit margin.

Although corporate income tax liability is determined on an annualized basis, business cycles do not follow the calendar. This can be problematic for corporations with cyclical income, enjoying high profitability one year and losses the next. To mitigate this reality, states (along with the federal government) allow corporations to deduct losses from previous years and future years to offset current taxes owed. These net operating loss (NOL) "carrybacks" and "carryforwards" smooth out tax obligations over time, ensuring that industries with cyclical income are not at a competitive disadvantage against industries with more consistent and stable revenue streams.

The deduction for net operating losses helps ensure that, over time, the corporate income tax is a tax on average profitability. Without the NOL deduction, corporations in cyclical industries pay much higher taxes than those in stable industries, even assuming identical average profits over time.

There are two important variables of a state's NOL provisions: the number of years allowed for carrybacks and carryforwards, and caps on the amount of carrybacks and carryforwards. The maximum that any state allows for carrybacks is three years, with no cap (that is, an unlimited dollar amount allowed). Among the states that allow carrybacks, the most common timespan is two years with no cap. The maximum carryforward given in any state is 20 years, again with no cap (most states allow either 15 or 20 years, though 20 is more desirable). The longer the overall time span, the higher the probability that the corporate income tax is being levied on the corporation's average profitability.

Currently, Iowa disallows carrybacks but offers a 20-year carryforward period with no cap. The present structure dates to 2009; previously, Iowa allowed three-year uncapped carrybacks as well.[99] Businesses which experience a period of negative income but return to profitability have the opportunity to deduct their losses against future taxes, but companies which fail to turn the corner no longer have an opportunity to fully deduct their losses.

Every state with a corporate income tax offers a carryforward provision. Thirty states and the District of Columbia parallel the federal government by offering 20 year uncapped carryforward periods, six states limit carryforwards to 15 years, and the remaining states offer more limited carryforward periods. Fifteen states permit net operating loss carrybacks.[100]

Table 3e shows the treatment of Net Operating Losses in Iowa and regional competitor states.

Table 3e.

Treatment of Net Operating Losses

Iowa and Select Regional Competitors (2016)

State	Carryback (Years)	Carryback Cap	Carryforward (Years)	Carryforward Cap
Iowa	0	$0	20	Unlimited
Illinois	0	$0	12	Unlimited
Minnesota	0	$0	15	Unlimited
Missouri	2	Unlimited	20	Unlimited
Nebraska	0	$0	20	Unlimited
South Dakota	Not applicable (no CIT)			
Wisconsin	0	$0	20	Unlimited

Source: Tax Foundation, *2016 State Business Tax Climate Index*; Bloomberg BNA, Tax and Accounting, Corporate Income Tax, Standard Apportionment Rules.

99 Iowa Senate File 483. Iowa Legislature, 83rd Session. https://www.legis.iowa.gov/legislation/BillBook?ga=83&ba=SF483.

100 Walczak, Jared, Scott Drenkard, and Joseph Henchman. *2016 State Business Tax Climate Index*. Tax Foundation. November 17, 2015. http://taxfoundation.org/article/2016-state-business-tax-climate-index, 63.

Alternative Minimum Tax

As it does with the individual income tax, Iowa imposes an alternative minimum tax (AMT) on corporate income. The tax generates little revenue and affects few taxpayers; only 288 businesses had AMT liability in 2013, raising a mere $5.8 million in state revenue.[101] Such minimal revenue is not worth the compliance burden for business filers or state auditors, as it necessitates calculating alternative liability even though only 1 percent of business filers are actually liable under the AMT.[102]

Evidence shows that AMTs do not increase efficiency or improve fairness in the tax code. They generate little money, impose compliance costs that may exceed collections, and encourage firms to cut back or shift their investments.[103] If a corporate AMT is intended to protect against corporations reducing their liability too much by taking an excessive amount of deductions or credits, then rather than creating a parallel tax code, lawmakers should consider making the state's tax credits less generous.

Apportionment and Sourcing

When businesses operate in more than one state, income must be apportioned among those states for tax purposes. The legal term for whether a state has the power to tax is *nexus*—which typically requires a business to have some physical presence, either property or employees, in a state—and the determination of the amount of that business's income subject to a given state's corporate income tax is known as *apportionment*. States apportion business profits based on some combination of the percentage of company property, payroll, and sales located within their borders.

Iowa has employed single sales factor apportionment from the outset, meaning that only sales are taken into account in determining income apportionment.[104] If, hypothetically, a business owned all of its property and employed all its personnel in Iowa, but only sold 10 percent of its sales in the state, then 10 percent of its net income would be subject to Iowa's corporate income tax. For decades, Iowa was alone in this practice, with other states adopting an evenly weighted three-factor apportionment formula of property, payroll, and sales. After Iowa's unique system survived a legal challenge in 1978,[105] however, other states followed suit, and what was once a unique feature of Iowa's tax system has since been adopted by 19 other states.

Significantly, all of Iowa's neighbors have either adopted single sales factor as their standard apportionment method or, in the case of Missouri, permit businesses to elect to use single sales factor apportionment. (Missouri's standard apportionment method is evenly weighted three-factor apportionment, meaning that property, payroll, and sales are weighted equally.)

101 Gullickson, Angela. "Iowa's Alternative Minimum Tax Credit." Iowa Department of Revenue, Tax Credits Program Evaluation Study. December 2015. https://tax.iowa.gov/sites/files/idr/Minimum%20Tax%20Credit%20Evaluation%20Study.pdf, 11.

102 Author's calculation based on documents provided by the Iowa Department of Revenue.

103 See generally, Chorvat, Terrence, and Michael Knoll, "The Economic and Policy Implications of Repealing the Corporate Alternative Tax," Tax Foundation, 2002, http://taxfoundation.org/sites/taxfoundation.org/files/docs/ef489a36f1e66f3dec528b95dc164a54.pdf.

104 Iowa Code Ann. §422.33(2)(a)(2).

105 *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

Beneficially, Iowa foregoes a throwback rule, which some states utilize in an attempt to capture and tax so-called “nowhere income” that is earned out of state in jurisdictions where it is not subject to foreign taxation.[106] The state has also retained unitary reporting, as opposed to combined (or consolidated) reporting. Uniquely, Iowa also offers an S Corporation Apportionment Credit which approximates the effect of corporate single sales factor apportionment for S corporations, which file through the individual income tax system (see Chapter 2).

Consistent with its approach on apportionment, Iowa also sources service income to the location where the benefit of a service is received. Nineteen states emphasize, in varying ways, the location where a service is performed or its benefit is received, which is known as market or benefit sourcing and stands in contrast to sourcing rules emphasizing the location of the greater proportion of income-producing activity (IPA sourcing).[107] Iowa’s particular benefits sourcing regime has been adopted in 12 other states.[108]

Service income is “sourced” to facilitate apportionment. As noted previously, the three factors that can be considered in apportionment are payroll, property, and sales, with Iowa focusing exclusively on sales. For income derived from the sale of goods, all states emphasize the location of the sale, or the destination if the good is shipped to the customer. Service income imposes an added wrinkle. If a company based in Iowa performs a service for a company in Nebraska, and those performing the service never leave Iowa while those receiving the benefit of the service remain in Nebraska, sourcing rules are necessary to determine whether the sales income is apportioned to Iowa.

Under Iowa’s system of benefits sourcing,[109] when an Iowa firm performs a service which is enjoyed in another state, that income is not sourced to Iowa for apportionment purposes. Conversely, when an out-of-state firm provides a service, the benefit of which is enjoyed in Iowa, the portion of the foreign corporation’s income represented by that sale is apportioned to Iowa. Iowa’s single sales factor apportionment rule and its sourcing method both result in a significant measure of tax exporting, limiting liability for firms based in Iowa while increasing liability for firms located outside of the state.[110]

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106 Walczak, Jared, Scott Drenkard, and Joseph Henchman. *2016 State Business Tax Climate Index*, 64.

107 Walczak, Jared. *Location Matters: The State Tax Costs of Doing Business*. Tax Foundation. 2015. http://taxfoundation.org/sites/taxfoundation.org/files/docs/TF_LocationMatters_2015.pdf, 114.

108 Arizona, California, Georgia, Illinois, Maine, Maryland, Michigan, Minnesota, Ohio, Utah, Washington, and Wisconsin. The other states with market or benefits-based sourcing are Florida and Oklahoma, which emphasize the state marketplace of the customer, and Alabama, Massachusetts, Nebraska, and Pennsylvania, which emphasize delivery of service to a location in a state.

109 Some Iowa sources refer to the state as using market-based sourcing. We employ the term “benefit sourcing” to distinguish Iowa’s approach from those adopted in other states, but Iowa’s system can be understood as falling under a broader umbrella of market-based sourcing, in contrast with IPA sourcing.

110 States’ disparate apportionment rules can result in more than 100 percent of a firm’s income being subject to corporate taxation. However, the courts have adopted an “internal consistency” rule which provides that no state may adopt an apportionment rule which, if uniformly adopted in all states, would result in taxation of more than 100 percent of income. See *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

Corporate Income Tax Reform Solutions

Our corporate income tax solutions would make Iowa more competitive by bringing its corporate income tax rate from the highest in the nation to rates more typical for the region while broadening the tax base by limiting or eliminating state tax policies which pick winners and losers. These policies help mitigate tax uncertainty for business, eliminate the "sticker shock" associated with Iowa's high statutory income tax rates, and begin moving the state away from a system of taxation which is only competitive for favored industries, positioning the state for future growth.

Repeal Federal Deductibility

The past three decades have seen three major efforts to repeal federal deductibility. These fell short due largely to concerns that the repeal would result in an increase in tax liability. Policymakers should explore ways to repeal federal deductibility on a revenue neutral (or better) basis, and to create institutional barriers to the subsequent tax hikes that many Iowans fear would follow the deduction's repeal.

Federal deductibility against the corporate income tax will reduce revenue by an estimated $43.6 million in fiscal year 2017. With the repeal of federal deductibility alone, Iowa could adopt a flat corporate income tax of 9.0 percent on a revenue neutral basis. (Note that 90 percent of corporate income tax revenue is generated from filers paying the top marginal rate.)

While a 9.0 percent rate is not itself competitive, combined with other reforms, the repeal of federal deductibility can help the state achieve a more modest—and ideally flat—rate. There is no concept of "ability to pay" with corporate net income, and consequently no compelling policy rationale for a graduated-rate structure. Failing the adoption of a single-rate tax, however, legislators should at least index the corporate income tax brackets to inflation to avoid "bracket creep."

Policymakers should also strongly consider reducing the rate below the revenue neutral threshold, or adopting revenue triggers to automatically reduce the rate should future revenue targets be met, to instill confidence that the elimination of federal deductibility is not a prelude to tax increases. For instance, legislation might stipulate that the rate will be reduced by a further percentage point once corporate income tax revenue increases by $50 million—a target which would allow some revenue growth to be retained, but still keep the state on the path of lower rates.[111]

111 Separate Iowa Department of Revenue analysis suggests that the revenue impact associated with a 4 percent flat individual income tax is only modestly distinct from the impact of a two-bracket structure, with a 2 percent rate on income under $150,000 and a 4 percent rate on all other corporate net income. The Department estimated $197.8 million in the first year for the two-rate system and $188.8 million for a flat-rate system.

Table 3f.
Federal Deductibility Reform Options

		Resulting Index Ranking	
Reform Option	Revenue Impact	Overall	Component
Current System	Revenue Neutral	40th	49th
9.0% Flat Tax	Revenue Neutral	40th	43rd
6.5% Flat Tax	-$100 million	37th	27th
4.0% Flat Tax	-$200 million[112]	32nd	6th

Rein in Tax Credits

Tax credits reduced corporate tax liability by $102.5 million in fiscal year 2013, and that figure can only be expected to rise, albeit fitfully. (Tax credit claims are highly volatile and difficult to project with any certainty, but the overall trajectory is upward.) Nearly half of this figure is associated with the Research Activities Tax Credit ($44.2 million) and the Supplemental Research Activities Tax Credit ($6.4 million).

The Iowa Economic Development Authority estimates that $478.1 million in economic development tax credits and $56.5 million in direct economic assistance has helped to create 44,786 jobs since January 2011, at a cost of $11,937 per job.[112] The actual cost may be significantly higher, since it is notoriously difficult to ascertain how many jobs would have been created in the absence of given tax incentives. As noted earlier, the Iowa Department of Revenue, in its rolling studies of tax credit efficacy, casts doubt on the ability of many of Iowa's tax incentives to yield the intended economic results. A well-structured tax code with a broad base and lower rates would be far superior in inducing job creation and economic growth.

At a minimum, policymakers should consider bringing all of Iowa's current tax credits under a unified cap, which rises at—or under—the rate of inflation, and insisting that all future tax credits be included under this cap without revision. This would create healthy competition among tax credits, as those advocating for an increase in one would have to find an offset elsewhere.

A standing tax expenditure committee or commission should be charged with making, and introducing, legislative recommendations based upon the tax expenditure studies already produced on a regular basis by the Department of Revenue. A slightly more ambitious scenario might involve a declining cap, under which legislators could work to preserve the comparatively more efficient credits by eliminating those with little or no return.

An ideal policy, of course, would involve the immediate reduction or even elimination of existing tax credits. Even assuming no growth in credits taken—an excessively conservative assumption—the elimination of all corporate income tax credits, combined with the repeal of federal deductibility, would allow a flat corporate rate of 6.5 percent on a revenue neutral basis, which would be far more conducive to growth than the current structure. A 50 percent reduction in credits would facilitate a flat rate of about 7.7 percent.

112 "Fiscal Year 2015 Annual Report." Iowa Economic Development Authority. 2015. http://www.iowaeconomicdevelopment.com/resources/reports/FY15Report.

Table 3g.
Tax Credit Reform Options
All options except the status quo also assume the repeal of federal deductibility.

		Resulting *Index* Ranking	
Reform Option	Revenue Impact	Overall	Component
Current System	Revenue Neutral	40th	49th
50% Credit Reduction + 7.7% Flat Rate	Revenue Neutral	38th	33rd
50% Credit Reduction + 5.2% Flat Rate	-$100 million	34th	17th
Repeal All Credits + 6.5% Flat Rate	Revenue Neutral	33rd	14th
Repeal All Credits + 3.9% Flat Rate	-$100 million	30th	3rd

Source: Iowa Department of Revenue; author's calculations.

Eliminate the Alternative Minimum Tax

A tax which only 1 percent of businesses pay, but which 100 percent must calculate to determine liability imposes needless compliance costs, particularly when total AMT liability has only exceeded $6 million once since 2005.[113] Only eight states impose an AMT.[114] A corporate AMT is essentially an admission of failure in reining in tax credits, serving as a backstop against businesses taking "too many" credits or deductions. Were the state to reduce its heavy reliance on tax incentives, the corporate AMT would become even less consequential.

Replacing the corporate AMT, taken alone, is not projected to improve Iowa's score on the *State Business Tax Climate Index*, but it can have an impact when combined with other reforms.

Improve Treatment of Net Operating Losses

Iowa's 2009 elimination of its three-year carryback provision penalizes struggling businesses, denying them the ability to deduct losses at the time of their greatest financial need. Iowa can improve business cycle neutrality by restoring its carryback provision, the elimination of which was projected to save the state an average of $18.7 million per annum over the first three years.[115]

This reform would improve Iowa by one rank on the corporate income tax component of the *Index*, or three ranks if combined with the elimination of the alternative minimum tax. At lower tax rates, the effect would be more significant.

113 Gullickson, Angela. "Iowa's Alternative Minimum Tax Credit," 11.
114 Walczak, Jared, Scott Drenkard, and Joseph Henchman. *2016 State Business Tax Climate Index*, 24.
115 Robinson, Jeff. "SF 483 Fiscal Note." Iowa Legislative Services Agency. https://www.legis.iowa.gov/docs/FiscalNotes/83_2703SVv0_FN.pdf, 2.

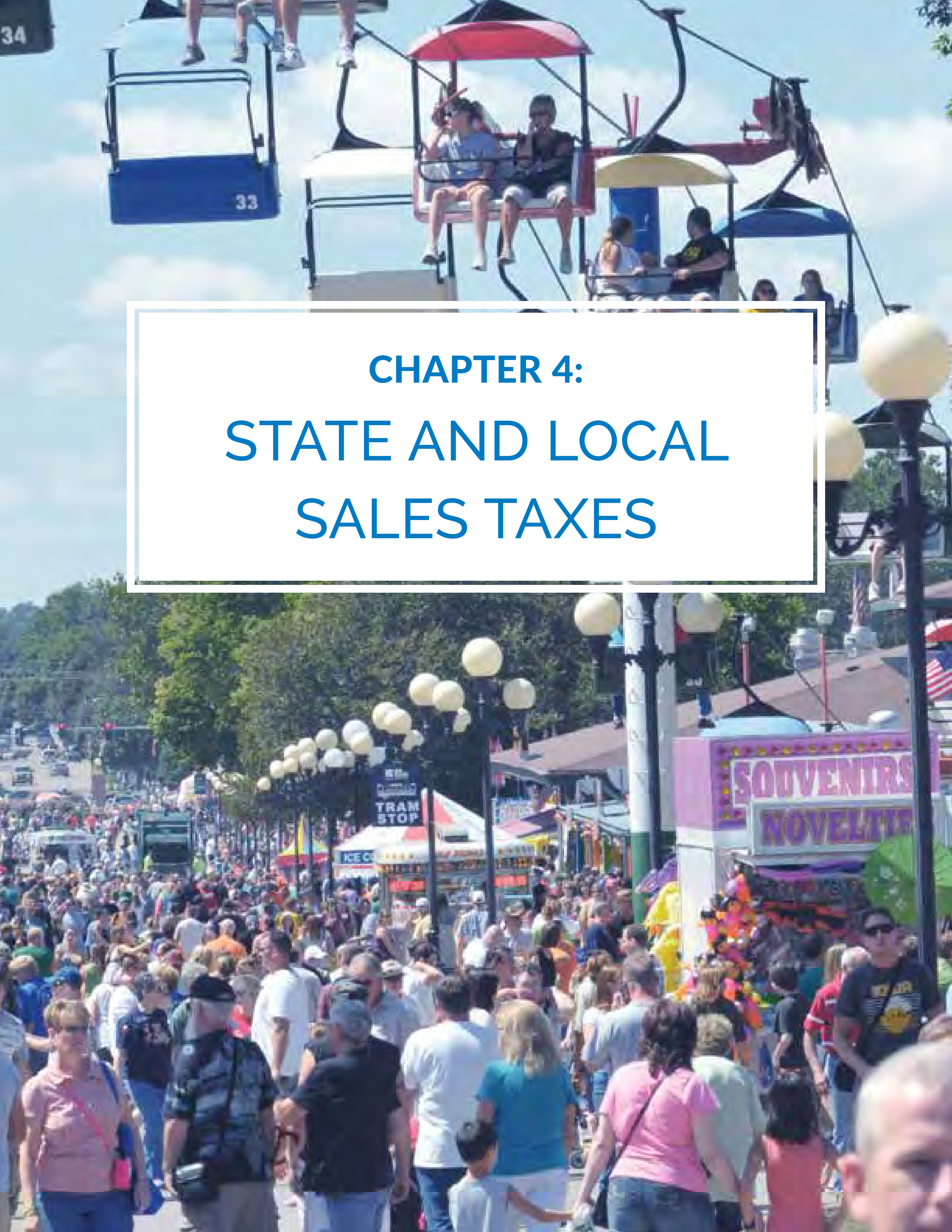
All Corporate Income Tax Reforms

Taken together, the most ambitious reform option for Iowa would include the following components:

- Adoption of a 3.9 percent flat corporate income tax;
- Repeal of federal deductibility;
- Elimination of all corporate income tax credits;
- Abolition of the alternative minimum tax; and
- Implementation of a three-year uncapped carryback.

