

## A 'SINGLE FACTOR' TO CONSIDER Taking Mystery Out of Loopholes and Combined Reporting

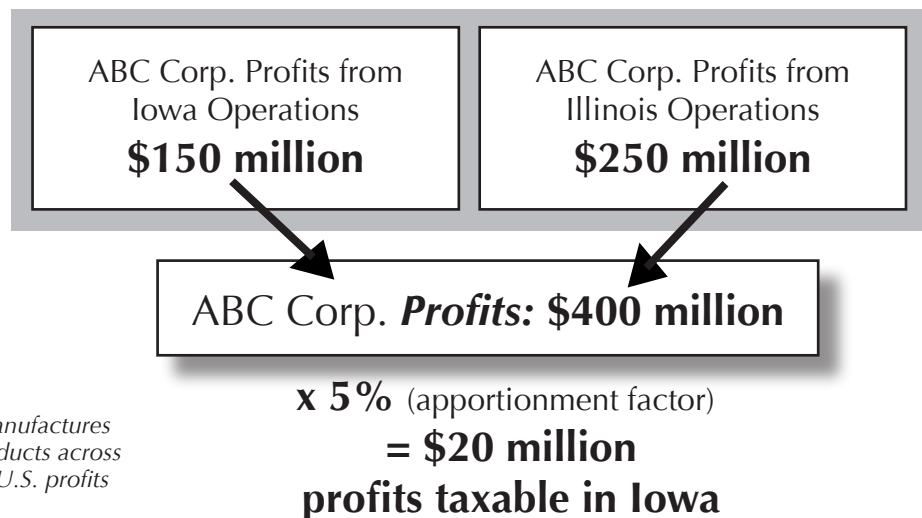
An idea being considered in the 2008 Legislature is plugging tax loopholes. The way to do it is with something called "combined reporting." So, what is it, and how does it work? It is uncomplicated — surprisingly so, given the nature of the complicated arguments against it by the big business lobby.

To illustrate the effects of combined reporting, consider a hypothetical large manufacturer, ABC Corporation, which has factories in Iowa and Illinois and sells its products on national markets. Iowa's corporate income tax begins with ABC's profits from all its U.S. operations. In Scenario I illustrated below, the plant in Iowa generates \$150 million in profits and the one in Illinois \$250 million. So the starting point is \$400 million in company profits. Because of our single-factor tax, these profits are then apportioned to Iowa solely on the basis of sales. We assume that the company has \$4 billion in annual sales across the U.S.; \$200 million of these sales (5 percent of the total) are in Iowa. Thus, regardless of how much of this company's goods are produced in Iowa, the state taxes only 5 percent of the \$400 million in company profits, or \$20 million.

### SCENARIO I

Iowa's Single-Factor  
Apportionment:  
**Sales to Iowa ÷ Total Sales**  
 $\$200 \text{ million} \div \$4 \text{ billion} =$   
**5%**  
(apportionment factor)

*A multistate firm (ABC Corp.) that manufactures goods in Iowa and Illinois sells its products across the country. It pays Iowa tax on total U.S. profits apportioned to Iowa.*



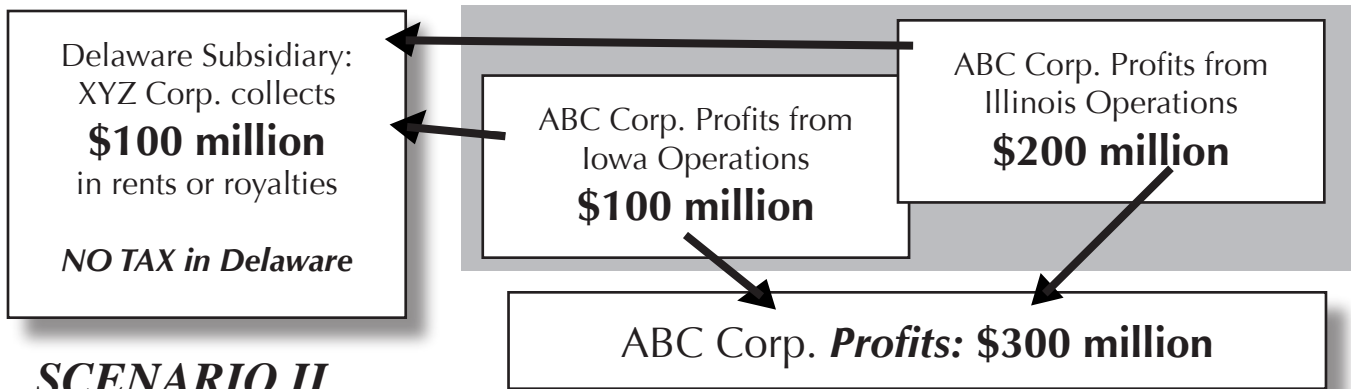
Scenario I shows fundamentally how Iowa's corporate tax is intended to be applied. The next two scenarios illustrate how corporations manage to avoid that intent (Scenario II), and how the state of Iowa can respond the way 21 other states have done (Scenario III).

