Joint Legislative Budget Committee
Staff Memorandum

1716 West Adams *Telephone: (602) 542-5491*
Phoenix, Arizona 85007 *Facsimile: (602) 542-1616*

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TO: Members, Joint Legislative Income Tax Credit Review Committee

FROM: Tim Everill, Revenue Section Chief

SUBJECT: 2004 INCOME TAX CREDIT REVIEW

This memo transmits background materials for the December 8**,** 2004 meeting of the Joint Legislative Income Tax Credit Review Committee.

<u>Background</u>

Laws 2002, Chapter 238 established the Joint Legislative Income Tax Credit Review Committee, and specified a schedule for review of corporate and individual income tax credits. The credits scheduled for review in 2004 include:

- Agricultural Pollution Control Equipment
  - A.R.S. § 43-1081.01 (Individual)
  - A.R.S. § 43-1170.01 (Corporate)
- Solar Energy Equipment
  - A.R.S. § 43-1083 (Individual)
- Agricultural Water Conservation System
  - A.R.S. § 43-1084 (Individual)

The Committee is charged with determining the original purpose of each of the existing income tax credits, and establishing a standard for evaluating the success or failure of the credit. Based on statute (A.R.S. § 43-221), the standard for evaluation of the credits may include: 1) the history, rationale and revenue impact; 2) the benefit to the state in various economic terms; and 3) the complexity in the use and administration of the credit.

<u>Limitations</u>

There are several limitations that affect the evaluation of income tax credits. For example, based on Department of Revenue (DOR) interpretation of Arizona law (A.R.S. § 43-2001), the department is generally prohibited from releasing company-specific tax credit data. While DOR provides tax credit information in aggregate form, in some cases so few companies take a particular credit, there is no financial data available related to the credit.

A second limitation is the timeliness of data that is available. Because tax credit data must be compiled manually from actual hard-copy tax returns, corporate tax credit data is currently available only through tax year 2002 and individual tax credit data through tax year 2001.

And finally, there is generally a lack of performance measures for tax credits. Some credits have stated performance measures or goals, but most of the credits do not have objectives included in statute. It should be noted that Chapter 238 requires any new credit to include a clause that explains the rationale and objective of the credit (A. R. S. § 43-223).

2004 Review

Attached are summaries for each of the three income tax credit categories that are included in the 2004 review. The following information is provided (where applicable) for each of the credit categories:

Description – the definition of the tax credit, and how the credit is calculated.

Refundable – whether or not the credit is refundable. A nonrefundable credit is one in which, when the credit exceeds the taxpayer's tax liability, the amount of credit that is greater than the liability may be carried forward to future tax years (as provided in statute). If a credit is refundable, the amount of credit that exceeds the taxpayer's liability is refunded to the taxpayer in each tax year. All of the credits included in the current review are nonrefundable.

Carry Forward – whether or not any unused nonrefundable credit may be carried forward into subsequent tax years, and if so, for how many years.

History and Rationale – the year the tax credit was implemented, revisions to the credit since it was implemented, and relevant information regarding the intended purpose of the credit.

Revenue Impact – based on information from DOR, information for each tax year on the number of claimants, the amount of new credit identified, total credit identified, credit used, and credit carried forward to a subsequent tax year. In addition, we provide data specific to each tax credit (where applicable), and more detailed definitions of the above terms.

Economic Benefits – a summary of information available related to any economic benefits associated with each tax credit, including economic development, new investments, job creation or retention of existing jobs, and any other economic benefits that may be specific to each credit.

Complexity – information related to the complexity of administration and application of each tax credit, including the perspective of the state agency administering the credit (generally DOR), trade associations, and representatives of the businesses and/or individuals that claim the credits.

Potential Performance Measures – a listing of potential measures that might be used to evaluate each of the income tax credits.