Were Iowa to adopt all of these provisions, the net revenue loss would be about $125 million, and Iowa would improve from 49th to third on the corporate component of the *Index*, and from 40th to 26th overall. The most aggressive revenue neutral reform outlined above would see Iowa move to 33rd overall, with a flat rate of 6.5 percent.

CHAPTER 4:
STATE AND LOCAL SALES TAXES



Introduction

The sales tax features prominently in Iowa tax reform considerations, and has for decades. Over the years, Iowa has added a local option sales tax; created, then modified, a sales tax increase to fund school infrastructure projects; diverted a small portion of that additional tax levy to property tax relief; expanded exemptions for manufacturing machinery and business inputs; and dedicated a portion of any future tax increase to conservation efforts. Proposals now exist to divert a portion of existing revenues to fund water quality improvement, or to increase the rate for similar purposes.

Iowa's sales tax faces challenges common to many of its regional competitors: a shrinking tax base, limited taxation of the service sector, constraints on collecting taxes on remote transactions, and uncertainty over tax definitions and administration. In some respects, Iowa is ahead of many other states. This holds true, for instance, in the number of services included in the base (though the state's inclusion of services remains modest), conformity with Streamlined Sales Tax, and preparedness for possible future taxation of online transactions through federal legislation such as the Marketplace Fairness Act or Retail Transactions Parity Act. However, in other respects—particularly those pertaining to certainty and predictability—the state lags behind its peers.

In this chapter, we provide a general overview of the Iowa sales tax system (both state and local) and offer recommendations for modernizing the state's sales tax. We explore the state's current sales tax structure, place Iowa's sales tax in both a regional and national context, consider the state's treatment of business inputs, explore options for expanding the base to include additional services, and review requirements incumbent upon states wishing to participate in prospective future federal remote seller regimes. We conclude the chapter by outlining three proposals for reform, including a menu of base expansion options.

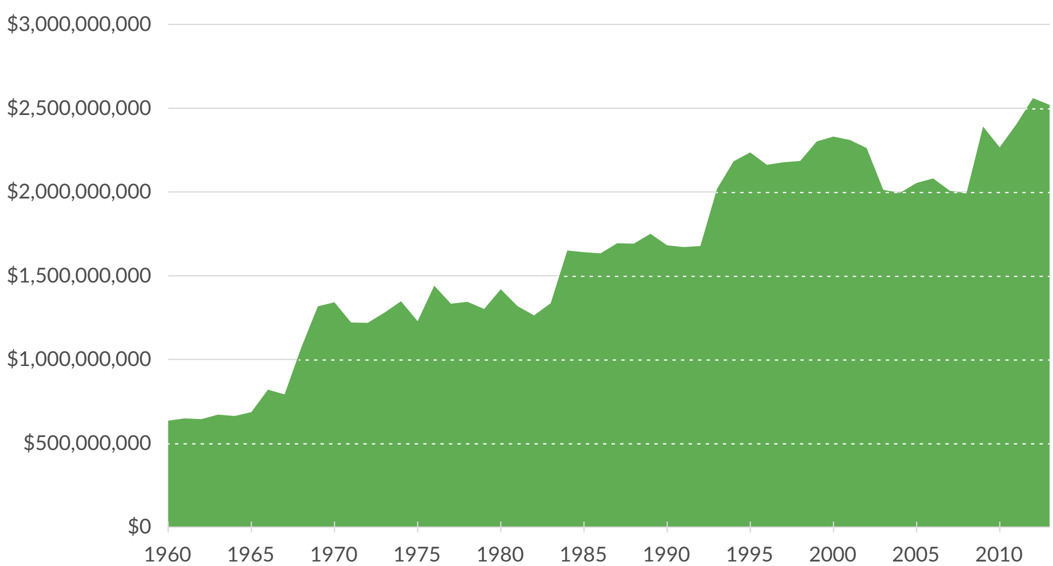
Sales Tax Collections

Sales taxes are a significant driver of state revenue but only a modest source of local government revenue in Iowa, accounting for 30.1 percent of total state tax collections but a mere 5.6 percent of local tax collections. The state figure hews closely to the national average, whereas the local share, as a percentage of local revenues, is just under half the average local government reliance on sales tax revenues.[116]

In fiscal year 2013, Iowa state and local governments raised $2.8 billion in state and local sales taxes, according to the Census Bureau, $2.5 billion of which went to state coffers. Collections have grown in real terms over time, though this trajectory has been contingent on a series of tax increases. Collections rose sharply after a 1992 rate increase, but peaked in the early 2000s, with declines (in real terms) continuing well after the country had climbed out of recession. Another tax hike in 2008 boosted collections, which by 2013 stood about $200 million higher than its earlier peak.[117]

Figure 4a.

Sales Tax Collections (Inflation Adjusted, 1977–2013)



Sales Tax Rate Composition

As of January 2016, Iowa had an average combined state and local sales tax rate of 6.79 percent, placing the state squarely in the middle of the pack on combined rates, and virtually on par with neighboring Nebraska (6.87 percent). Wisconsin (5.41 percent) and South Dakota (5.84 percent) have lower rates, though the sales tax base in South Dakota is much broader, covering a wider range of goods and services, while combined rates in Missouri (7.86 percent) and Illinois (8.64 percent) exceed the rate in Iowa.[118]

116 "State and Local Government Finance." Census Bureau. http://www.census.gov/govs/local/.
117 Id.
118 Drenkard, Scott, and Nicole Kaeding. "State and Local Sales Tax Rates in 2016." Tax Foundation. March 2016. http://taxfoundation.org/article/state-and-local-sales-tax-rates-2016, 7.

Table 4a.

Average Combined State and Local Sales Tax Rates

Iowa and Select Regional Competitors (2016)

State	State Rate	Local Rate	Total Rate
Iowa	6.00%	0.79%	6.79%
Illinois	6.25%	2.39%	8.64%
Minnesota	6.875%	0.39%	7.27%
Missouri	4.225%	3.64%	7.86%
Nebraska	5.50%	1.37%	6.87%
South Dakota	4.00%	1.84%	5.84%
Wisconsin	5.00%	0.41%	5.41%

Source: Tax Foundation, "State and Local Sales Tax Rates in 2016."

Most states—Iowa's regional competitors among them—have a two-part sales tax: a state-level rate that is levied throughout the entire state and local option sales taxes that are levied in specific jurisdictions or tax districts. Iowa's sales tax currently consists of a 5 percent general state sales tax, a 1 percent state-collected sales tax with revenues remitted to local governments for school infrastructure expenditures, and local option sales taxes of 1 percent in most, but not all, local jurisdictions.[119] Accordingly, while the average combined rate is 6.79 percent, in any given jurisdiction the total rate is always either 6.0 or 7.0 percent. This weighted average confirms that the vast majority of Iowa's populated areas assess a local sales tax. The local revenue components are explored in greater detail below.

Local Option Sales Tax

In Iowa, referenda on local option sales taxes are held countywide, but the tax is only imposed in local subdivisions—incorporated and unincorporated—in which the measure receives majority support. Contiguous incorporated areas are treated as a unified incorporated community. The tax must be approved by a majority of the residents in aggregate, even when the incorporated areas cross county lines.[120] Theoretically, two adjacent cities could impose a local option sales tax even though the measure failed to receive majority support in one of the cities, while other cities and unincorporated communities in a county may not see the tax imposed, even if the measure won majority support in the county as a whole. This serves to create a patchwork, not only among counties but within them, adding compliance costs for some sellers, particularly service providers and those offering delivery services.

Somewhat unusually, local option sales tax revenue is not retained by or remitted to the collecting localities, but instead remitted to the state and disbursed by formula, weighted 75 percent by population and 25 percent by the sum of local property taxes levied.[121] The emphasis on population eliminates the advantage that might otherwise accrue to local jurisdictions with high retail sales volume, while the linkage with local property tax collections both incentivizes greater reliance on property taxes as a local revenue stream and rewards jurisdictions with higher property tax valuations, as opposed to those with greater taxable sales.

119 "Iowa Local Option Sales Tax (LOST) Jurisdictions." Iowa Department of Revenue. 2015. https://tax.iowa.gov/sites/files/idr/lostcit-6Percent.pdf.

120 I.C.A. § 423B.5.

121 I.C.A. § 423B.7.

This unique structure can also lead to scenarios in which an unincorporated community votes against the tax but, by virtue of being situated within a county where other incorporated and unincorporated communities elect to adopt the tax, the county will receive a share of local option sales tax revenue from which the untaxed subdivision will benefit. Generally speaking, countywide local option sales tax determinations would create greater conformity and predictability, particularly for the provision of taxable services.

School Infrastructure Sales Tax

In 1998, the state approved an additional local option sales tax to fund school infrastructure projects. The School Infrastructure Local Option (SILO) Sales Tax Act permitted counties to adopt, with voter assent, a local sales tax with a maximum rate of 1 percent. In 2003, use of the funds was extended to include property tax relief, and a new fund was created to collect the revenues and remit the proceeds to localities by formula, superseding the prior system whereby the taxing jurisdiction retained the revenues generated by its local sales tax.[122]

The SILO increased tax complexity by applying to a narrower base than the sales tax and by lacking a corresponding use tax component, but its adoption was swift. By February 2007, every county in Iowa had approved a SILO sales tax add-on, and all but one was set at the maximum rate of 1 percent.[123]

A year after the tax had achieved statewide saturation, the Iowa General Assembly replaced the school infrastructure local option (SILO) tax with a statewide 1 percent sales tax component for school infrastructure and property tax relief, with a grandfather clause holding local receipts harmless against the former SILO allocations for a number of years, though all school districts now receive identical per pupil allocations.[124] Moneys from this portion of the state sales tax are deposited into the Secure an Advanced Vision for Education (SAVE) Fund, after which a small portion is credited to the Property Tax Equity and Relief (PTER) Fund.[125]

Moneys in the PTER Fund are allocated to provide property tax relief to school districts which have adopted levy rates above the statewide average, starting with those with the highest levies and bringing them closer to the statewide average until funding is exhausted.[126] The perverse incentives of such a system are self-evident: the result is a policy of subsidy for jurisdictions with high property taxes, funded by those with more modest levies.

122 See, generally, Prouty, Dennis, "School Infrastructure Local Option Sales Tax," Iowa legislative Services Agency, December 19, 2007, http://www.legis.iowa.gov/docs/publications/IR/6423.pdf.

123 Nineteen of the first 36 local option elections failed to pass, but as the local option sales tax concept took hold, opposition tapered off, with the measures carrying in 101 of the subsequent 104 local option elections, cf. "History of Local Option Elections," Iowa Department of Education, 2013, https://www.educateiowa.gov/documents/statewide-school-infrastructure-sales-and-services-tax/2013/05/history-local-option.

124 "Secure an Advanced Vision for Education (SAVE) and Property Tax Equity Relief (PTER) Funds." Iowa Legislative Services Agency. October 2011. https://www.legis.iowa.gov/DOCS/LSA/Fiscal_Topics/2012/FTSLS002.PDF, 1.

125 "State Sales Tax for School Infrastructure Brief." Iowa Association of School Boards. 2015. http://www.ia-sb.com/uploadedFiles/IASB/Information_Center/Finance/Taxes/SAVE_PTER_Brief_v1.pdf.

126 The dedications within SAVE have drawn criticism, as the moneys may only be applied to school infrastructure projects, irrespective of the most pressing needs of a school district, where teacher compensation or technology might otherwise have primacy over new construction or, in many cases, athletic fields.

Should the Fund be ever be financed substantially, local governments could find themselves in an ultimately unwinnable battle to increase local tax burdens more than the average locality, rather than to keep them in check. In practice, however, little revenue has been made available to property tax relief.

Since 2014, SAVE Fund revenues have been distributed on a per pupil basis, and only 2.1 percent of the amount raised by the tax is dedicated to property tax relief.[127] Since revenues are increasing faster than school enrollment, the per pupil allocation is growing—it stood at $900 per pupil in fiscal year 2014, based on $429.9 million in SAVE Fund revenue—while the amount allocated to property tax relief actually declined to a low of $6.3 million.[128]

Future Outlook

In 2010, Iowa voters ratified an amendment to the state constitution establishing a natural resources and outdoor recreation trust fund, with revenues dedicated from the first three-eighths of a cent of any subsequent sales tax rate increase.[129] Although the sales tax rate has not increased since that time, efforts to affect a three-eighths cent sales tax increase—estimated to raise $120 to $180 million annually—are very much in circulation.[130] Regardless of the success or failure of such initiatives, this pending diversion must be taken into consideration in the context of any possible sales tax reform, and were the sales tax base to be broadened at some juncture, any future rate increase would result in the dedication of more revenue to conservation efforts than originally contemplated by the voters.

It would not be easy. Repeal would require the legislature to adopt an amendment, by a simple majority vote, in two successive general assemblies, and then for the ballot referendum to win majority support. It is, however, an undertaking which must be considered as a part of any broader system of tax reform.

The one cent sales tax increase for statewide school infrastructure funding adopted in 2008 is set to sunset at the end of 2029.[131] As an alternative to a tax increase to raise money for conservation efforts, Governor Terry Branstad floated a diversion of a portion of the existing school infrastructure component of the sales tax to support water quality improvement efforts, possibly coupled with the elimination of the provision's sunset date.[132] Many legislators have expressed their objection to any proposal which would sweep existing school funding to fund other programs, including conservation efforts.

127 "SAVE and PTER Funds Calculation and Distribution." Iowa Department of Revenue. 2014. https://tax.iowa.gov/sites/files/idr/13SF452H.pdf.
128 "State Sales Tax for School Infrastructure Brief." Iowa Association of School Boards, 2.
129 "Chapter 185: Proposed Constitutional Amendment — Natural Resources And Outdoor Recreation Trust Fund." Laws of the Eighty-Third G.A., 2009 Session. May 6, 2009. https://www.legis.iowa.gov/DOCS/IowaActs/83/1/pdf/Chapter_0185.pdf.
130 Boshart, Rod. "Crowd advocates sales tax boost for Iowa natural resources." *The Gazette*. May 17, 2015. http://www.thegazette.com/subject/news/crowd-advocates-sales-tax-boost-for-iowa-natural-resources-20150317.
131 I.C.A. § 423F.6.
132 Petroski, William, and Brianne Pfannenstiel. "Branstad weights school tax diversion for water quality." *Des Moines Register*. January 4, 2016. http://www.desmoinesregister.com/story/news/politics/2016/01/04/branstad-weighs-school-tax-diversion-water-quality/78282150/.

Sales Tax Base Composition

Like most states, Iowa imposes its sales tax on a base that consists of most goods—with economically significant policy carve-outs—and relatively few services. Although service taxation in Iowa is somewhat broader than in the average state, it falls short of what most public finance scholars would define as optimal. The tax is imposed on a much narrower base than the one employed in neighboring South Dakota, which is known for having a broader base.

Iowa does not tax food, prescription drugs, or gasoline under its state sales tax, exempting a sizable and stable portion of consumer spending.[133] In Iowa, 13.3 percent of personal consumption expenditures in 2014 were spent on off-premise food and beverage consumption and gasoline and other energy goods.[134] The state also exempts many, though not all, services, and select other goods. By law, tangible personal property is included in the sales tax base unless expressly exempted, whereas services are only subject to tax if specifically enumerated.

Services comprise an ever larger share of consumer transactions. Combined with pressure to exempt certain other goods from time to time, base erosion is inevitable. As the tax base shrinks, lawmakers tend to look to rate increases for additional revenue. A better option is to broaden the tax base, which can permit rate reductions even in revenue positive scenarios.

Taxation of Business Inputs

When contemplating broadening the sales tax base, it is important to maintain proper treatment of business inputs. A well-structured sales tax is imposed on all final consumer goods and services while exempting all purchases made by businesses that will be used as inputs in the production process. This is not because businesses deserve special treatment under the tax code, but because applying the sales tax to business inputs results in multiple layers of taxation embedded in the price of goods once they reach final consumers, known as “tax pyramiding.” The result is higher and inequitable effective tax rates for different industries and products, which is both non-neutral and non-transparent.

133 I.C.A. § 423.3.

134 “Total personal consumption expenditures (PCE) by state (millions of dollars).” Bureau of Economic Analysis. GDP & Personal Income series.