Now suppose that ABC Corporation forms a shell corporation, XYZ, in Delaware for the purpose of shifting taxable profits out of Iowa and reducing Iowa income taxes. ABC transfers a patent it owns to XYZ in Delaware. This is Scenario II, shown on page 2. The factories in Iowa and Illinois now pay royalties to the Delaware subsidiary for the right to use the patent, and deduct these costs from the profits of ABC Corporation. Because Iowa has "separate entity reporting," XYZ Corporation is treated as a separate entity and is not taxable in Iowa because it has no presence here. So the starting point for Iowa taxes is now \$300 million instead of \$400 million. Sales remain the same, so the 5 percent apportionment factor is applied and Iowa taxable profits are now \$15 million instead of \$20 million.

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**SCENARIO II**

*The multistate firm (ABC Corp.) opens a Delaware subsidiary (XYZ Corp.) to transfer profits out of other states; Iowa tax falls.*

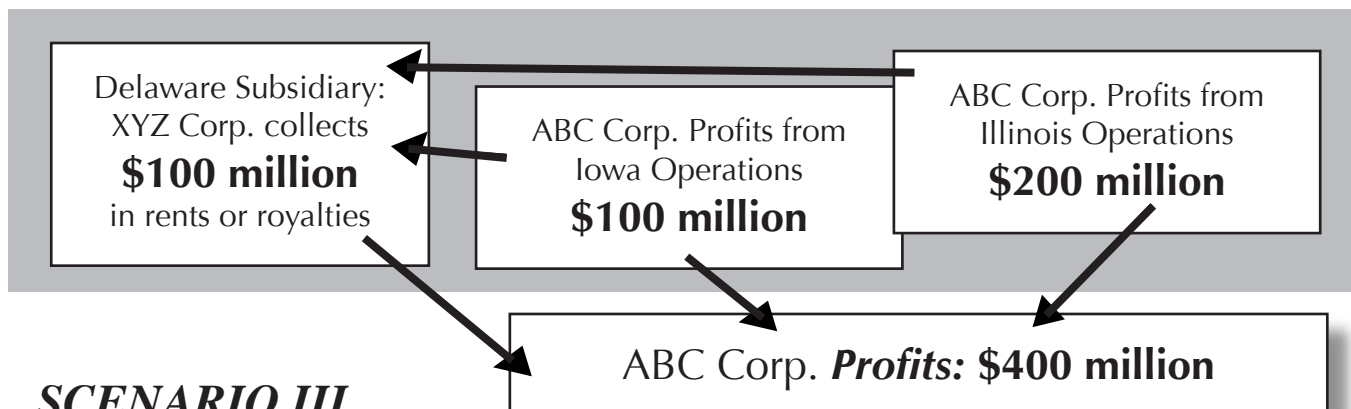
$$= \$300 \text{ million} \times 5\% \text{ (apportionment factor)} = \$15 \text{ million profits taxable in Iowa}$$

Now consider Scenario III below. Iowa adopts combined reporting instead of separate entity reporting. Nothing about ABC or XYZ Corporations has changed. But now when ABC Corporation files its Iowa income tax, it must include in total company profits the profits of all related affiliate corporations. This includes XYZ Corporation, which has \$100 million in profits in the form of royalties. So the combined profit is restored to its original \$400 million level, and Iowa taxable profits are once again \$20 million.

Illinois, by the way, already is doing this. Illinois is one of 16 states that have had combined reporting for decades; another five have added it in recent years.

With or without combined reporting, the fact that a large share of ABC’s production occurs in Iowa does not matter. It also would not matter if this changed — if the company moved a plant from Illinois to Iowa, or vice versa — as long as total company profits and the Iowa percent of sales remained the same. As long as the company has a minimal presence in Iowa — tax nexus — it would pay tax here, and that tax would be based on total company profits and Iowa sales.

In other words, combined reporting provides accountability on taxes, while at the same time posing no impediment to businesses locating in the state, nor any incentive for them to move to one of the dwindling number of non-combined reporting states. Combined reporting does not change the single-factor formula. Combined reporting assures that total company profits cannot be artificially lowered through the establishment of subsidiaries in other states.



**SCENARIO III**

*Same ABC Corporation under combined reporting; Iowa tax restored.*

$$= \$400 \text{ million} \times 5\% \text{ (apportionment factor)} = \$20 \text{ million profits taxable in Iowa}$$