Information under the above headings from each income tax credit category was obtained from a variety of sources. JLBC Staff reviewed the statutes establishing each of the credits, as well as the tax forms and instructions used by businesses and individuals to claim the credits. Staff also had discussions with current and former legislative staff.

Staff also reviewed summaries and minutes of committee and subcommittee hearings that were held prior to adoption of the credits. Some individuals and organizations that testified at the hearings were contacted in order to better understand the testimony contained in the summaries. In addition, research conducted by the Governor's Citizens Finance Review Committee was reviewed. Various state agencies were contacted, including DOR and the Department of Commerce.

In order to get a perspective on each credit from those who actually claim the credit, various business organizations, industry and government representatives, and individual businesses were contacted.

And finally, the Arizona Tax Research Association and the Arizona Chamber of Commerce were contacted.

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Attachments - 4

Agricultural Pollution Control Equipment Tax Credit

Statute

A.R.S. § 43-1170.01 (Corporate) and A.R.S. § 43-1081.01 (Individual)

Description

The agricultural pollution control equipment credit is provided for the purchase of real or personal property that is used in the taxpayer's business to prevent or control pollution associated with the commercial production of livestock and agricultural crops, including the cultivation of flowers, ornamental plants, and grapes.

Note that only that portion of the property that is directly used to prevent or control pollution is eligible for the credit. The amount of the credit is 25% of the cost of the property, up to a maximum credit of $25,000. This credit can be claimed against both individual and corporate income taxes.

Refundable

The credit is not refundable

Carry Forward

The tax credit may be carried forward for five taxable years.

History and Rationale

This credit was created by Laws 1998, Chapter 286 and became effective as of January 1, 1999. According to a document prepared by the Senate Staff on June 18, 1998, the agricultural industry was under increasing pressure by the government to reduce the amount of pollution it emitted as a result of traditional farming practices. The agricultural pollution control credit was created to mitigate the costs incurred by farmers and ranchers to comply with environmental regulations.

This credit is similar to the general pollution control equipment credit that was reviewed by the committee last year. For expenses to qualify under the general credit, the pollution control equipment must meet or exceed the rules or regulations regarding air, water, or land pollution of the U.S. Environmental Protection Agency, Arizona Department of Environmental Quality, or a political subdivision. Note that such requirements are not necessary in order to qualify for the agricultural pollution control credit.

According to the Arizona Farm Bureau Federation, dust pollution is the main source of agricultural pollution in Arizona. However, to a lesser extent, agricultural pollution can also be caused by streambank erosion. Dust pollution can be controlled by such means as installing dust filters in cattle feedyards, replacing dirt roads with gravel roads, and building wind breaks. Streambank erosion can be controlled by fencing areas near streams to keep cattle away.

Revenue Impact

Corporate: Unknown. The Department of Revenue (DOR) has not released data on the corporate income tax impact of this credit due to confidentiality concerns.

Individual: The cost of the credit was $17,337 in 2001, the last year for which data is available. The table below, which was provided by DOR, summarizes the individual income tax impact of the credit.

	1999	2000	2001
# of Claimants	Data Not Releasable	9	8
Total Credit	Data Not Releasable	$77,096	$29,870
Used	Data Not Releasable	$17,562	$17,337
Carry Forward	Data Not Releasable	$59,534	$12,533

# of Claimants – the number of taxpayers who claimed the credit in each year.
Total Credit – the total tax credits identified in each tax year, including any new credits and any credits carried over from a previous year and identified in that year.
Used – the total value of credits claimed in each year.
Carry Forward – the total credit identified but not used in each year. The full carry forward may not be reflected in the following year's estimate. For example, a taxpayer could have $1 million in a particular credit identified in tax year 2000, use $400,000 of it in 2000 (leaving $600,000 as a carry forward). If that taxpayer did not identify or claim the credit in 2001, that $600,000 carry forward would not be included in the carry forward total for 2001.