As a legislatively-commissioned study of Iowa's state and local tax structure observed, "In this regard, the Iowa sales tax (as well as those of other states) deviates from the pure public finance concept of a sales tax as a retail-level tax on final consumption,"[135] with significant consequences:

> "Cascading or multiple taxation of final consumption is one implication of including business purchases in the sales tax base. As these taxes become embedded in the price of final products sold to Iowa residents, effective tax rates on some products can exceed the statutory rate. Furthermore, items that are statutorily exempt, such as health care, actually bear an indirect sales tax cost from the taxation of business purchases."[136]

While most states make some effort to exclude business inputs from taxation, few do so consistently or uniformly. It has been estimated that 22.6 percent of total business taxes paid in Iowa are general sales taxes, above the national average of 18.6 percent.[137] In a perfectly structured tax code, that share would be zero. The state has taken steps to address the taxation of business inputs in recent years, moving to exempt machinery and equipment from the sales tax and providing greater clarity on the distinction made between equipment and supplies. Nevertheless, business supplies and other inputs continue to be subject to the tax, undermining tax neutrality and allowing tax costs to be embedded in the final price of goods several times over.

Currently, replacement parts are exempt from the sales tax; consumable supplies will be exempted as of July 2016. A replacement part is defined as "any machinery or equipment part substituted for another part" that is broken, worn out, obsolete, or unable to perform its intended function. Replacement parts must add to the value, prolong the life, or support the operating condition of machinery or equipment, and must have a useful life of at least one year. Examples of supplies would include coolants, lubricants, drill bits, and air filters. While consumable supplies will soon be exempt from the sales tax, many supplies and other business inputs will continue to fall under the sales tax.[138]

Because these involve the sale of tangible personal property, they fall under the general umbrella of what is taxable in Iowa. Either specific exemptions should be written for these transactions, or a broad sales tax exemption for business inputs should be enacted.

135 "Final Report." Iowa Tax Fairness and Equity Interim Study Committee. February 1993. https://www.legis.iowa.gov/docs/publications/IP/257034.pdf, vi.

136 Id.

137 Rosaen, Alex, and Jason Horwitz. *2014 State Business Tax Burden Rankings*. Anderson Economics Group. July 29, 2014. http://www.andersoneconomicgroup.com/Portals/0/upload/aAEG%20Tax%20Burden%20Study%204th%20Edition%20-%202013.pdf.

138 "Iowa Sales and Use Tax on Manufacturing and Processing." Iowa Department of Revenue. https://tax.iowa.gov/iowa-sales-and-use-tax-manufacturing-and-processing.

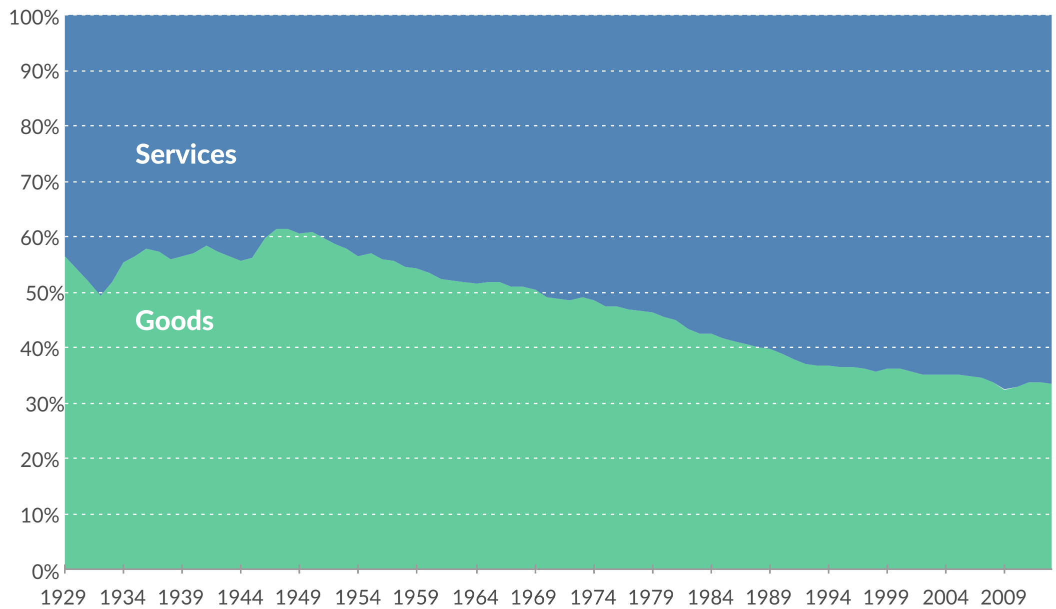
Taxation of Services

Another major contributing factor to the shrinking sales tax base over time—in Iowa and elsewhere—is that American consumption habits have shifted over the years. Whereas the U.S. economy was heavily weighted toward goods when sales taxes were first imposed, today the economy is increasingly service-oriented. Figure 4b shows national goods and services consumption shares since 1929.

Figure 4b.

Percent of Total Personal Consumption Expenditures

Goods vs. Services, U.S. (1929–2013)

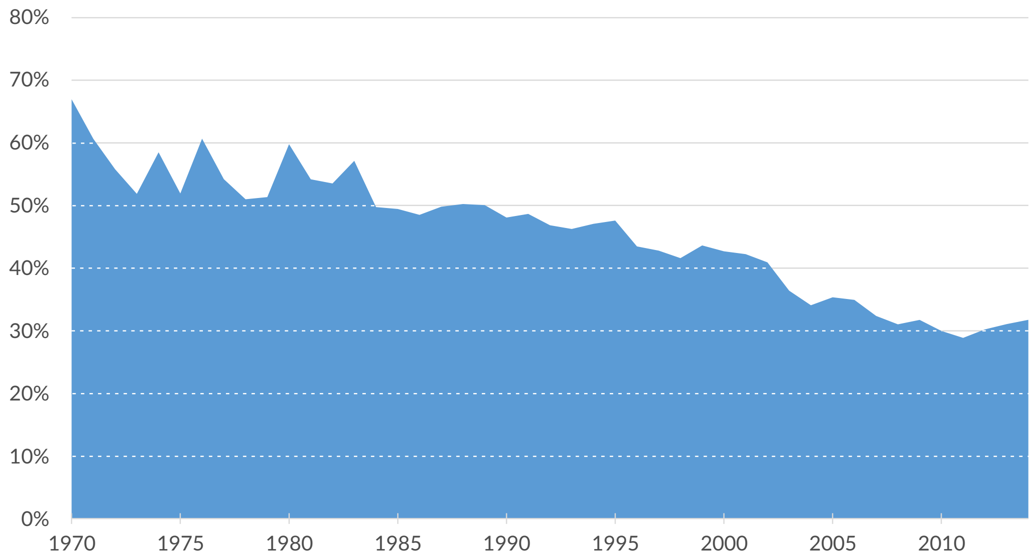


Source: Bureau of Economic Analysis, *National Income and Product Accounts*, "Personal Income and Outlays."

Since 1970, Iowa's sales tax breadth—a measure of the broadness of the tax base—has fallen from an implicit sales tax base equal to 67 percent of personal income to a mere 32 percent of personal income in 2014 (see Figure 4c). Even though Iowa taxes more services than some of its peer states, the failure to modernize the state sales tax base presages continued erosion and commensurate pressure to raise rates. Unsurprisingly, sales tax base broadening was considered by state tax study committees in 1985, 1993, 1995, and 1999.[139]

139 1985: "Report of the Tax Study Committee: A Study of State and Local Taxes in Iowa," Iowa Legislative Service Bureau, https://www.legis.iowa.gov/docs/publications/IP/256370.pdf; 1993: "Final Report," Iowa Tax Fairness and Equity Interim Study Committee, https://www.legis.iowa.gov/docs/publications/IP/257034.pdf; 1995: "Final Report," Nonbusiness Taxation Study Committee, https://www.legis.iowa.gov/DOCS/Shelves/InterimCommFinal/1996/NonBusiness%20Taxation%20Study.pdf; 1999: "Final Report," Iowa Legislative Service Bureau, Task Force to Study Iowa's System of State and Local Taxation, https://www.legis.iowa.gov/docs/publications/IP/257174.pdf.

Figure 4c.
Iowa's Sales Tax Breadth (1970–2014)



The Federation of Tax Administrators (FTA) periodically publishes a survey of services taxable under each state's sales tax, with the most recent data compiled in 2010. The survey includes both business-to-business services (which should be exempted under a well-structured sales tax, as discussed earlier) and final consumer services. Seventy-one of the transactions could be either, depending on the identity of the final purchaser.

Tables 4b, 4c, and 4d enumerate these service categories and note whether or not the Iowa sales tax applies to each service type. As of 2010, Iowa taxed 99 of the 181 services enumerated in the FTA survey under the general sales tax. Of those, at least 25 should be exempted because they are business inputs.

Table 4b.
Iowa's Tax Treatment of Business Input Services

Business Input Service	Taxed in Iowa?
Advertising, Billboards	
Advertising, Magazine	
Advertising, Newspaper	
Advertising, Radio & Television (Local)	
Advertising, Radio & Television (National)	
Advertising Agency Fees (Excluding Ad Placement)	
Armored Car Services	
Bulldozers, Draglines, & Construction Machinery Rentals (Long-Term)	✓
Bulldozers, Draglines, & Construction Machinery Rentals (Short-Term)	✓
Check & Debt Collection	
Commercial Art & Graphic Design	
Commercial Linen Supply	✓
Credit Information & Credit Bureaus	
Custom Fabrication Labor	✓
Data Processing Services	
Employment Agencies	✓
Financial & Tickertape Reporting	
Food Storage	
Industrial Sewer & Refuse Services	✓
Information Services	
Interstate Telephone & Telegraph	
Intrastate Telephone & Telegraph	✓
Labor Charges, Repairs to Commercial Fishing Vessels	✓
Labor Charges, Repairs to Interstate Vessels	✓
Labor Charges, Repairs to Intrastate Vessels	
Labor Charges, Repairs to Railroad Rolling Stock	✓
Lobbying & Consulting Services	
Mainframe Computer Access & Processing Services	
Maintenance & Janitorial Services	✓
Marketing	
Metal, Non-Metal, & Coal Mining Services	
Mini-Storage	✓
Oil Field Services	
Online Data Processing Services	
Packing & Crating	✓
Process Server Fees	
Public Relations & Management Consulting	
Rental of Films & Tapes by Theaters	
Rental of Hand Tools to Licensed Contractors	✓
Secretarial & Court Reporting Services	
Security Services	✓
Seismograph & Geophysical Services	
Sign Construction & Installation	✓
Software, Material Custom Programs	
Software, Modifications to Canned Programs	
Software, Professional Services Custom Programs	
Soil Preparation, Custom Bailing, & Other Agricultural Services	
Swimming Pool Cleaning & Maintenance	✓
Telemarketing Services (Contract)	
Telephone Answering Services	✓
Temporary Help Agencies	✓
Test Laboratories (Excluding Medical)	✓
Test Laboratories (Medical)	
Typesetting & Platemaking for Print Trades	
Utilities, Electricity (Nonresidential)	✓
Utilities, Natural Gas (Nonresidential)	✓
Utilities, Other Fuel (Including Heating Oil, Nonresidential)	✓
Utilities, Water (Nonresidential)	✓
Welding Labor (Fabrication & Repair)	✓

Source: Federation of Tax Administrators (2010).

Table 4c.

Iowa's Tax Treatment of Consumer Services

Consumer Services	Taxed in Iowa?
900 Number Services	✓
Aircraft Rental to Individual Pilots (Long-Term)	
Aircraft Rental to Individual Pilots (Short-Term)	✓
Amusement Park (Admission & Rides)	✓
Bail Bond Fees	
Barber Shops & Beauty Parlors	✓
Billiard Parlors	✓
Bowling Alleys	✓
Circuses & Fairs (Admission & Games)	✓
Coin-Operated Video Games	✓
Cultural Events (Admission)	✓
Dating Services	✓
Debt Counseling	
Dentists	
Diaper Service	✓
Downloading, Movies & Digital Video	
Downloading, Music	
Downloading, Other Electronic Goods	
Electricity (Residential)	✓
Fishing & Hunting Guide Services	
Funeral Services	
Fur Storage	✓
Garment Services (Altering & Repairing)	✓
Gift & Package Wrapping Services	✓
Health Clubs & Gyms	✓
Horse Boarding & Training (Excluding Race Horses)	
Household Goods Storage	✓
Laundry & Dry Cleaning Services (Coin-Operated)	✓
Laundry & Dry Cleaning Services (Non-Coin-Operated)	✓
Local Transit (Intra-City) Buses	
Massage Services	✓
Natural gas (Residential)	✓
Nursing Services (Out of Hospital)	
Other Fuel (Including Heating Oil, Residential)	✓
Pari-Mutuel Racing Events	✓
Personal Instruction (Dance, Golf, Tennis, Etc.)	
Pet Grooming	✓
Physicians	
Pinball & Other Mechanical Amusements	✓
Private Clubs (Membership Fees)	✓
Professional Sports Events (Admission)	✓
Rental of Video Tapes for Home Viewing	✓
Residential Sewer & Refuse Services	
School & College Sports Events (Admission)	✓
Shoe Repair	✓
Tanning Parlors & Salons	✓
Tax Return Preparation	
Taxidermy	✓
RV Parks (Overnight)	✓
Tuxedo Rental	✓
Water (Residential)	✓

Source: Federation of Tax Administrators (2010).

Table 4d.

Iowa's Tax Treatment of Other Service Types

(in which whether the service is a business input or consumer transaction depends on the identity of the final purchaser)

Service	Taxed in Iowa?
Accounting & Bookkeeping	
Architects	
Attorneys	
Auto Service (Except Repairs, Including Painting & Lube)	✓
Automobile Rental (Long-Term)	
Automobile Rental (Short-Term)	✓
Automotive Road & Towing Services	✓
Automotive Rustproofing & Undercoating	✓
Automotive Storage	
Automotive Washing	✓
Automotive Waxing	✓
Banking Service Charges	✓
Cable TV Services	✓
Carpentry, Painting, Plumbing, & Similar Trades	✓
Carpet & Upholstery Cleaning	✓
Cellular Telephone Services	✓
Chartered Flights (with Pilot)	
Cold Storage	
Construction Contracting Labor	
Construction Service (Grading, Excavating, Etc.)	✓
Custom Meat Slaughtering, Cutting, & Wrapping	
Custom Processing (on Customers' Property)	
Direct Satellite TV	
Downloading, Books	✓
Engineers	
Exterminating	✓
Hotels, Motels, & Lodging Houses	✓
Installation Charges by Persons Other than Seller of Goods	
Installation Charges by Persons Selling Property	
Insurance Services	
Interior Design & Decorating	✓
Internet Service Providers, Dialup	
Internet Service Providers, DSL or Other Broadband	
Interstate Air Courier (Billed In-State)	
Intrastate Courier Service	
Intrastate Transportation of Persons	
Investment Counseling	✓
Labor Charges, Repairs Delivered Under Warranty	
Labor Charges, Repairs or Remodeling of Real Property	✓
Labor Charges, Repairs to Aircraft	✓
Labor Charges, Repairs to Motor Vehicles	✓
Labor charges, Repairs to Other Tangible Property	✓
Labor Charges, Repairs to Radio, TV, and Other Electronic Equipment	✓
Land Surveying	
Landscaping Services (Including Lawn Care)	✓
Limousine Service (with Driver)	✓
Loan Broker Fees	
Marina Service (Docking, Storage, Cleaning, & Repair)	
Marine Towing Service (Including Tugboats)	
Parking Lots & Garages	✓
Photo Finishing	✓
Photocopying Services	✓
Printing	✓
Private Investigation & Detective Services	✓
Property Sales Agents (Real Estate or Personal)	
Real Estate Management Fees (Rental Agents)	
Real Estate Title Abstract Services	
Repair Labor (Generally)	✓
Repair Material (Generally)	✓

Table 4d. *Continued*

Iowa's Tax Treatment of Other Service Types

(in which whether the service is a business input or consumer transaction depends on the identity of the final purchaser)

Service	Taxed in Iowa?
Service Contracts Sold at the Time of Sale of Tangible Personal Property	✓
Software, Downloaded	
Software, Package or Canned Program	✓
Storage of Personal Property (Long-Term)	✓
Storage of Personal Property (Short-Term)	✓
Taxi Service	
Tire Recapping & Repairing	✓
Travel Agent Services	
Veterinary Services	
Water Softening & Conditioning	✓
Water Well Drilling	✓
Window Cleaning	✓

Source: Federation of Tax Administrators (2010).

In a very broad, ideal sales tax, all of the services outlined in Table 4c (consumer services) would be subject to the sales tax. The services in Table 4b (business input services) would all be exempt from the sales tax. However, since sales tax breadth is not the only policy consideration facing lawmakers, certain services are sometimes exempted for other reasons.

Taxing the services enumerated in Table 4d requires creative administration to ensure that when purchased by consumers these service transactions are taxed, but when purchased by businesses they are not. One option is to grant businesses a business identification number registered with the Iowa Department of Revenue. The firm would then present this number upon purchase of any goods or services used in the production process and be exempted from paying sales tax on those purchases. This is similar to how some states identify nonprofit organizations for purposes of exempting them from taxation.

Existing Sales Tax Exemptions

The Iowa Department of Revenue releases periodic tax expenditure reports, the most recent (issued in 2014) covering tax year 2010. Despite the age of the data, there is much to be gleaned from the report.

A tax expenditure is something that would have been taxed but was specifically exempted or abated, or a subtraction, credit, deduction, or exclusion that was implemented to reduce or completely eliminate an entity or individual's tax liability. The report cites 134 different sales tax exclusions which carve billions of dollars from the sales tax base. Not all of these expenditures are created equal, however, and different starting definitions of the sales tax base makes comparison across states difficult.