Economic Benefits

Measurable Economic Development
New Investments
Creation of New Jobs or Retention of Existing Jobs

This credit is not intended to promote economic development or spur new investments that would result in new jobs. Instead, according to DOR's August 2000 report "Income Tax Credits in Arizona," it is one of several tax credits in statutes intended to encourage environmentally responsible behavior.

However, theoretically, the credit may provide some economic benefits to Arizona. Environmental regulations impose costs on farmers and ranchers. To the extent that this credit mitigates such costs, it may enhance Arizona's competitiveness relative to other agricultural states. However, since so few taxpayers have claimed the credit, it is unlikely to have had a measurable impact on the state's economy.

Other

Generally, the credit may have a positive impact on the environment insofar as it induces taxpayers to reduce pollution that otherwise would not be reduced. However, since so few taxpayers have claimed the credit since it was created, it is unlikely that the credit has had any significant impact on agricultural pollution in Arizona.

According to a report by the Governor's Citizens Finance Review Commission issued August 22, 2003, none of the 10 states identified as Arizona's competitors offers a similar credit.

Complexity

The credit does not seem to be unnecessarily complex in the application, administration, and approval process.

Potential Performance Measures

Performance measures could include:

1. A requirement to report on pollution reduction resulting from the installation of new equipment. However, such a measure may not be meaningful as it is difficult, if not practically impossible, to ascertain the impact on the environment.
2. Number of states where a farmer or rancher receives a comparable credit.

Solar Energy Equipment Tax Credit

Statute

A.R.S. § 43-1083 (Individual)

Description

The statute provides an individual with an income tax credit for installing a solar energy device in the taxpayer's Arizona residence. Solar energy devices are defined in A.R.S. § 42-5001 as systems or mechanisms that provide heating, cooling, electrical and mechanical power, daylighting, and energy storage.

The solar energy credit is equal to 25% of the cost of the device up to maximum of $1,000. The maximum credit in a taxable year cannot exceed $1,000, and the total solar energy credits allowed for a single residence cannot exceed $1,000. The maximum credit a taxpayer may take for all solar energy devices installed in the same residence cannot exceed $1,000.

Refundable

The credit is not refundable.

Carry Forward

The unused portion of the credit may be carried forward for a maximum of five consecutive years.

History and Rationale

The federal government first introduced individual solar energy tax credits with the Energy Tax Act of 1978. Arizona created its first solar energy tax credit in 1979. The federal tax credit expired in 1985 and Arizona's tax credit expired in 1987.

Arizona's current solar energy device tax credit was first passed and signed into law in June 1994 (Laws 1994, Ch. 117) and became effective for the 1995 tax year. It has been substantively amended once. Laws 1997, Ch. 218 amended the list of qualifying solar energy devices to exclude "a solar hot water heater plumbing stub out that was installed by the builder of a house or dwelling unit before title was conveyed to the taxpayer." This law also created a separate tax credit for these devices (A.R.S. § 43-1090).

The statute creating the tax credit does not include a specific statement of purpose or a rationale. The credit was included as a floor amendment to SB 1523 that was passed by the House Committee of the Whole. An earlier bill, HB 2440, which included provisions for the solar energy device tax credit, was heard by the House Ways and Means Committee. At that time, the bill's sponsor stated the purpose of the solar energy tax incentives was to restore Arizona to a position of leadership in the solar energy field and to promote energy efficiency.

The credit was intended to promote the growth of the solar energy industry and the development of sustainable solar technologies. A related goal would be to reduce the consumption of non-renewable fuels that would otherwise be use to generate electricity.

By itself, the credit creates an incentive to purchase solar energy systems by reducing the cost. Historically, the credit was used mostly to purchase solar water heaters and daylighting systems. The cost of a $3,000 solar water heater is reduced by $750 when the credit is used. In recent years, the electric utility companies have introduced customer rebate programs in order to meet either regulatory or self-imposed standards for renewable energy generation. In combination with the tax credit, the cost of an $8,000 photovoltaic energy system can be reduced by approximately $50%.