For instance, the single largest sales tax exemption—worth an estimated $2.6 billion—is for the purchase of wholesale goods intended for resale. Because applying the tax at both the wholesale and retail level constitutes clear double taxation, no state applies sales taxes to wholesale goods, and many would define the sales tax base in such a way that the exclusion would not even appear as a line item in a tax exemption report.

There are, however, many other ways that sales taxes can pyramid, hence efforts to exclude other business inputs, from industrial machinery to processing chemicals to categories as granular as "agricultural feed for farm deer and bison." Fifty-two of Iowa's sales tax exemptions are the proper exclusion of business inputs from the sales tax base.

Late in 2010, moreover, the Iowa Supreme Court ruled in favor of a more expansive definition of the exemption for manufacturing machinery and equipment, holding—consistent with good tax policy—that such equipment need not be housed in a manufacturing facility to qualify for the exemption.[140] More recently, the state Department of Revenue updated definitions further distinguishing between consumable supplies and replacement parts—both business inputs—thus expanding, at least somewhat, the state's exclusion of such business-to-business transactions.[141] Ideally, these sundry should not be framed or offered as industry-specific tax benefits, but instead as part of a broad policy of exempting business inputs.

Eighteen provisions can be deemed largely administrative, exempting, say, governmental transactions and interstate sales which Iowa is not legally permitted to tax, or seeking to arrive at accurate definitions of sales attributable to the state. At least eight exemptions could be business inputs or consumer sales depending on the identity of the final purchaser—transportation and delivery services, for instance, may be used by companies or individuals—and a further 57 exemptions, worth over $1 billion, reflect policy choices made by the legislature.

Of these, the exemption for groceries comes with the largest price tag, worth $363 million in 2010. Preferential treatment for nonprofits, and particularly for hospitals and health service providers, is responsible for much of the remaining foregone revenue, with exemptions for nonprofits' construction contracts, nonprofit hospitals, prescription drugs and medical devices, and laboratory tests taking the next three spots for a combined $437 million in exemptions. The legislature has also leaned on sales tax exemptions to support the solar energy industry, boost lottery ticket sales, offer a tax break on newspapers, and exclude many education services from the tax.

It is worth noting that the tax expenditure report does not quantify the loss associated with not taxing services more broadly, since services are not part of the sales tax base unless expressly included by statute. Goods, by contrast, are excluded unless expressly exempted. If the exclusion of most services was treated as a sales tax exemption, it would dwarf most of those presently quantified.

The policy rationales for many of these exemptions are understandable. They do, however, carve away the sales tax base, forcing the rate to be higher in order to raise the same revenue on a smaller base of transactions. The following tables attempt to classify existing tax expenditures that were worth more than $1 million in 2010.[142]

140 *The Sherwin-Williams Company v. Iowa Department of Revenue*, Iowa No. 07-1534.
141 ARC 2178C. "Notice of Intended Action." Iowa Department of Revenue. https://rules.iowa.gov/Notice/Details/2178C.
142 "2010 Iowa General Fund Tax Expenditures." Iowa Department of Revenue. https://tax.iowa.gov/report/Tax-Expenditures.

Table 4e.
Tax Expenditures for Administrative Purposes

Tax Expenditure	Tax Expenditure Value
Tangible Personal Property for Resale	$2,578,600,000
Interstate Sales	$382,300,000
Gambling Boat Games & Admissions[143]	$364,900,000
Trade-In for Remanufacture or Resale	$135,000,000
Residential Utility Exemption	$129,500,000
Sales by a City or County	$121,400,000
Tax Levying or Certifying Bodies In Iowa	$90,000,000
Advertising Materials Out of State	$3,400,000
E911 Service Surcharge	$1,000,000

Table 4f.
Tax Expenditures for Business Inputs

Tax Expenditure	Tax Expenditure Value
New Products Used in Processing	$229,600,000
Agricultural Feed	$219,600,000
Commercial Fertilizer & Lime	$103,600,000
Farm Machinery, Self-Propelled	$96,900,000
Industrial Machinery, Equipment and Computers	$92,100,000
Packaging Containers	$72,000,000
Processing Power & Fuel	$61,100,000
Processing Chemicals	$39,700,000
Agricultural Chemicals	$36,700,000
Fuel for Implements of Husbandry	$34,400,000
Breeding Stock	$15,400,000
Farm Machinery, Special Purpose	$12,900,000
Fuel Used in Grain Drying	$12,200,000
Railroad Rolling Stock	$11,000,000
Fuel to Heat/Cool Livestock Buildings	$9,100,000
Commercial Amusement Enterprises	$8,900,000
Information Services	$8,400,000
Printers' & Publishers' Supplies	$7,600,000
Agricultural Drainage Tile	$6,900,000
Inert Gases	$6,700,000
Web Search Portal & Data Center Business Purchases	$5,700,000
Aircraft Repair & Replacement Parts	$4,400,000
Laboratory Tests on Animals	$3,500,000
Processing Services & Goods for Food Products	$3,100,000
Electricity to Private Water Companies	$2,400,000
Advertising Envelopes	$1,800,000
Automotive Fluids to a Retailer	$1,400,000
Core-Making, Mold Making, & Sand-Handling Equipment	$1,300,000

143 Preferential treatment of gaming in the tax code would constitute a policy consideration, but since Iowa imposes a separate tax on gross gaming revenue, this sizable tax expenditure is intended to avoid double taxation and is thus administrative in nature.

Table 4g.
Tax Expenditures that Can Be Business Inputs or Consumer Purchases

Tax Expenditure	Tax Expenditure Value
Transportation Services	$420,900,000
Domesticated Fowl	$8,900,000
Digital Goods	$7,900,000
Air Charters Transportation Services	$6,100,000
Long-Term Room Rental	$1,800,000
Software Maintenance or Support Contract	$1,500,000
Aircraft	$1,100,000

Table 4h.
Tax Expenditures Reflecting Policy Decisions

Tax Expenditure	Tax Expenditure Value
Food Sales for Human Consumption	$362,800,000
Construction Contracts with Tax Exempt Entities	$158,500,000
Nonprofit Hospitals	$125,400,000
Prescription Drugs & Medical Devices	$119,700,000
Laboratory Tests on Humans	$33,600,000
Food Sales Purchased with Food Stamps	$32,200,000
On-Line Computer Service	$27,500,000
Lottery Tickets	$15,800,000
Nonprofit Disabled Service Providers	$14,000,000
Nonprofit Private Educational Institutions	$14,000,000
Nonprofit Private Art Centers & Museums	$13,600,000
Rental or Broadcast of Entertainment Media	$12,400,000
Casual Sale, Business Liquidation	$9,800,000
Nonprofit Health Services Computers	$8,400,000
Massage Therapy	$6,400,000
Medicaid Service Providers	$5,900,000
Clothing Sales Tax Holiday	$4,400,000
Reconditioning Services	$4,000,000
Sales by State, County, & District Fairs	$3,700,000
High Quality Job Program (HQJ) Sales Tax Refund	$3,507,000
Nonprofit Health Centers	$3,500,000
Newspapers	$3,400,000
Fees for Games & Amusements	$3,300,000
Nonprofit Hospice Facilities	$3,000,000
Processing Photography	$2,900,000
Casual Sale, Not Business Liquidation	$2,600,000
Processing Tire Retreading	$2,400,000
Community Action Agency	$1,800,000
Housing Enterprise Zone Program (HEZ) Sales Tax Refund	$1,362,000
Bullion, Coins, & Currency	$1,200,000
Modular Home	$1,100,000

Taxation of E-Commerce

Another factor contributing to dwindling sales tax bases over time is the lack of taxation of remote purchases, such as those made over the internet. Currently, retailers are only required to collect sales taxes in states in which they have a physical presence of property or employees. This geographic limitation on the scope of state taxing power, while not new, has come under pressure due to the growing size of internet retail and the resultant disparity in tax treatment between goods purchased online and goods purchased at brick-and-mortar stores.

Keeping the sales tax aligned with the modern economy is important for the state and brick-and-mortar retailers, just as making multistate sales tax collection as seamless and simple as possible is important for internet retailers and the national economy as a whole.

The Limits of Use Taxes

Use taxes were enacted as complements to sales taxes not long after their introduction. While the sales tax is owed for purchasing an item, the use tax is owed for using an item when sales tax has not been paid. States introduced use taxes out of concern that taxpayers would avoid sales taxes by purchasing goods in states with lower or no sales tax instead of purchasing them within their home state and paying the sales tax. The use tax thus creates a tax obligation for consumers who do this, and all states with a sales tax also have a use tax with the same rate as the sales tax.

However, because the use tax requires self-reporting and payment by the consumer instead collection at the point-of-sale by the retailer, use tax compliance is very low except for large purchases or business purchases susceptible to a state audit.[144] Thus, consumers do not tend to report many of their internet purchases in order to avoid paying use tax on them.

An Increased Push to Tax Internet Purchases

Americans spent about $263 billion in internet retail purchases in 2013, a growth of 15 percent over the previous year and comprising about 6 percent of the $4.5 trillion in total retail sales.[145] The growth rate has been fairly steady, and it is likely that internet commerce will continue to grow as a share of national retail.

While the largest driver of continued discussion of e-commerce taxation is the desire for more revenue, there is also a neutrality argument at play. There is no economically justifiable reason why the same good should be untaxed if it is purchased online versus if it were purchased in a brick-and-mortar store. Such discrepancies are non-neutral and favor online purchases at the expense of purchases made at traditional retail establishments.

144 About half the states also include a use tax payment line on their income tax form, but the collections from this method are minimal. Features of this sometimes include an exemption for purchases under a certain threshold and a lookup table where taxpayers can pay a certain amount based on their income rather than tracking all purchases throughout the year. See, e.g., Manzi, Nina, "*Use Tax Collection on Income Tax Returns in Other States*," Minnesota House of Representatives Research Department Policy Brief, April 2012, http://www.house.leg.state.mn.us/hrd/pubs/usetax.pdf.

145 *Quarterly Retail E-Commerce Sales 1st Quarter 2014*. Census Bureau. May 15, 2014. http://www2.census.gov/retail/releases/historical/ecomm/14q1.pdf.

However, state taxing power is generally limited to individuals and businesses within the state's borders (to prevent harm to the national economy from tax exporting). To get around this issue, some states have passed "click-through nexus" or "affiliate nexus" statutes requiring out-of-state retailers to collect sales tax under certain circumstances, leading to extended litigation and uncertainty. Examples include New York's "Amazon" Tax Law (and subsequent similar laws in other states).[146]

These types of laws are problematic because they're non-neutral, only applying to certain online retailers. Further, they can discourage companies from locating distribution facilities or other operations in states with such laws and can be triggered by *de minimis* contact with a state (e.g., an Amazon affiliate being located in the state).

By 1999, a task force charged with studying ways to modernize and improve Iowa's system of state taxation was examining the possibility of taxing internet services and catalog sales.[147] Seventeen years later, the prospect of taxing remote transactions still looms large over any discussion of sales tax reform.

Iowa was a charter member of the Streamlined Sales Tax Project (SSTP), amending its statutes for compliance in advance of the Streamlined Sales and Use Tax Agreement (SSUTA)'s October 1, 2005 effective date. The SSTP is a joint effort by states and the business community to reduce administrative and sales tax compliance burdens with an eye toward convincing Congress to authorize states to obligate the remittance of use tax by remote sellers, and also to encourage voluntary remittances by select remote vendors. Twenty-four states representing 33 percent of the U.S. population have ratified the Streamlined Sales and Use Tax Agreement.[148]

However, this effort to balance states' reserved powers with the need for simpler rules and remittance procedures has been severely hamstrung by the refusal of many large states to participate, including California, Illinois, New York, and Texas. While no state should be compelled to participate in SSTP, the Project suffers because many states believe they can assert expanded tax authority without the hard work required by SSTP, such as centralizing tax collection and auditing, reducing local sales tax complexity, adopting uniform definitions of items, and compensating vendors for administrative costs.

146 Henchman, Joseph. "The Marketplace Fairness Act: A Primer." Tax Foundation. July 14, 2014. http://taxfoundation.org/article/marketplace-fairness-act-primer.

147 "Final Report." Task Force to Study Iowa's System of State and Local Taxation. Iowa Legislative Service Bureau, 7.

148 Arkansas, Georgia, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Vermont, Washington, West Virginia, Wisconsin, and Wyoming.

In an attempt to attract more member states, the SSTP Governing Board has focused increasingly on uniformity and not simplification. In many cases, the Project has enabled state sales tax complexity by permitting separate tax rates for certain goods, not addressing growing local tax jurisdiction complexity, and permitting states to retain parochial sales tax rules.[149]

Iowa, for instance, adopted modest simplification efforts in 2004 to meet Streamlined requirements, including exempting from the sales tax goods which are purchased with the intent to be leased or rented, and applying the destination rather than origin local option tax rate on property shipped within the state.[150] Nevertheless, the state continues to tax a range of business inputs and allows slight base discrepancies for different components of the sales tax. If the goal is to create adequate uniformity to limit compliance costs under a future remote sellers regime, Iowa—along with other SSTP states—may be further along than its peers, but still has a long way to go.

Federal Solutions

Presently, there are three options for the taxation of remote sellers being weighed federally—the Marketplace Fairness Act (MFA),[151] the Online Sales Simplification Act (OSSA),[152] and the Remote Transactions Parity Act (RTPA)[153]—all of which would authorize states to require collection of their sales taxes by out-of-state retailers.[154]

Each bill approaches the issue differently. The MFA and the RTPA are similar in that they depend on destination sourcing in exchange for states making their sales tax administration simpler, with the RTPA adding the requirement that states integrate freely-provided tax lookup software into retailer systems and sharply limiting the ability of states to audit businesses without physical presence. The OSSA uses hybrid-origin sourcing and would transform the sales tax from a tax on consumers to a tax on businesses.[155]

149 See, generally, Isaacson, George, "A Promise Unfulfilled: How the Streamlined Sales Tax Project Failed to Meet Its Own Goals for Simplification of State Sales and Use Taxes," 30 *State Tax Notes* 339, October 27, 2003; Henchman, Joseph, "Nearly 8,000 Sales Taxes and 2 Fur Taxes: Reasons Why the Streamlined Sales Tax Project Shouldn't Be Quick to Declare Victory," Tax Foundation, July 28, 2008, http://taxfoundation.org/blog/nearly-8000-sales-taxes-and-2-fur-taxes-reasons-why-streamlined-sales-tax-project-shouldnt-be-quick; Henchman, Joseph, "Testimony before Maryland Legislature on the Streamlined Sales Tax Project," Tax Foundation, February 18, 2009, http://taxfoundation.org/article/testimony-maryland-legislature-streamlined-sales-tax-project. See also Hamilton, Billy, "Happy Birthday, SSUTA!," 66 *State Tax Notes* 513, November 12, 2012; Buhl, John, "Governing Board Gives Initial Approval to Clothing Threshold," 50 *State Tax Notes* 687, December 15, 2008; Parker, Eric, "New Jersey Fur Tax Sparks Streamlined Governing Board Meeting Dispute," 42 *State Tax Notes* 853, December 25, 2006.

150 "What is Streamlined Sales Tax?" Iowa Department of Revenue. https://tax.iowa.gov/what-streamlined-sales-tax-0.

151 *Marketplace Fairness Act of 2015*, S. 698. 114th Congress, 2015–2016. https://www.congress.gov/bill/114th-congress/senate-bill/698.

152 A discussion draft of the Online Sales Simplification Act of 2015 was circulated by House Judiciary Committee Chairman Bob Goodlatte, January 2015, http://www.subnet.nga.org/downloads/1501HybridOriginDiscussionDraft.pdf.

153 *Remote Transactions Parity Act of 2015*, H.R. 2775. 114th Congress, 2015–2016.

154 Henchman, Joseph. "The Marketplace Fairness Act: A Primer."

155 Id.

States are understandably interested in knowing how much revenue could be collected if they could require sales tax collection on internet commerce. Revenue estimates, however, are difficult to make with certainty because one must guess both how much internet commerce could be taxed and how much is currently untaxed (some percentage of internet sales taxes are actually presently collected because of retail physical presence, voluntary reporting of business purchases, or voluntary vendor collection by Streamlined Sales Tax Project vendors).

In 2009, Bruce, Fox, and Luna estimated that states would lose $11 billion in 2012 if they could not collect sales tax on internet purchases, and this became the leading source of revenue estimates by virtue of being the only one.[156] Subsequent experience casts doubt on the accuracy of this estimate. For instance, New York, with its law collecting tax on online sales in effect during the pendency of a legal appeal, collected $360 million through February 2012, well short of the $2.5 billion estimated by the Bruce, Fox, and Luna study.[157] Economic consultant Jeff Eisenach produced scaled-down estimates of states' sales tax collection potential in 2013, pegging it at $3.9 billion nationwide.[158]

While it is true that state tax collections will increase if federal legislation is enacted, states relying on the previous study's numbers risk writing excessive revenue expectations into their budget plans. States should therefore act cautiously with respect to spending anticipated new revenue when a federal bill is enacted.

Iowa's Ability to Require Remote Sellers to Collect Sales Taxes

If legislation such as the Marketplace Fairness Act were to be enacted, Iowa's active participation in SSTP would go a long way toward ensuring the state's compliance, though there remain opportunities to enhance neutrality and uniformity in the sales tax code. Nevertheless, the state must exercise great caution in considering any changes which introduce new complexity in sales tax administration, or which allow non-uniform bases or disparate treatment in local or add-on sales taxes.

156 Bruce, Donald, William F. Fox, and LeAnn Luna. *State and Local Government Sales Tax Revenue Losses from Electronic Commerce*. April 13, 2009. http://cber.utk.edu/ecomm/ecom0409.pdf.

157 Id.

158 Eisenach, Jeffrey A., and Robert E. Litan. *Uncollected Sales Taxes on Electronic Commerce: A Reality Check*. Empiris LLC. 2013. http://netchoice.org/wp-content/uploads/eisenach-litan-state-estimates.pdf.

Administrative Considerations

The complexity of Iowa's sales tax base and longstanding uncertainty over definitions increases compliance costs for businesses and yields time-consuming appeals which burden businesses and the Iowa Department of Revenue alike. Business leaders with whom we spoke praised recent efforts to clarify sales tax definitions, and expressed optimism that newly promulgated rules will lead to greater certainty, but also noted appeals that dragged on for years and pointed to the confusion arising from the absence of clear guidance on sales tax issues.

Even if, for instance, businesses are clear on the tax treatment of repair parts, they may draw conclusions about what constitutes a repair part which differs from the judgment of the Department of Revenue. Recent clarifications are a step in the right direction. Clear regulations and published guidance can help lower compliance and administrative burdens, and reduce the number of appeals.

Sales Tax Reform Solutions

Iowa's sales tax begins with a broader base than is found in many states, but it remains too narrow to grow with today's service-oriented economy, with carve-outs for select goods further reducing revenue stability and requiring higher rates than might otherwise be required. The tax is encumbered, moreover, by a haphazard approach to tax exemptions and a patchwork of policies, from disbursement formulas to local option sales tax adoption rules to future dedications, which introduce unnecessary complexity, undermine predictably, and create dubious incentives for localities.

A cumbersome sales tax can hold the state back, particularly should Congress adopt legislation like the Marketplace Fairness Act at some juncture. However, it is also important to acknowledge how valuable the sales tax is to local government operation, and to be mindful of concerns about the impacts of possible changes.

Our sales tax solutions focus on simplification and predictability. Moderate base broadening options are also included.

Base Broadening Options

A well-structured sales tax applies to all final consumer purchases, both goods and services, while exempting business inputs. Currently, the Iowa sales tax specifically exempts a significant number of consumer transactions which, if included in the base, would permit substantial rate reductions.

Among existing exemptions of consumer goods, the groceries exemption is by far the largest, worth $364.9 million in 2010. If food for home consumption were included in the sales tax base, the average combined state and local rate in Iowa could decline from 6.79 percent to 6.08 percent while retaining revenue neutrality. Other exemptions and incentives, from lottery tickets to the clothing sales tax holiday to the High Quality Job Program sales tax refund, also contribute to the erosion of the sales tax base, yielding higher rates than would otherwise be necessary.

Lawmakers should also consider expanding the sales tax base to include additional services, while exempting business inputs. Table 4i shows three options for base broadening, where the "small" option adds a few additional consumer services to the sales tax base, and the "large" option is the broadest, adding all final consumer services.

When services could constitute either a final consumer transaction or a business input, depending on the identity of the final purchasers, the state should either define the categories in such a way as to exclude business inputs or, preferably, provide a mechanism by which business purchases are exempted, in much the same way as purchases by non-profits are exempted in many states.

In outlining these options, we do not attempt to quantify the political considerations that are bound to accompany any discussion of base broadening. Portions of the existing sales tax base are also presented for reference. Providing a few base broadening options allows lawmakers to decide how broad they would like to make the sales tax base, while still accounting for other policy considerations.

Table 4i.

Sales Tax Base Broadening Options

Service Type	In Current Tax Base?	Expanded Base Options (includes current base items)		
		Small	Medium	Large
Communication Services	✓[159]	✓	✓	✓
Automobile Services	✓	✓	✓	✓
Motor Vehicle Rental & Leasing	✓[160]	✓	✓	✓
Membership Clubs (For Profit)	✓	✓	✓	✓
Video Rental Services	✓	✓	✓	✓
Accommodations	✓	✓	✓	✓
Dry Cleaning, Clothing Repair, & Shoe Repair Services	✓	✓	✓	✓
Household Services (Moving, Repairs, & Cleaning)	✓	✓	✓	✓
Personal Care Services	✓	✓	✓	✓
Household Utilities	✓	✓	✓	✓
Museum, Zoo, & Recreation Activities Admissions		✓	✓	✓
Veterinary Services		✓	✓	✓
Amusements		✓	✓	✓
Investment Services			✓	✓
Trust, Fiduciary, & Custody Services			✓	✓
Legal Services			✓	✓
Accounting Services			✓	✓
Membership Clubs (Nonprofit)			✓	✓
Labor Organization Dues			✓	✓
Professional Association Dues			✓	✓
Funeral & Burial Services			✓	✓
Financial Service Charges, Fees, & Commissions			✓	✓
Real Estate Services				✓
Rental Housing				✓
Healthcare Outpatient Services (Including Physicians and Dentists)				✓
Hospitals, Nursing Homes, & Home Healthcare				✓
Higher Education Tuition & Expenses				✓

Business Input Exclusion

In recent years, Iowa has taken meaningful strides in excluding business inputs from the sales tax base to avoid tax pyramiding. However, sales taxes still represent an above-average proportion of taxes remitted by businesses in Iowa. Most business supplies, for instance, are still subject to sales tax, though replacement parts have been exempted.

159 Iowa taxes cellular telephone services and intrastate telephone services but not interstate telephone service.
160 Currently, short-term rental and leasing is taxed, but long-term leases are not.

Similarly, at least 25 categories of services currently taxed in Iowa, ranging from construction machinery rentals to laboratory services and commercial utilities, are business inputs. Either specific exemptions should be written for goods and services likely to constitute business inputs, or businesses should be granted the ability to claim an exemption from the sales tax for all business purchases. Many states allow non-profit organizations to make sales tax exempt purchases. Similar provision could be made for business purchases to avoid taxation of business inputs without attempting to ascertain which goods and services are likely to constitute business-to-business transactions.

The Iowa Department of Revenue should also strive to provide clearer published guidance on what goods and services are subject to the sales tax to cut down on costly appeals.

Limitation of Current and Future Dedications

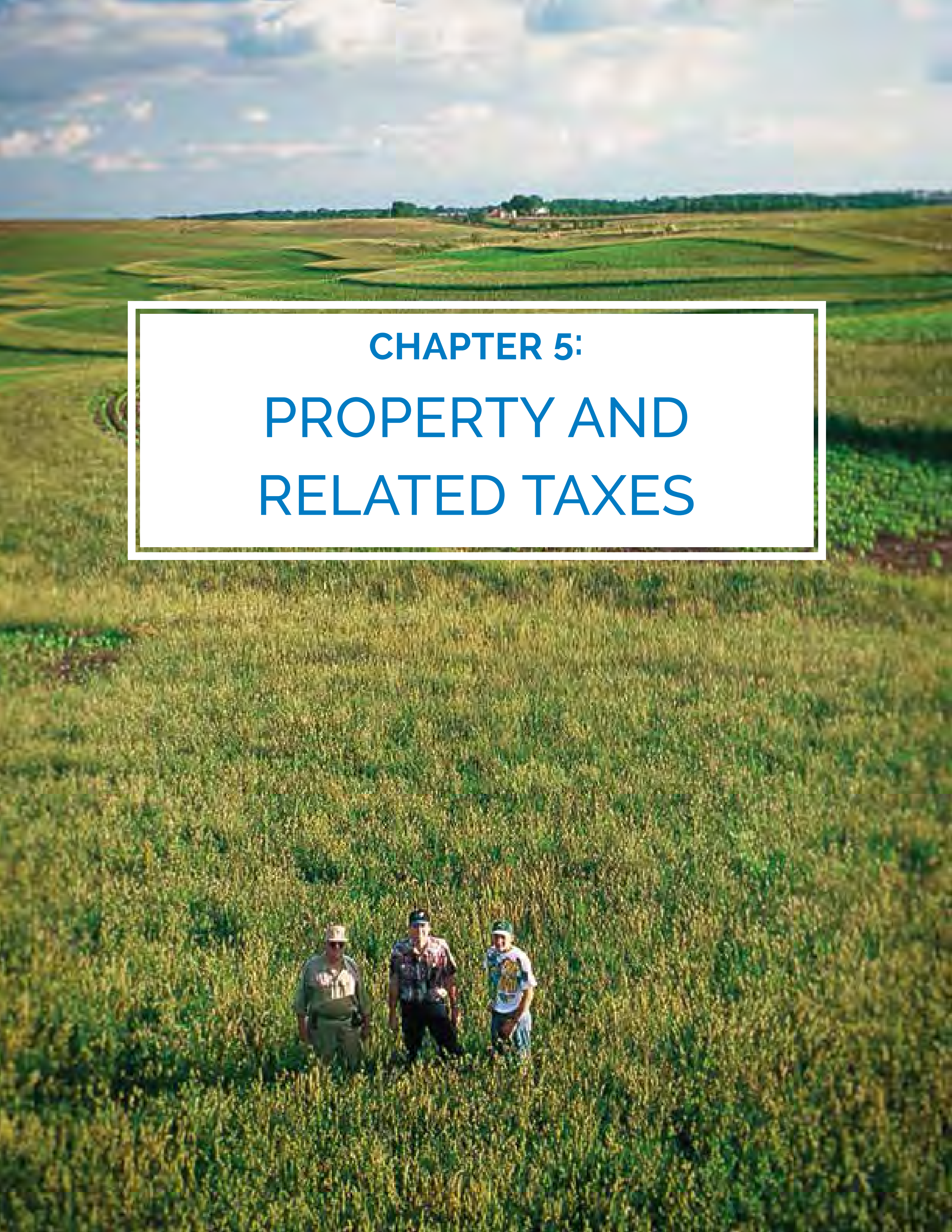
Iowa's sales tax dedications limit flexibility for policymakers, potentially hamstringing reform efforts. If, for instance, the state were to broaden the sales tax base substantially to pay down a rate reduction, the 1 percent currently dedicated to school infrastructure would represent a substantial diversion of sales tax revenue unless reduced proportionately. Future changes to the rate and base could also be complicated by the constitutional dedication of the first three-eighths of a cent of any future rate increase, which could be a larger diversion than anticipated were the base broadened.

The miniscule diversion into the Property Tax Equity and Relief (PETR) fund, moreover, serves little purpose. With annual revenues dipping as low as $6.3 million, local distributions are *de minimis* and have a negligible impact on keeping property tax rates in check. Moreover, the transfer provides no assurance of property tax relief. It essentially operates as a simple transfer to local governments with the expectation that it will alleviate the need for property tax increases.

Since referenda have constitutional status in Iowa, modification or repeal of some dedications, like the three-eighths cent future dedication to an environmental fund, pose a significant challenge. Iowa should, however, be wary of adopting additional dedications in the future and consider eliminating the relatively insignificant PETR dedication. A modification of the school infrastructure dedication to make it more responsive to future tax base changes could be incorporated into any extension of its sunset, or adopted concurrently with base expansion. Under a regime of significant base expansion, a constitutional revision to the three-eighths cent dedication may prove prudent as well.

CHAPTER 5:

PROPERTY AND RELATED TAXES



Introduction

Iowa relies heavily on local property taxes, imposing above-average property tax burdens on Iowans overall, even as an arcane and needlessly complex structure seeks to abate costs for select taxpayers. Over the years, the state has turned to opaque rollback provisions and adopted a panoply of exemptions to keep tax costs in check, rendering the system increasingly byzantine and making it difficult to predict tax liability from one year to another. Efforts to dedicate funding from other taxes to property tax relief have accomplished little.

Base-narrowing exemptions, formula-driven adjustments, and divergent assessment ratios on different classes of property combine to produce a property tax structure that few understand, while larger businesses may seek to abate their own burdens through negotiated economic development zones unavailable to the average taxpayer. Iowa also imposes a real estate transfer tax and an inheritance tax (from which spouses, lineal heirs, and charities are exempted). This convoluted system limits the competitiveness of Iowa's tax code and often imposes highly non-neutral tax burdens.

In this chapter, we provide an overview of the property tax system in Iowa and then provide four ideas for improvement, along with the resulting *State Business Tax Climate Index* rankings that could be achieved.

A General Overview of Iowa Property Taxes

Property taxes are among the oldest forms of taxation, and remain the most significant source of local government revenue in many states, Iowa included. In the early days, when Iowa was a county of Michigan, property taxes could be levied by both the board of supervisors and the school directors, the latter with a unique provision firmly identifying the nascent tax authority with the benefit principle: authorization to “exempt any persons in the district who were so far removed that they received no reciprocal benefits.”[161] Later, when the Michigan territory was divided and what is now Iowa became part of the territory of Wisconsin, real estate was taxed to provide for the construction of roads, a tax that could be discharged monetarily or by labor in building highways (corvée).[162]

These early instances of Iowa taxation are, in many respects, worlds removed from the modern property tax system, but two points of continuity remain: a connection, from the outset, between property taxes and public education, and a recognition of a benefits test in property taxation, in which the tax burden has some measure of correspondence with reciprocal government benefits.

Once a significant state, as well as local, revenue tool, the property tax’s current form is the product of many decades of evolution. Today, the property tax is primarily levied on land and improvements, and serves as the main source of revenue for local governments across the state. The property tax helps fund cities, counties, schools, hospitals, and other local offices.

Property taxes are entwined in the complex interplay of state and local taxes. A very modest share of sales tax revenues (as little as $6.3 million) is remitted to local tax jurisdictions to reduce property tax burdens, and several significant provisions in the state budget—including school aid—can revert to local property taxes should the legislature fail to provide adequate funding. Some recent legislative actions to limit property tax liability, such as a rollback for commercial and industrial properties, have been backfilled initially, but will ultimately fall to local governments to address.[163]

When compared to other states’ property tax systems, Iowa ranks poorly, both regionally and nationally. On our *2016 State Business Tax Climate Index*, only Illinois scored worse on the property tax component ranking among neighboring states, while Minnesota, Missouri, Nebraska, South Dakota, and Wisconsin scored better.[164] Table 5a shows Iowa’s *2016 State Business Tax Climate Index* property tax component ranking, in addition to select competitor states’ rankings. Although the state’s above-average property tax burden contributes to these results, Iowa’s poor ranking is primarily driven by broader structural issues, including its continued reliance on inheritance and real estate transfer taxes.

161 Noble, F.H. *Taxation in Iowa: Historical Sketch, Present Status, and Suggested Reforms*. New York: Philip Cowen, 1897, 11.
162 Id., 15.
163 “Annual Report FY 2015.” Iowa Department of Revenue. https://tax.iowa.gov/sites/files/idr/IDR%20Annual%20Report%20FY2015.pdf, 17.
164 Walczak, Jared, Scott Drenkard, and Joseph Henchman. *2016 State Business Tax Climate Index*. Tax Foundation. November 17, 2015. http://taxfoundation.org/article/2016-state-business-tax-climate-index, 3.

Table 5a.
State Business Tax Climate Index
Property Tax Component Rankings
Iowa and Select Regional Competitors (2016)

State	Component Ranking
Iowa	40th
Illinois	45th
Minnesota	30th
Missouri	8th
Nebraska	39th
South Dakota	22nd
Wisconsin	33rd

Source: Tax Foundation, *2016 State Business Tax Climate Index.*

Property Tax Rates and Collections

In fiscal year 2013, property taxes made up 86.5 percent of local tax collections in Iowa, making them by far the most significant source of local collections. While significant local government reliance on property taxes is a fact of life throughout the country, Iowa leans on property taxes more heavily than does the nation as a whole. On average, 72.8 percent of local revenue derives from property taxation.[165]

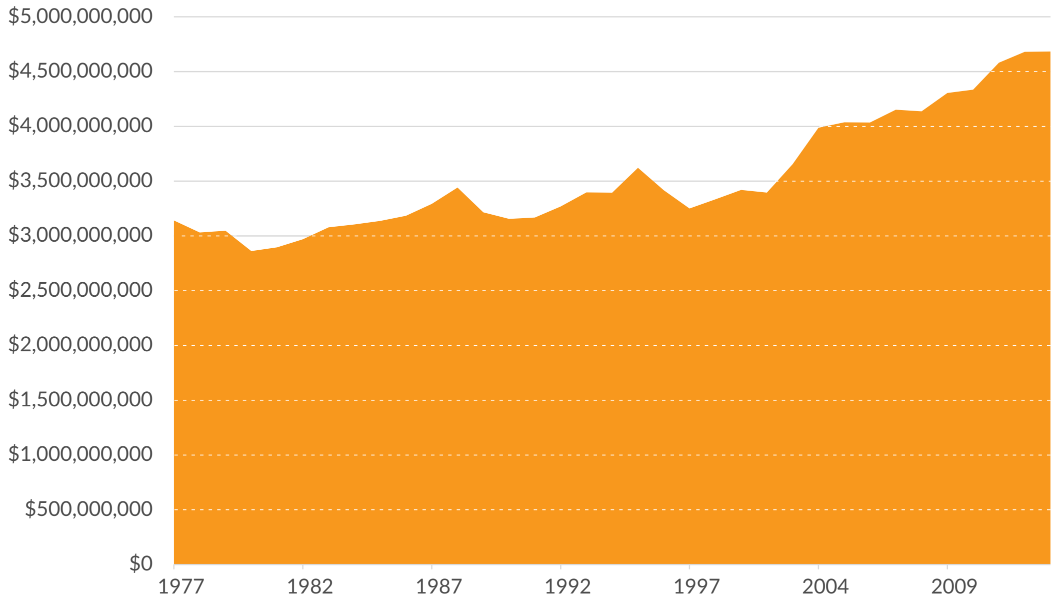
Iowa's above-average property tax burdens, however, are not the product of gradual accretion. On the contrary, efforts to constrain property tax growth have met with success judging by collections data. Property tax collections have risen more slowly than the rate of increase for Iowa tax collections as a whole. While the rate of increase is slower than for other taxes, the state is still collecting more from property taxes, even after adjusting for inflation. It has increased from $3.14 billion (inflation-adjusted) in 1977 to $4.68 billion in 2013.[166] Iowa's high rates of property taxation, then, are a legacy of long standing, though collections did see an average annual growth rate of 4.4 percent between fiscal years 2001 and 2014.[167]

Property tax rates in Iowa are generally expressed as a consolidated rate, consisting of subcomponent rates funding general government and specific local services. The components of local property taxes are important for the distribution of revenues, but for the taxpayer, collections are unified.

165 "State and Local Government Finance." Census Bureau. 2013. http://www.census.gov/govs/local/.
166 Id.
167 "Iowa Property Tax and Local Government Finance Trends." Iowa Legislative Services Agency. December 11, 2013. https://www.legis.iowa.gov/DOCS/LSA/IssReview/2014/IRJWR000.PDF, 8.