Revenue Impact

The cost of the credit was $766,000 in 2001, the last year for which reasonably complete data is available.
The following table summarizing the individual income tax impact of this credit was provided by the Arizona Department of Revenue.

	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
# of claimants	1,924	1,632	1,827	2,175	2,877	2,660	2,298
Total credit	$655,000	$534,174	$550,128	$728,291	$997,463	$935,627	$792,391
Used	$593,000	$512,838	$524,600	$691,218	$917,941	$924,231	$766,385
Carry forward	$63,000	$66,634	$103,893	$103,511	$149,976	$141,204	$118,132

# of claimants – the number of taxpayers who claimed the credit in each year.
Total credit – the total tax credits identified in each tax year, including any new credits and any credits carried over From a previous year and identified in that year.
Used– the total value of credits claimed in each year.
Carry forward– the total credit identified but not used in each year. The full carry forward may not be reflected in the following year's estimate. For example, an individual could have $500 in credit identified in tax year 2000, use $400 of it in 2000 (leaving $100 as a carry forward). If that individual didn't identify or claim that credit in 2001, that $100 carry forward would not be included in the carry forward total for 2001.

Economic Benefits

Measurable Economic Development
New Investments
Creation of New Jobs or Retention of Existing Jobs

We cannot measure the economic development, new investment, or the creation or retention of jobs related to this credit with the data available. We do know that investment in solar energy equipment has increased in recent years and that thousands of taxpayers have used the credit. We are unable to establish a direct link between the credit and subsequent economic development or a specific number of jobs. According to experts in the solar manufacturing and electric utility industries, the credit helped Arizona to remain active in encouraging energy conservation and the development of new solar photovoltaic electricity generation technology.

Complexity

The solar energy device credit does not appear to be unusually complex in its description, calculation and application.

Potential Performance Measures

Performance measures could include:

1. Total megawatt hours of electricity generated from solar energy devices.

2. Total megawatt hours of electricity conserved from non-renewable energy sources.

3. Number of persons employed in businesses that manufacture, install or service solar energy devices.

The statute does not impose any requirements related to these measures. Arizona Public Service Co. (APS) and Unisource (TEP and Citizens Utilities) measure and report the amount of solar electricity generated in their service territories to the Arizona Corporation Commission on a regular basis. Salt River Project plans to publicly report similar information from their new solar energy incentive program. However, the amount of energy saved by other solar energy devices, including water heaters, can only be estimated, and requiring this information would create an additional reporting burden. It also would be difficult to estimate the number of persons employed by the solar energy industry without requiring additional information to be collected and reported.

Attachment 3

Agricultural Water Conservation System Tax Credit

Statute

A.R.S. § 43-1084 (Individual)

Description

The agricultural water conservation system credit is provided for the purchase and installation of systems primarily designed to substantially conserve water on land used to produce agricultural products or sustain livestock. The credit is available only as an individual income tax credit, and not as a corporate income tax credit.

The credit is equal to 75% of the expenses incurred during the taxable year for the purchase and installation of the system. The expenses must be consistent with a conservation plan that the taxpayer has filed and is in effect with the U.S. Department of Agriculture (USDA).

According to USDA, the term "agricultural water conservation system" refers to a wide range of water management measures. For example, the term applies to irrigation equipment and machinery, including sprinklers, pipes, pumps, motors and engines, and computer systems for irrigation and water management.

Refundable

The credit is not refundable.

Carry Forward

The tax credit may be carried forward for five taxable years.

History and Rationale

This credit was created by Laws 1994, Chapter 90 and became effective retroactively from January 1, 1994. According to legislative staff and the Arizona Farm Bureau Federation, the credit was created in response to the enactment of the 1980 Arizona Groundwater Management Code. One of the provisions in the Code directs the Arizona Department of Water Resources (ADWR) to develop and implement water conservation requirements for agricultural, municipal, and industrial water users in 5 consecutive periods. Each management period covers 10 years with the first period starting in 1980. Under the Code, the management plans will contain more rigorous water conservation and management requirements with each successive period.