Figure 5a.

Iowa Property Tax Collections (1977–2013)



Per capita state and local property tax collections ran $1,515 in 2013, ranking 16th highest in the nation. Similarly, property taxes paid as a percentage of owner-occupied housing value in Iowa are the 13th highest in the nation at 1.42 percent of housing value.[168] These figures reflect effective rates, not millages. As will be discussed in detail later, rollbacks, the homestead credit, and other tax preferences yield an effective tax rate significantly lower than the published property tax rates.

Table 5b.

Property Taxes Paid as a Percentage of Owner-Occupied Housing Value

Iowa and Select Regional Competitors (2016)

State	Effective Rate
Iowa	1.42%
Illinois	1.98%
Minnesota	1.09%
Missouri	1.00%
Nebraska	1.65%
South Dakota	1.22%
Wisconsin	1.74%

Source: Tax Foundation, *Facts & Figures 2016: How Does Your State Compare?*

168 Kaeding, Nicole. *Facts & Figures 2016: How Does Your State Compare?* Tax Foundation. February 29, 2016. http://www.taxfoundation.org/article/facts-figures-2016-how-does-your-state-compare, Table 31.

Property Tax Structure

Assessment Classifications

Iowa adopts seven classifications of real property: agricultural, residential, multi-residential, commercial, industrial, public utility, and railroad. The latter two are centrally assessed, whereas the other classifications are assessed locally. Each class of property is taxed differently, though in keeping with the state constitution, all property is technically assessed at 100 percent of its market value in exchange.[169] The effect of different assessment ratios is accomplished indirectly, however, through the use of rollbacks which are more favorable for some classes of property than others.

The multi-residential classification is the newest addition.[170] Until recently, multi-family apartment buildings (defined as buildings containing three or more units) were classified as commercial property, resulting in a far higher effective rate of taxation. Inevitably, some property owners under the old system sought to limit their tax exposure by re-designating apartment complexes as cooperatives, subject to the residential rate,[171] or by building standalone units when apartment complexes would otherwise have been more cost-effective. By eliminating the disparity over the course of a few years, Iowa will make its treatment of property more neutral and remove the incentive to find inefficient ways to limit tax liability.

Iowa classifies properties based on their primary use, as opposed to providing dual classifications for mixed-use properties and assessing each portion of the property under its own classification. Beginning in 2016, an exception has been made for properties that are both multi-residential and either commercial or industrial, allowing the portion of the parcel satisfying the requirements for multi-residential classification to be assessed in that manner. Other possible dual-use combinations, however, like residential and commercial, are prohibited.[172]

Table 5c.

Taxable Valuations by Property Classification

Property Class	Taxable Valuation
Residential	$78.9 billion
Agricultural	$30.2 billion
Commercial	$32.3 billion
Industrial	$7.1 billion
Railroads	$1.5 billion
Utilities	$2.9 billion

Source: Iowa Department of Management, "Iowa Taxable Valuation History by Class," (2014).

169 I.C.A. § 441.21.
170 Gloudemans, Robert. "Recommendations for the Handling of Multi-Residential and Dual Use Properties." Iowa Department of Revenue. 2014. https://tax.iowa.gov/sites/files/idr/documents/EqualizationReport%20.pdf.
171 *Krupp Place 1 Co-op, Inc. v. Board of Review of Jasper County*. Iowa No. 09-0654.
172 Iowa Admin. Code 701-71.1.

Agricultural Assessment Factor

In response to concerns that agricultural land values were rising more rapidly than agricultural production and imposing increasingly onerous burdens on farmers, agricultural land in Iowa is assessed on the basis of farm productivity and net earning capacity, which is not to exceed—and is generally well below—its fair market value. This approach is highly unusual and reflects the size and influence of the agricultural sector in Iowa.

The agricultural factor tends to lag market conditions by several years. This is because it relies not only on an income formula "that uses data on the yield and prices for corn and silage, soybeans, wheat, oats and hay, along with the cost of agricultural production" to calculate net earning capacity, but also incorporates a five-year rolling average of productivity values.[173] It has been estimated that the taxable value of agricultural land in Iowa is only about 16 percent of its market value.[174]

Assessors are charged not only with assessing agricultural land on this preferential basis, but also with making an "agricultural adjustment" to the market value of agricultural buildings and structures based on an "agricultural factor" for each jurisdiction.[175] As explained in the Administrative Code:

> "The agricultural factor for each jurisdiction shall be the product of the ratio of the productivity and net earning capacity value per acre as determined under subrule 71.12(1) over the market value of agricultural buildings and structures as determined under the Iowa Real Property Appraisal Manual prepared by the Department [of Revenue]. The agricultural factor shall be applied uniformly to all agricultural buildings and structures in the assessing jurisdiction. As an example, if a building's actual value is $500,000 and the agricultural factor is 50 percent, the productivity value of that building is $250,000."[176]

Assessment Limitations

Iowa's property tax structure is designed to insulate property owners from at least some of the effects of inflation through the use of assessment limitations which cap the annual growth in the valuation of each class of real property. These growth allowances apply only to increased value due to revaluation, not to increased value due to improvements.[177]

173 Pearson, Beth, and Peter Fisher. "Grounds for Confusion: Iowa's Distorted Assessment of Farm Property." Iowa Fiscal Partnership. July 2008. http://www.iowapolicyproject.org/2008docs/080717-agprop2.pdf, 5.
174 Id., 8. This estimate includes the effect of both the agricultural assessment factor and rollbacks, discussed subsequently.
175 Nervig, James. "Iowa Tax Assessment Law After the 2013 Commercial Property Tax Reform." Brick Gentry P.C. http://www.brickgentrylaw.com/support/upload/news/AssessmentLaw.pdf, 8.
176 Iowa Admin. Code 701-71.3.
177 "Iowa Property Tax and Local Government Finance Trends." Iowa Legislative Services Agency, 2.

When assessed values increase in excess of these annual caps, a "rollback percentage" is determined which keeps the taxable value within the designated bounds. Over time, these rollbacks have compounded to the point where the taxable value of agricultural property was a mere 46.1 percent of assessed value in 2015, while residential property stood at 55.6 percent of assessed value.[178]

Assessment limitations have their origin in the rapid increase in the value of agricultural land in the 1970s. Between 1971 and 1976, the average price of farmland in Iowa tripled, but assessment values lagged, growing only 72 percent. A correction was inevitable, resulting in a one-year 52 percent increase in assessed values in 1975 which spurred policymakers to action to prevent taxable value from ever rising so quickly again.[179]

The growth cap for both residential and agricultural property currently stands at 3 percent—down from 4 percent, where it stood through 2012, and significantly down from its original cap of 6 percent. A linkage exists between the two classes, such that if one of those classes of property experiences growth of less than 3 percent, the other class is also capped at that lower rate of growth.[180] Since, in practice, this policy exists to limit growth in the taxable value of residential property by reference to agricultural property, it is commonly known as the "Ag Tie."[181]

If, for example, agricultural assessment values rose by 4 percent and residential values increased by 5 percent, the rollback would adjust to keep taxable value growth to 3 percent. If, however, agricultural assessment values had only risen by 2 percent, then the taxable value increase for both property classifications would be limited to 2 percent.

Since commercial and industrial property did not receive the benefit of such rollbacks, over time these properties experienced much higher effective tax rates than did residential or agricultural property. In an effort to lessen the disparity, the state legislature adopted a commercial and industrial property rollback in 2013, but set the rollback percentages by statute—reducing taxable value to 95 percent of assessed initially, further declining to 90 percent the following year. Unlike the residential and agricultural rollbacks, these rollback percentages do not contain a provision for their continued expansion by formula in future years.[182]

Until 2015, apartment complexes with three or more units were classified as commercial property. With the advent of a multi-residential classification, they are now on a path toward sharing a rollback percentage with residential property.[183] Statutorily, the rollback percentage for multi-residential properties was set at 86.3 percent in 2015, declining 3.75 percentage points a year to a low of 63.8 percent in 2021 before the rollback percentages are merged in 2022.[184]

178 "Iowa Assessment Limitations." Iowa Department of Revenue. 2015. https://tax.iowa.gov/sites/files/idr/documents/15rollbackchart.pdf.

179 Hopkins, Brad. "Iowa's Property Tax System and the Agricultural Tie: Effect on Local Government Revenue Generation." *Drake Journal of Agricultural Law* 17, no. 2 (2012): 454.

180 Id., "Property Tax – Assessment Limitations." https://tax.iowa.gov/property-tax-assessment-limitations.

181 "Iowa Property Tax and Local Government Finance Trends." Iowa Legislative Services Agency, 2.

182 I.C.A. § 441.21(5).

183 "Multiresidential Property Classification." Iowa Department of Revenue. https://tax.iowa.gov/sites/files/idr/13SF295E.pdf.

184 Nervig, James, 20.

Under federal law, the treatment of railroad property must be equal to the most favorable treatment among commercial, industrial, and utility property,[185] so railroad property also receives the advantage of the 90 percent rollback afforded to commercial and industrial property. Utility property, however, receives no rollback.[186]

Table 5d.

Rollback Percentages by Property Classification

Classification	Rollback %
Agricultural	46.1%
Residential	55.6%
Multi-Residential	86.3%
Commercial	90.0%
Industrial	90.0%
Utility	100.0%
Railroad	90.0%

It is important to note that assessment limitations function differently from the caps in place in some other states, which limit the increase in taxable value for a given parcel. The assessment limitation provides for a rollback based on the valuation increase of a class of property statewide; the tax imposed on any given taxpayer's parcel may increase more or less than the increase in the state overall. Although a present estimate is unavailable, Iowa's rollbacks were valued at $1.6 billion in 2010,[187] when the assessment limitation stood at 4 percent per year and the rollback for all classes but residential property were higher than they are now.[188]

185 45 U.S.C. § 17.

186 "Iowa Assessment Limitations." Iowa Department of Revenue.

187 Id., "2010 Property Tax Expenditure Report," https://tax.iowa.gov/report/Tax-Expenditures.

188 Rollback percentages in 2010: agricultural, 66.3%; residential, 46.9%; commercial, industrial, utility, and railroad, 100%. Rollback percentages in 2015: agricultural, 46.1%; residential, 55.6%; commercial, industrial, and railroad, 90%; utility, 100%.

Property Tax Credits and Exemptions

Homestead Credit

A homestead exemption excludes a portion of a taxpayer's primary residency from property taxation, meaning that the property tax is levied on a lesser taxable value than it would have been absent the exemption. Iowa is among the minority of states providing such a benefit in the form of a credit rather than an exemption. The credit is equal to the tax levy on the first $4,850 of taxable value of one's primary residence,[189] and results in the single largest property tax expenditure, valued at $131.3 million in fiscal year 2015.[190]

Imagine, by way of example, a property with an assessed value of $100,000 in a jurisdiction with a consolidated rate of 35 mills. Given the current residential property tax rollback, the taxable value of this $100,000 property is $55,626, which at 35 mills yields a tax of $1,946.91. The homestead credit is for the value of the tax on $4,850 of taxable value, in this case $169.75). At the rate of 35 mills, the final tax bill is reduced by the homestead exemption to $1,777.16, yielding an effective rate of 1.78 percent. The homestead credit, in this instance, reduced tax liability by about 8.7 percent.

Iowa's homestead credit amplifies the effect of its preferential treatment of owner-occupied residential property, providing a further benefit to the owners of such property which is unavailable to the owners of commercial, industrial, or even rental property, though other allowances are made for certain renters.

Credits for Elderly, Disabled, and Low-Income Individuals

Iowa provides credits to elderly, disabled, and low-income homeowners. Furthermore, in an acknowledgement that the economic incidence of property taxes on residential structures is borne by the occupants and not by the owners of a given property, Iowa—uniquely among states—also provides "rent reimbursements" to low-income heads of household.

Since rental properties—whether apartment complexes or single-family dwellings—do not receive the benefit of the homestead credit or the more generous credits for low-income homeowners, the state provides low-income renters a "rent reimbursement" meant to offset the share of rental costs going to property taxes. The state assumes that property taxes are responsible for 23 percent of rental costs, and provides credits worth 25 to 100 percent of that portion of rental payments up to $1,000, depending on income.[191] Elderly and disabled homeowners receive credits worth between 25 and 100 percent of their actual property tax burden.[192] Credits are claimed by filing a rent reimbursement claim form with the Iowa Department of Revenue; its complexity leads many renters to take advantage of rent reimbursement assistance offered at many sites across the state.

189 I.C.A. § 425.
190 "2010 Property Tax Expenditure Report." Iowa Department of Revenue.
191 Unger, Cole. "Iowa's Disabled and Senior Citizens Property Tax Credit and Rent Reimbursement Program Expenditure Projections Study." Iowa Department of Revenue. August 2012. https://tax.iowa.gov/sites/files/idr/PTCandRRPForecast.pdf, 3.
192 Id., 7–8.

Unlike the standard homestead credit, which is quite modest, credits for low-income, elderly, and disabled homeowners and renters are fairly generous. The credit for elderly and disabled individuals is also available to those residing in nursing homes or other care facilities.[193] These credits, which are essentially an extension of the homestead credit, were worth a cumulative $24.2 million in fiscal year 2015. A supplemental credit for low-income owners of modular and fabricated homes added a further $99,248 in tax expenditure.[194]

Business Property Tax Credit

In conjunction with the limited rollback extended to businesses as part of the 2013 tax reform package, the legislature also adopted a Business Property Tax Credit which, if fully funded, would allow the first $145,000 in assessed value of qualified commercial or industrial property to be treated as if it were classified as residential property. This is accomplished by providing a credit equal to the difference between the amount of taxes otherwise due and the amount due if the property were taxed as residential property.[195] For the first year, however, there was only adequate funding—$50 million—for a credit worth approximately $523, about one-sixth of the fully funded value.[196] The appropriation is to increase to $125 million for fiscal year 2017 and thereafter.[197]

Credits for Agricultural Land

In addition to the preferential treatment for agricultural land provided through the farm productivity assessment method and generous rollbacks, Iowa also offers two credits for agricultural land, both offering a credit for any school general fund tax in excess of $5.40 per $1,000 of assessed value. The Agricultural Land Property Tax Credit has fewer eligibility conditions and is a passive credit, meaning that the county auditor determines eligibility and automatically applies the credit.[198] The Family Farm Property Tax Credit, by contrast, is an active credit, with eligibility requirements revolving around ownership and demonstration of active agricultural use.[199]

Although the credits are the same, and all those who qualify for the Family Farm credit are also automatically eligible for the Agricultural Land credit, the former has priority in funding. Both credits tend to be massively oversubscribed and are only available on a *pro rata* basis.

193 Crowley, Susan, and Michael Duster. "Local Property Tax." Iowa Legislative Services Agency. https://www.legis.iowa.gov/docs/publications/LG/9447.pdf, 25. Although these residents do not own property, they, like renters, are permitted to claim a reimbursement on the grounds that their nursing home payments contain some share of the unabated property taxes imposed on the facility.
194 "Annual Report FY 2015." Iowa Department of Revenue. https://tax.iowa.gov/sites/files/idr/IDR%20Annual%20Report%20FY2015.pdf, 17.
195 Crowley, Susan, and Michael Duster. "Local Property Tax," 28.
196 Nuss, Christopher, Kelly Hamborg, and Adam Van Dike. "State of Iowa Property Tax Reform." January 2, 2014. http://www.brownwinick.com/news-blogs/legal-news/state-of-iowa-property-tax-reform.aspx.
197 Robinson, Jeff. "SF 295 Fiscal Note." Legislative Services Agency. 2013. https://www.legis.iowa.gov/docs/FiscalNotes/85_1464SVv2_FN.pdf.
198 I.C.A. § 426.
199 I.C.A. § 425A.

Therefore, properties qualifying for the Family Farm Property Tax Credit as well as the Agricultural Land Property Tax Credit receive a more substantial benefit.[200] The combined annual allocation for these credits is $39.1 million, of which $10 million is dedicated to the Family Farm Property Tax Credit.[201]

Exempt Property

Like all states, Iowa exempts certain property from taxation. In 2015, $10.9 billion in property was excluded from the tax rolls due to exemptions for religious institutions ($4.2 billion), educational institutions ($1.9 billion), charitable and benevolent societies ($1.2 billion), low-rent housing ($359 million), and other tax-advantaged entities, including racetracks ($17.9 million).[202] States often exclude certain properties from the tax base to promote, or in deference to, their societal functions, but it must be borne in mind that each exemption increases the burden on properties still included in the base.

Iowa also increasingly relies on tax increment financing to promote economic development, often allowing businesses in designated areas to obtain a rebate of property taxes paid on the improved value of their land in what constitutes a *de facto* tax abatement. Tax increment financing is considered separately in Chapter 6.

Other Property Taxes

Inheritance Tax

Iowa is one of only six states to impose an inheritance tax, levied at rates ranging from 5 to 15 percent. Two states with inheritance taxes also impose an estate tax, while another 13 states levy an estate tax but not an inheritance tax. While estate taxes are charged against the estate regardless of who inherits the assets, inheritance taxes are levied on the transfer of assets to heirs, based on the relationship of the inheritor to the deceased.

Some property from an estate can pass to an heir without being subject to an inheritance tax; this exemption is predicated on the relationship of the beneficiary to the decedent. In Iowa, surviving spouses and lineal ascendants (e.g., parents, grandparents, great-grandparents) and descendants (e.g., children, grandchildren, and great-grandchildren) are exempt from the inheritance tax.[203] All other beneficiaries are subject to tax, with rates incumbent upon their status or relationship to the deceased.

200 Crowley, Susan, and Michael Duster. "Local Property Tax," 26-27.
201 "Annual Report FY 2015." Iowa Department of Revenue, 17.
202 Id., "Exempt Property Report," 2015, https://tax.iowa.gov/equalization-and-rollbacks.
203 Adopted children and stepchildren share in the exemption for lineal descendants. As of January 2016, property passing to the lineal descendants of stepchildren is also exempt from the inheritance tax.

Table 5e.
Inheritance Tax Rates by Beneficiary Class

	Rates	
Beneficiaries	Min.	Max.
Siblings & Sons- & Daughters-in-Law	5%	10%
All Other Individual Beneficiaries, Including Other Relatives	12%	15%
Firms, Corporations, & Other For-Profit Organizations	15%	15%
Charitable, Educational, or Religious Organizations	10%	10%
Unknown Heirs	5%	5%

Source: Iowa Department of Revenue, “Iowa Inheritance Tax Rate Schedule” (2015).

Inheritance taxes can be particularly harmful to small, family-owned businesses—including farms—if they do not possess the liquid assets necessary to cover the tax liability. The inheritor may be forced to downsize the business, or sell part or all of it, to pay the inheritance tax. If, for instance, a decedent leaves her small business, worth $200,000, to her niece, that niece will have to come up with $30,000 to cover the inheritance tax, which may well exceed the business’s liquid assets.[204]

The inheritance tax does not apply to net estates of less than $25,000, but this is a filing threshold, not an exemption, meaning that, for any estate exceeding that amount, the entirety is subject to tax. Moreover, even if an inheritor receives less than $25,000, the inheritance tax is owed provided the estate was valued at $25,000 or more. The federal estate tax, by contrast, exempts the first $5.45 million from taxation.

As early as 1985, a tax study committee, chaired by then-Lt. Governor Terry Branstad, recommended “future consideration of inheritance tax law changes” based on “indications that the present law is at least one factor in causing certain people to leave our state.”[205] The consultants retained to prepare the report recommended eliminating the inheritance tax altogether.[206]

While the consultants’ recommendation was not adopted, in subsequent years, the state acted to exempt a range of close relatives, substantially lessening the burden of the tax. Nevertheless, Iowa taxpayers with whom we spoke offered numerous examples of wealthy Iowans not only choosing to retire in states like South Dakota or Texas over income tax considerations, but also taking future taxation of heirs into account. Iowa’s inheritance tax raised $87.0 million in fiscal year 2015.[207]

204 See, e.g., Walczak, Jared, Scott Drenkard, and Joseph Henchman, *2016 State Business Tax Climate Index*, 26.
205 “Report of the Tax Study Committee: A Study of State and Local Taxes in Iowa.” Iowa Legislative Services Bureau. 1985. https://www.legis.iowa.gov/docs/publications/IP/256370.pdf, 16.
206 Id., xii.
207 “Annual Report FY 2015.” Iowa Department of Revenue, 6.

Real Estate Transfer Tax

Another, more common form of asset transfer tax is the real estate transfer tax. Iowa imposes a real estate transfer tax with an effective rate approximating 1.6 mills, or $1.60 per $1,000 of consideration paid in the sale of property. More precisely, it is a tax of 80 cents per increment of $500, or fraction thereof, above $500.[208] The real estate transfer tax on property assessed at $100,000, therefore, is $159.20, while if the property was assessed at $101,000, the tax would be $160. Perhaps rendering the tax more confusing than need be, the state provides 20 pages of tax tables providing the actual tax liability for every increment of $500 up to $2 million ($3,199.20 in tax liability).[209] The tax is imposed on the seller, and raised $19.1 million in revenue in fiscal year 2015.[210]

Real estate transfer tax payments are remitted to the county recorder. The majority of revenue generated by the tax, however, ultimately goes to the state. The county recorder remits 82.75 percent to the state while disbursing the remaining 17.25 percent to the county's general fund.[211]

Thirty-six states impose real estate transfer taxes,[212] with rates ranging from 0.1 mills in Colorado to a maximum of 20 mills in Delaware.[213] Due to additional transfer taxes in New York City, a rate of 26.25 mills is possible on some homes, though most states with real estate transfer taxes adopt rates more in line with Iowa's, or modestly higher. Among the 36 states with such taxes, Iowa's rate is the eighth lowest.[214] Considering the 14 states that forego the tax, 21 states offer a lower (or no) tax on transfers than does Iowa. The tax can be particularly burdensome to businesses with frequent property transactions.

Property Tax Administration

The Council on State Taxation (COST) releases a report detailing the property tax administration practices of the 50 states, in addition to giving each state's system a letter grade based on their practices. According to COST,

> [I]t is essential for state legislators and tax administrators to ensure the tax is administered fairly and without perceptions of bias or undue administrative burdens. Taxpayers are much more willing to fairly and fully comply with a property tax system perceived as unbiased, equitable and efficient.[215]

208 I.C.A. § 428A.1.
209 "Iowa Real Estate Transfer Tax Table." Iowa Department of Revenue. 2015. https://tax.iowa.gov/sites/files/idr/documents/57004.pdf.
210 "Annual Report FY 2015." Iowa Department of Revenue, 6.
211 I.C.A. § 428A.8.
212 Walczak, Jared, Scott Drenkard, and Joseph Henchman. *2016 State Business Tax Climate Index*, 80.
213 Arizona imposes a flat recordation fee of $2. It is not included here.
214 "Real Estate Transfer Taxes." National Conference of State Legislatures. 2012. http://www.ncsl.org/research/fiscal-policy/real-estate-transfer-taxes.aspx.
215 "The Best and Worst in Property Tax Administration." Council on State Taxation. May 2011. http://www.cost.org/workarea/downloadasset.aspx?id=78745, 1.

States are evaluated based upon whether or not they have a uniform tax base and rates, adopt efficient filing procedures, centralize review and uniform appeal procedures, and limit payment requirements to the uncontested portion of valuations.[216]

Based on these criteria, Iowa receives a grade of C-, faring better than only seven states. A range of factors contribute to this score, including the lack of standardization of when reports are due to local assessors, the lack of interest on overpayments, a narrow appeals window, the state's range of assessment ratios, and the fact that tax cannot be escrowed.[217]

Property Tax Solutions

A well-designed property tax system has certain advantages over other forms of taxation, which tend to have a larger adverse impact on economic decision making. Commendably, Iowa exempts personal property from taxation, properly circumscribing the tax base to land and improvements. The state does, however, diverge sharply from a neutral treatment of taxable property, and imposes an economically harmful inheritance tax.

The following property tax solutions are designed to be severable, to be considered individually or in concert with each other. Each solution would improve the competitiveness of the state's property tax structure.

Reform Iowa's Rollback Structure

Decades of rollbacks for agricultural and residential property, while commercial and industrial property continued to be taxed at 100 percent of assessed value, had the effect of shifting the property tax burden disproportionately toward commercial and industrial property. In an effort to reduce this disparity, in 2013, the legislature adopted a statutorily-set commercial and industrial rollback along with the business property tax credit, for a combined tax expenditure cost (once phased in) of $278.7 million per year. While this had the effect of reducing the disparity temporarily, over time the gap will widen further as rollbacks continue to insulate some, but not all, classes of property from some of the effects of inflation.

The legislature could act to restrict further imbalances by extending the 3 percent allowable growth factor enjoyed by agricultural and residential property to commercial and industrial property as well, and, optionally, to further adjust the initial rollback percentage for these classes of property to bring them closer to parity with residential and agricultural property. The taxable value of commercial and industrial property has grown much more slowly than the value of residential and agricultural land, and it may be anticipated that any rollbacks would be modest. Such a policy would, however, ensure greater neutrality in the treatment of property in the future.

216 Id. at 2.
217 Id. at 14, 34.

In recent years, the legislature has considered several bills to extend assessment limitations to commercial and industrial property. In 2005, the Iowa House Ways and Means Committee introduced legislation to include such property in the rollback formula. Similar proposals were introduced in 2006 and 2009, and in 2011, the governor's budget proposal recommended setting a commercial and industrial rollback of 60 percent. The state's Legislative Services Agency estimated that the 2005 and 2006 proposals would reduce tax collections by a figure in the neighborhood of $25 million per year.[218] Even assuming some increase due to the passage of time and the change in the assessment limitation—then 4 percent, now 3 percent—the costs of such a policy would clearly be modest compared to the expenditures associated with the 2013 tax reform package.

Currently, the business property tax credit provides the benefit of the residential rollback to a portion of commercial and industrial property's taxable value. If necessary, as the commercial and industrial rollbacks became more significant, this credit—a patch to address a growing disparity—could be reduced. The state may also wish to consider eliminating the "Ag Tie," an artificial restriction on the rate of assessment growth for residential property.

Standardize Filing Deadlines

Currently, assessors are free to set their own filing and payment deadlines for local property taxes, creating needless administrative costs for individuals and businesses with property in multiple localities. Statutorily requiring localities to adopt a standard filing schedule would reduce compliance costs and make the state more business friendly without any loss of revenue. If necessary, a transitional filing schedule could be utilized to ensure that any shift did not create a temporary revenue flow issue for local governments.

Repeal the Inheritance Tax

Iowa's inheritance tax disadvantages some bequests more than others. Significant reforms undertaken in recent decades exempted spouses and lineal ascendants and descendants from the inheritance tax, but many bequests, including to other relatives, are still subject to a tax that is imposed in only five other states. The tax can prove uniquely burdensome to small businesses, potentially requiring them to be broken up to pay the tax bill.

Under the current system, some Iowans may elect to adopt tax avoidance strategies such as making lifetime gifts, even if they would otherwise prefer to retain ownership throughout their life. Such arrangements are suboptimal for the individuals involved without conferring any revenue advantage to the state.

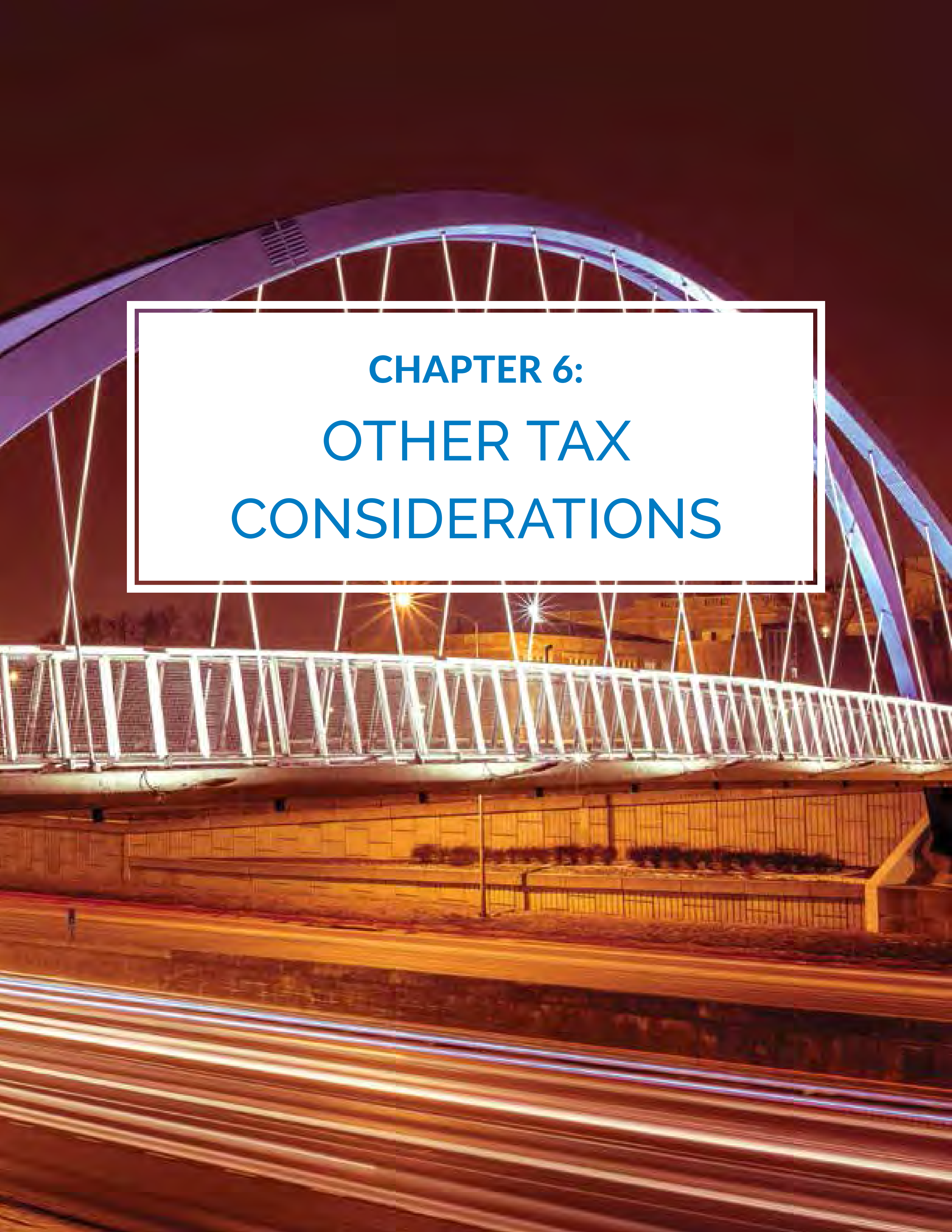
218 Hopkins, Brad. "Iowa's Property Tax System and the Agricultural Tie: Effect on Local Government Revenue Generation," 460-465.

Iowa policymakers should consider finishing the work that prior legislatures began by repealing the inheritance tax. If the revenue loss—$87 million in 2015—cannot be absorbed immediately, it could be phased out over five years, with rates for all classes reduced proportionately in each year. Some of the loss may be offset, in the long run, through additional tax receipts from individuals who might otherwise leave the state, but such revenues cannot be predicted and should not be relied upon as a significant offset.

Repealing the inheritance tax would allow the state to improve from 40th to 35th on the property tax component of the *State Business Tax Climate Index*. Additional reforms could also improve the state's *Index* score if they served to reduce effective property tax rates.

	Iowa's Current Ranking	Ranking with Full Implementation of Property Tax Reform Recommendations
Overall *Index* Ranking	40th	40th
Property Tax *Index* Component Ranking	40th	35th

CHAPTER 6:
OTHER TAX CONSIDERATIONS



Introduction

In this final chapter, we review several other important taxes and tax topics in Iowa. Tax increment financing assumes an outsized role in Iowa, perhaps due to the high effective rates of taxation on commercial and industrial property. The franchise tax creates a parallel business tax structure for financial institutions. Finally, the gas tax was recently increased, but, lacking inflation indexing, will continue to erode in real terms over time. Each of these taxes is considered in turn.

Tax Increment Financing

In turning to tax increment financing (TIFs) to fund some community projects, Iowa is not unique: 49 states make use of TIFs in urban planning.[221] Where the state stands out, however, is in just how broad the parameters have become. What began as a tool to combat blight has evolved into a financing mechanism so versatile that, with sufficiently clever local administrators, practically no project is wholly off-limits.

Tax increment financing in Iowa refers to a mechanism by which property tax revenues generated on improvements in designated urban renewal areas (URAs) are used to fund the area's urban renewal projects.[222] Under a TIF, property tax levied against any increase in the taxable valuation of the properties within the urban renewal area over the base valuation (that is, the value of the properties before the TIF program began) is separated out, deposited in a special fund, and used to pay for obligations incurred in improving the region.[223] This additional revenue associated with any increase in value over the frozen base valuation is known as the "tax increment." The portion of the increment spent covering debt or other renewal expenses is the "used increment," while any excess revenues returned to the underlying taxing authorities is the "unused increment."[224]

Technically, there are limitations on how the tax increment can be spent. The municipal authority must adopt a resolution making a finding that the rehabilitation, conservation, redevelopment, or development of the area in question—which need not be contiguous—is necessary for public health, safety, or welfare,[225] and the increment must be used to retire debt incurred in the renewal process.[226] However, projects funded by tax increment financing can range from public improvements (like roads and utilities) to service expansion (like constructing a new fire hall) to private development (like shopping plazas and housing developments).[227]

Definitions of debt, moreover, are flexible. These projects can be funded not only by general obligation debt, but also by internal loans and even rebate agreements with developers.[228] Under these rebate agreements, which effectively function as tax abatements, the tax increment attributable to developers is returned to them in reimbursement for select development costs.[229]

221 Girardi, Anthony. "Iowa Tax Increment Financing." Iowa Department of Revenue, Tax Credits Program Evaluation Study. December 2013. https://tax.iowa.gov/sites/files/idr/TIF%20Evaluation%20Study%202013.pdf, 12.

222 Sales tax TIFs are also allowable for designated projects, though they are used more sparingly. Currently, the Newton Race Track and the All-Star Baseball Haven receive sales tax TIFs, and flood mitigation projects, reinvestment zones, and select local urban renewal projects (through the local option sales tax only) can also be eligible. Through June 2013, about $3.1 million had been diverted through sales tax TIFs. See generally, Legislative Services Agency, "Tax Increment Financing – Sales Tax," November 2013, https://www.legis.iowa.gov/DOCS/LSA/Fiscal_Topics/2014/FTSLS001.PDF.

223 Crowley, Susan. "Legislative Guide to Urban Renewal and Tax Increment Financing." Iowa Legislative Services Agency. https://www.legis.iowa.gov/DOCS/Central/Guides/urbannew.pdf, 7.

224 Girardi, Anthony. "Iowa Tax Increment Financing," 10.

225 Crowley, Susan. "Legislative Guide to Urban Renewal and Tax Increment Financing," 2.

226 Girardi, Anthony. "Iowa Tax Increment Financing," 10.

227 Josten, Robert. "What is Tax Increment Financing?" Dorsey & Whitney. http://www.extension.iastate.edu/communities/sites/www.extension.iastate.edu/files/communities/3%20Tax%20Incremental%20Financing.pdf, 1.

228 Id., 3.

229 Swenson, Dave, and Liesl Eathington. "Tax Increment Financing Growth in Iowa." Iowa State University. April 2006. http://www2.econ.iastate.edu/research/webpapers/paper_12586.pdf, 18.