According to the Arizona Farm Bureau Federation, this credit was established in an effort to mitigate the costs incurred by farmers and ranchers to comply with the increasingly rigorous water conservation requirements under the Code.

Laws 1999, Chapter 318 repealed the corporate credit for agricultural water conservation systems as of January 1, 2000. However, the law provided for corporate taxpayers to carry forward unused credits from prior tax years for up to 5 years. Besides this credit, the act also repealed 4 other corporate income tax credits. (Note that Laws 1999, Chapter 318 did not repeal any individual income tax credits.)

According to legislative documents, the intention of this legislation was to eliminate corporate income tax credits that were not widely used and then use the resulting General Fund savings to "buy down" the corporate income tax rate from 8.00% to 7.968%.

Revenue Impact

Corporate: Although the corporate tax credit was repealed as of January 1, 2000, unused carry-forward amounts may still be claimed through tax year 2005. According to the Department of Revenue (DOR), only 17 corporate taxpayers have claimed this credit since it was established in 1994. The cost of the credit was $35,531 in 1994, the last year for which DOR has released data. (Data from subsequent years has not been released due to confidentiality concerns.)

Individual: The cost of the credit was $1,438,790 in 2001, the last year for which data is available. The table below, which was provided by DOR, summarizes the individual income tax impact of the credit.

	1994	1995	1996	1997	1998	1999	2000	2001
# of Claimants	35	54	75	63	94	129	130	129
Total Credit	$1,800,000	$2,600,000	$4,247,392	$3,752,833	$4,567,632	$8,484,744	$8,157,000	$8,132,558
Used	$382,000	$923,000	$721,093	$430,131	$625,826	$970,210	$1,578,411	$1,438,790
Carry Forward	$1,400,000	$1,700,000	$3,524,790	$3,323,906	$3,941,164	$7,213,521	$6,527,281	$5,895,706

# of Claimants – the number of taxpayers who claimed the credit in each year.
Total Credit – the total tax credits identified in each tax year, including any new credits and any credits carried over from a previous year and identified in that year.
Used – the total value of credits claimed in each year.
Carry Forward – the total credit identified but not used in each year. The full carry forward may not be reflected in the following year's estimate. For example, a taxpayer could have $1 million in a particular credit identified in tax year 2000, use $400,000 of it in 2000 (leaving $600,000 as a carry forward). If that taxpayer did not identify or claim the credit in 2001, that $600,000 carry forward would not be included in the carry forward total for 2001.

Economic Benefits

Measurable Economic Development
New Investments
Creation of New Jobs or Retention of Existing Jobs

This credit is not intended to promote economic development or spur new investments that would result in new jobs. Instead, according to DOR's August 2000 report "Income Tax Credits in Arizona," this credit is one of several tax credits in statutes primarily intended to encourage environmentally responsible behavior.

However, the credit may have a general economic benefit for Arizona. For example, lower water usage as a result of improved conservation measures (for which qualified taxpayers only bear 25% of the cost) is likely to reduce the cost of production, which in turn may enhance Arizona's competitiveness relative to other agricultural states. We are not able to measure such impact with available data.

Other

USDA employees at the Yuma Service Center, who are familiar with this program, provided a favorable assessment of the agricultural water conservation system credit. While the USDA employees were unable to quantify the impact of the credit, they believed that the water savings resulting from this incentive have been substantial.

Complexity

The credit does not seem to be unnecessarily complex in the application, administration, and approval process.

Potential Performance Measures

Performance measures could include:

3. A requirement to report on the savings (in terms of water usage) incurred from the installation of a water conservation system. However, such a performance measure may not be meaningful as it may be difficult to both collect and corroborate such data.
4. Number of states where taxpayers receive a comparable credit.

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