Tax increment financing occasionally stirs up controversy, as when the city of Altoona diverted $56 million in property tax revenue to build a Bass Pro Shop-anchored development, or when Coralville snagged a Von Maur department store at a cost of $9.5 million in tax increment—a store that relocated from a few miles away.[230] Most TIFs, by contrast, draw little attention, but they divert about $300 million a year in local tax revenue, with increment valuation on the tax rolls reaching $9.5 billion in 2012.[231] At present, about 60 percent of property in urban renewal areas is commercial, and another quarter is residential.[232] The amount of annual revenue divided and allocated by TIFs more than doubled between 2000 and 2012.

Table 6a.

Tax Increment Financing Growth (2000–2012)

Year	# of URAs	Frozen Base Valuation	Increment Valuation	Estimated TIF Revenues
2000	1,125	$6.6 billion	$4.5 billion	$130.3 million
2006	1,296	$7.6 billion	$7.3 billion	$237.8 million
2012	1,614	$9.3 billion	$9.5 billion	$291.9 million

Source: Anthony Girardi, "Iowa Tax Increment Financing," Iowa Department of Revenue, Tax Credits Program Evaluation Study, December 2013, 37.

In 2012, 88.6 percent of classifiable urban renewal area tax increment was at least partially for economic development purposes, and nearly all TIF districts implemented over the past three decades have been economic development-related. Since 1989, roughly the time when TIFs had completed their transition from a blight elimination tool to an economic development mechanism, the increment valuation has increased, in nominal terms, by nearly 1,400 percent.[233]

Table 6b.

Increment Valuation of Urban Renewal Areas by Purpose

Year	Slum/Blight	Economic Development	Dual Purpose	No Data	Total
2000	$0.4 billion	$2.3 billion	$0.8 billion	$0.9 billion	$4.5 billion
2006	$0.6 billion	$4.4 billion	$1.5 billion	$0.8 billion	$7.3 billion
2012	$0.9 billion	$6.0 billion	$1.2 billion	$1.4 billion	$9.5 billion

Source: Anthony Girardi, "Iowa Tax Increment Financing," Iowa Department of Revenue, Tax Credits Program Evaluation Study, December 2013, 39.

Most studies of tax increment financing for economic development purposes have concluded that these measures provide little or no net economic benefit. Arguments for TIFs are likely to be strongest where there is a clear public purpose—investments in local infrastructure, for instance—and weakest where the intended benefit is to be realized through subsidization of private development.

230 DeWitte, Dave. "Why tax increment financing works, and why it's causing worry." *The Gazette* [Cedar Rapids]. March 31, 2014. http://www.thegazette.com/2012/07/29/why-tax-increment-financing-works-and-why-its-causing-worry.

231 Girardi, Anthony. "Iowa Tax Increment Financing," 37

232 Id., 16.

233 Swenson, David, and Liesl Eathington, "Do Tax Increment Finance Districts Spur Regional Economic and Demographic Growth?" Iowa State University. June 2002. http://www2.econ.iastate.edu/research/webpapers/paper_4094_N0138.pdf, 2–3.

Iowa State University economists David Swenson and Liesl Eathington have produced multiple studies on Iowa's system of tax increment financing, concluding that the data yields "virtually no evidence of broad economic or social benefits in light of the costs" and, outside of a modest benefit to the manufacturing sector, demonstrates "no evidence of economy-wide benefit (trade, all nonfarm jobs), fiscal benefits, or population gains" attributable to TIF utilization.[234] In a separate study, they noted that "[t]here is little evidence to support the assertion that local incentives actually determine business locations" or that "local economic development activities substantially alter overall regional economic opportunities."[235] In other words, localities frequently find themselves subsidizing projects that would have been pursued either way.

Economists Richard Dye and David Merriman have attempted to quantify this phenomenon, concluding that to the extent that TIF areas are associated with economic growth, it is because they tend to be implemented in areas already poised for growth. They write:

> Observing high growth in an area targeted for development is unremarkable. The issues we have studied are (1) whether the targeting causes the growth or merely signals that growth is coming; and (2) whether the growth in the targeted area comes at the expense of other parts of the same municipality. We find evidence that the non-TIF areas of municipalities that use TIF grow no more rapidly, and perhaps more slowly, than similar municipalities that do not use TIF.[236]

Not all economists are unfailingly critical of TIFs. Another Iowa State University economist, Mark Edelman, responded to Swenson and Eathington by arguing that unilateral elimination of TIFs could make Iowa less competitive even under the assumption that TIFs as a whole represent a race to the bottom. He cautions that studies finding TIFs ineffective are analyzing TIFs as they are structured currently, and that better utilization of TIFs could enhance performance. Edelman also suggests that TIFs may be superior to other economic development tools commonly utilized by state and local governments.[237]

Many new TIF projects involve a single firm, with incremental taxes paid by that firm ultimately returned to them.[238] While some such rebates are contingent on meeting job creation requirements,[239] Iowa's TIF structure does not inherently contain any performance requirements. Some economists argue that even if TIFs have value at some level, they yield diminishing returns when they become more common, as they have in Iowa.[240]

234 Swenson, David, and Liesl Eathington. "Do Tax Increment Finance Districts Spur Regional Economic and Demographic Growth?" 11.

235 Id., "Tax Increment Financing Growth in Iowa," 5–6.

236 Dye, Richard, and David Merriman. "Tax Increment Financing: A Tool for Local Development." *Land Lines* 18, no. 1 (January 2016): 7. https://www.lincolninst.edu/pubs/dl/1076_Jan2006-Final.pdf.

237 See generally, Edelman, Mark, "Appraisal Comments on Tax Increment Financing Effectiveness in the Context of Evaluating Iowa Tax Policy Alternatives," Iowa State University Working Paper #03005, March 2003, http://www.econ.iastate.edu/sites/default/files/publications/papers/p3818-2003-03-06.pdf.

238 Swenson, David, and Liesl Eathington. "Do Tax Increment Finance Districts Spur Regional Economic and Demographic Growth?" 18.

239 Girardi, Anthony. "Iowa Tax Increment Financing," 28.

240 Id., 14.

The Iowa Department of Revenue's own regression analysis found that "the percent of urban property tax revenues diverted to TIF in 2002 through 2012 does not explain any variation in the level of aggregate wage growth relative to standardized estimates for such growth during the decade."[241]

Given the lack of evidence that tax increment financing helps facilitate economic growth, coupled with the substantial tax costs involved, Iowa localities should be cautious about further reliance on TIFs. They force many businesses and individuals to incur higher tax burdens to offset the incentives granted to a few. In recent years, the state has moved to enhance accountability measures for TIFs,[242] but optimally, policymakers would identify ways to phase out economic development TIFs altogether or, failing that, to at least require a demonstration of how the TIF will encourage development that would not have been realized otherwise.

Some businesses have embraced TIFs as a mechanism for ameliorating Iowa's otherwise heavy taxation of commercial property, and this is understandable, but far better policy would be to use the revenue diverted by TIFs to cut taxes for all payers.

Taxes on Financial Institutions

Iowa imposes a tax on banks and other financial institutions, called the franchise tax. It is important to distinguish the term, as many states also use the term "franchise tax" to denote a capital stock tax on all businesses, whereas Iowa's franchise tax is imposed on banks, charters savings and loans, production credit associations, and other financial institutions, but not credit unions, which are subject to the alternative moneys and credit tax.[243] In broad terms, Iowa's franchise tax behaves similarly to the corporate income tax, from which institutions liable under the franchise tax are exempt. The definition of net income used for franchise tax purposes, however, captures more income than would the corporate income tax itself.[244]

241 Id., 28.
242 See, e.g., House File 2460 (2012), https://www.legis.iowa.gov/legislation/BillBook?ga=84&ba=HF2460.
243 "Franchise Tax." Iowa Legislative Fiscal Bureau. October 28, 1994. https://www.legis.iowa.gov/docs/publications/IR/951.pdf, 1–2.
244 Id. For a brief overview of state taxation of financial institutions, see generally, Serether, Jeffrey, Maria Eberle, and Michael Colavito Jr., "Can You Take This to the Bank? State Taxation of Financial Institutions," *Tax Analysts*, March 7, 2011.

Every state but Wyoming imposes a tax on financial institutions. Of the remaining 49 states, 29 impose a franchise tax on financial institutions, while 20 simply subject banks and other financial institutions to their corporate income tax.[245] Tax structures and nexus and apportionment rules can vary greatly across states and often diverge from treatment under the corporate income tax.[246] Among Iowa's neighbors, Illinois, Minnesota, and Wisconsin include financial institutions in their corporate income tax base, while Missouri, Nebraska, and South Dakota impose franchise taxes, each operating quite distinctly from the Iowa tax.[247]

In Iowa, calculation of net income for franchise tax purposes diverges from calculation under the corporate income tax in the following ways:

- Interest and dividends from government securities are added back to net income;
- The federal deduction is unavailable; and
- Interest expense allocated to tax-exempt interest is deductible.[248]

Because the tax base is broader and federal deductibility is unavailable, the franchise tax is a single-rate tax of 5.0 percent.[249] Some, but not all, of the tax credits which reduce corporate income tax liability can also be applied to the franchise tax. [250] Additionally, since financial institutions organized as S corporations would otherwise face two layers of taxation, a franchise tax credit is available against individual income taxes to eliminate double taxation of shareholders.[251]

In tax year 2013, $13.6 million in credits were claimed against the franchise tax. Table 6c lists the nine tax credits claimed that year, along with the value of those claims.

245 Gullickson, Angela. "Iowa's Franchise Tax Credit." Iowa Department of Revenue, Tax Credits Program Evaluation Study. December 2011. https://tax.iowa.gov/sites/files/idr/Franchise2011.pdf, 5.

246 See generally, Serether, Jeffrey, Maria Eberle, and Michael Colavito Jr., "Can You Take This to the Bank? State Taxation of Financial Institutions," *Tax Analysts*, March 7, 2011; and Awdeh, Lutof, and Richard Gowen, "State Taxation of Financial Institutions: A Multidimensional Landscape," *The Tax Adviser*, September 1, 2015, http://www.thetaxadviser.com/issues/2015/sep/state-taxation-financial-institutions.html.

247 Id., 6. As summarized by the Iowa Department of Revenue, "Missouri's tax is 0.033 percent of the par value of shares outstanding apportioned to Missouri, not to exceed the amount of tax from the 2010 taxable year. Nebraska calculates the franchise tax as $0.47 per $1,000 of average deposits (calculated quarterly), but limited to 3.81 percent of the institution's net financial income. South Dakota's rate decreases as income rises; the tax rate starts at 6 percent and eventually reaches 0.25 percent."

248 "State Taxation – Corporate Income Tax and Franchise Tax." Iowa Legislative Services Agency. November 2013. https://www.legis.iowa.gov/docs/publications/LG/24337.pdf, 29.

249 I.C.A. § 422.63.

250 "State Taxation – Corporate Income Tax and Franchise Tax." Iowa Legislative Services Agency, 31–32.

251 See generally, Gullickson, Angela, "Iowa's Franchise Tax Credit."

Table 6c.
Credits Claimed Against the Franchise Tax (2013)

Tax Credit	2013 Amount
Historic Preservation & Cultural & Entertainment District Tax Credit	$10,248,752
Enterprise Zone Housing Investment Tax Credit	$1,368,135
Venture Capital Tax Credit – Iowa Fund of Funds	$910,180
Renewable Energy Tax Credit	$737,738
Investment Tax Credit	$238,728
Iowa Alternative Minimum Tax Credit	$60,086
Redevelopment Tax Credit	$49,063
Endow Iowa Tax Credit	$10,688
Venture Capital Tax Credit – Venture Capital Fund	$173

Source: Data provided to the author by the Iowa Department of Revenue. For prior year published data, see generally, Gullickson, Angela, "Iowa's 2012 Tax Credit Claims," Iowa Department of Revenue (July 2015).

The franchise tax accounted for $36.2 million in net revenue in 2015.[252] The current tax structure routinely draws objections from banks, who note that credit unions—which are increasingly empowered to offer most of the same financial services as banks—are exempt. In lieu of the franchise tax, credit unions are subject to a 0.5 percent moneys and credit tax on their reserves. A range of credits may be taken against moneys and credit tax liability, though the value of credits claimed is not reported. Net liability under the moneys and credit tax is minimal, though collections for this tax are not broken out by the Iowa Department of Revenue.[253]

Figure 6d.
Credits Available Against the Moneys and Credit Tax[254]

Tax Credit
Endow Iowa Tax Credit
Enterprise Zone Program Investment Tax Credit
High Quality Jobs Program Investment Tax Credit
High Quality Jobs Program Corporation Tax Credit for Third Party Sales Tax
Innovation Fund Tax Credit
Redevelopment Tax Credit
Solar Energy System Tax Credit
Venture Capital Tax Credit
Workforce Housing Tax Incentive Program

Motor Fuel Taxes

When Iowa increased its motor fuel tax by 10 cents in 2015,[255] it was seen as the largest gas tax increase in state history. In real terms, however, the tax is still nearly 40 percent off its 1955 peak of 52.9 cents per gallon (in 2015 cents). The state's tax levy on motor fuel currently consists of a 31 cent per gallon motor fuel excise and a 1 cent per gallon environmental protection charge, yielding a total state tax rate of 32 cents per gallon. Before the tax increase, Iowa's gasoline tax was the 35th highest in the nation; it now ranks 14th.[256]

252 "Annual Report FY 2015." Iowa Department of Revenue. https://tax.iowa.gov/sites/files/idr/IDR%20Annual%20Report%20FY2015.pdf, 6. Note that prior to FY 2004, $8.8 million in franchise tax collections was remitted to cities and counties.
253 I.C.A. § 533.329.
254 "Tax Credits Users' Manual: A Descriptive Guide to Iowa's State Tax Credits," Iowa Department of Revenue, 2015, https://tax.iowa.gov/sites/files/idr/Tax%20Credits%20Users%27%20Manual%2020160115.pdf, 4-5.
255 Senate File 275. 2015. https://www.legis.iowa.gov/legislation/BillBook?ga=86&ba=SF257.
256 *Facts & Figures: How Does Your State Compare?* Tax Foundation. Multiple years.

The state's first gas tax was imposed in 1925 at 2 cents per gallon; the environmental protection charge dates back to 1991.[257] Table 6d provides a rate history of Iowa's gas tax, expressed in both nominal and real (inflation-adjusted) terms.

Table 6d.

Iowa's Motor Fuel Tax Rates (in 2015 Dollars, 1925–2015)

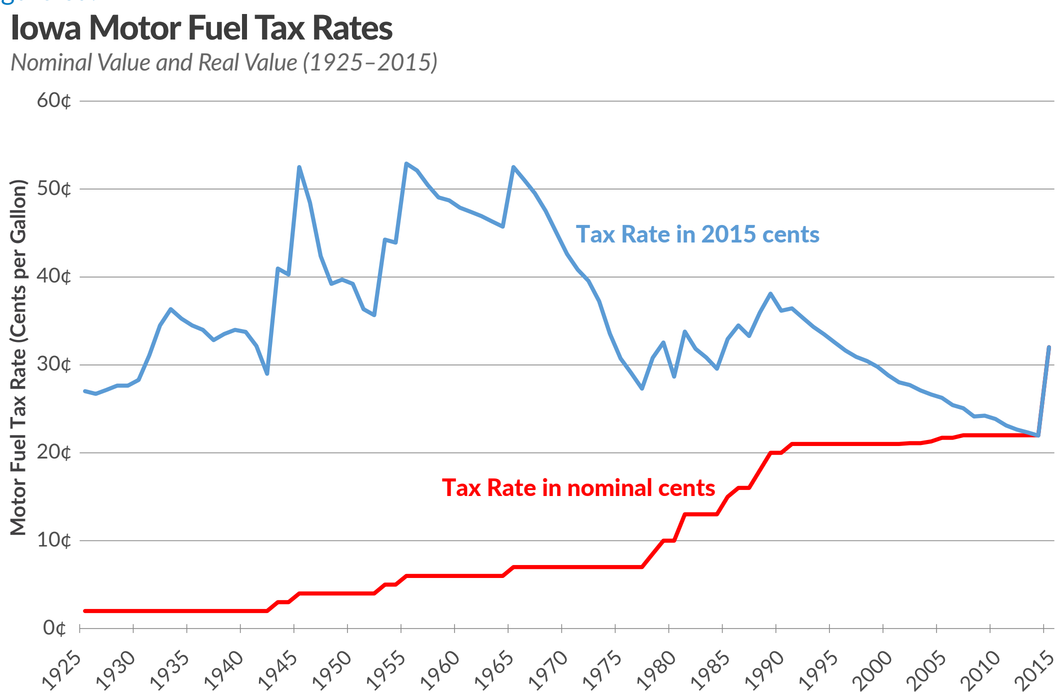
Year	Tax Rate (cpg)	Inflation-Adjusted Tax Rate (cpg)
1925	2.0	27.0
1943	3.0	41.0
1945	4.0	52.5
1953	5.0	44.2
1955	6.0	52.9
1965	7.0	52.5
1978	8.5	30.8
1979	10.0	32.5
1981	13.0	33.8
1985	15.0	32.9
1986	16.0	34.5
1988	18.0	35.9
1989	20.0	38.1
1991	21.0	36.4
2002	21.1	27.7
2004	21.3	26.6
2005	21.7	26.3
2007	22.0	25.1
2015	32.0	32.0
Average (1925–1965)		45.5
Average (1966–2015)		32.1
Average (1925–2015)		38.1

Source: Iowa Department of Revenue, "Iowa Tax Rate History" (2015).

Because state motor fuel taxes are usually imposed as an excise of a given amount per gallon, and tend not to be indexed for inflation, tax collections tend to decline in real terms over time. Iowa is no different in this regard, as Figure 6a shows. Although the 2015 gas tax increase does not solve the erosion issue, it does represent a step in the right direction. The best way to mitigate erosion is to adopt inflation indexing of gasoline and diesel excise taxes.

257 "Environmental Protection Charge." Iowa Department of Revenue. https://tax.iowa.gov/environmental-protection-charge. Many states impose such taxes, designed to abate the costs of cleaning up leaks from old underground storage tanks.

Figure 6a.



Note: Includes the motor fuel excise tax (currently 31 cpg) and the environmental protection charge (1 cpg).

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