# Joint Legislative Budget Committee
# Staff Memorandum

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DATE: December 9, 2003

TO: Members, Joint Legislative Income Tax Credit Review Committee

FROM: Tim Everill, Revenue Section Chief

SUBJECT: 2003 INCOME TAX CREDIT REVIEW

This memo transmits background materials for the December 9, 2003 meeting of the Joint Legislative Income Tax Credit Review Committee.

Background

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 through 2006. The credits scheduled for review in 2003 include:

- Research and Development
  - A.R.S. § 43-1074.01 (Individual)
  - A.R.S. § 43-1168 (Corporate)
- Taxes Paid for Coal Consumed in Generating Electrical Power
  - A.R.S. § 43-1178 (Corporate)
- Pollution Control Devices
  - A.R.S. § 43-1081 (Individual)
  - A.R.S. § 43-1170 (Corporate)
- Underground Storage Tanks
  - A.R.S. § 43-1085 (Individual)
  - A.R.S. § 43-1173 (Corporate)

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.

Limitations

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 2001, and individual tax credit data through tax year 2000.

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).

<u>2003 Review</u>

Attached are summaries for each of the four income tax credit categories that are included in the 2003 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 for 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, and in the case of the pollution control credit, the original sponsor of the legislation.

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 and the State Science and Technological Institute was reviewed. Various state agencies were contacted, including DOR, the Department of Commerce, and the Department of Environmental Quality.

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

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Attachments – 4

## Research and Development Tax Credit

**Statute**

A.R.S. § 43-1168 (Corporate) and A.R.S. § 43-1074.01 (Individual).

Description

The individual income tax credit and the corporate income tax are virtually identical. The starting point for computing the tax credit is:

- Qualified research expense for the taxable year over the base amount as defined in Section 41(c) of the Internal Revenue Code. Qualified research includes expenses for discovering information which is:

    1. Technological in nature.
    2. Useful in the development of a new or improved business component, such as inventions, computer software, and production processes.
    3. Experimental, as it relates to a new or improved function, performance, reliability or quality.

- Basic research payments as defined in Section 41(e)(1)(a) of the Internal Revenue Code. Basic research includes any original investigation for the advancement of scientific knowledge not having a specific commercial objective.

The credit is computed as follows:

1. Add the amount that exceeds the base amount defined in Sections 41(c) of qualified research expenses for the taxable year to the basic research payments determined under Section 41(e)(1)(A) of the Internal Revenue Code.

2. If the sum is less than or equal to $2.5 million, the credit is 20% up to a maximum of $500,000.

3. If the sum is greater than $2.5 million, the credit is $500,000 plus 11% of the amount exceeding $2.5 million.

For tax year 2000 and earlier years, the credit was limited to $500,000, for any eligible taxpayer, per year. The limit was increased to $1.5 million for 2001 and $2.5 million for 2002. For tax years beginning from and after December 31, 2002, the tax credit amount is not limited.

Refundable

This credit is not refundable

Carry Forward

The qualifying expenses from which the credits are calculated may be carried forward for 15 years. Expenses carried forward from years beginning before January 1, 2003 may be limited. The amounts carried forward from these years must be less than or equal to the lesser of:

1. Tax liability minus the current year credit; or,

2. The difference between $500,000 and the current year credit.

History and Rationale

The corporate R & D credit was first passed and signed into law in July 1992 (Laws 1992, Ch. 295) and became effective for the 1993 tax year. It has been amended several times. The initial statute had a sunset provision; the credit is now permanent. The credit was capped as described above through 2002. Effective January 1, 2003, the credit is not limited. The credit was extended to non-corporate taxpayers, including individuals (Laws 1999, 1st S.S., Ch. 5), effective beginning in tax year 2001.

The purpose and rationale for the credit, which was made into law in 1992, was to create a business climate in Arizona that would be competitive with other states seeking to attract companies emphasizing research and technology. During the 1992 session, the Ways and Means Committee was told that 16 states had similar legislation.

According to a study done by the State Science and Technology Institute in 1997, 35 states offered some type of research and development tax credit. Of those, 15 states offered a credit modeled on the federal research tax credit concepts. Each state among a group of competitors identified by the Governor's Citizens Finance Review Commission (including California, Colorado, Florida, Georgia, New Mexico, Oregon, Texas, Utah, and Washington) offers a similar credit.

Revenue Impact

Corporate

The cost of the credit was $5.7 million in 2001, the last year for which data is available. The Governor's Citizens Finance Review Commission published a report in August 2003 analyzing Arizona's corporate income tax credits. The report estimated that the cost of the research and development credit might increase by as much as $20 million beginning in 2003, the first year in which the annual limits were removed.

The following table summarizing the corporate income tax impact of this credit was provided by the Arizona Department of Revenue.

| | **1995** | **1996** | **1997** | **1998** | **1999** | **2000** | **2001** |
|---|---|---|---|---|---|---|---|
| **# of claimants** | 86 | 111 | 132 | 124 | 132 | 105 | 59 |
| **Total R&D expenses and payments** | $162,826,676 | $331,808,012 | $274,922,518 | $476,093,215 | $632,907,225 | $874,583,689 | $217,724,590 |
| **New credit** [1/] | $8,595,822 | $13,539,335 | $17,331,381 | $16,982,182 | $16,954,014 | $18,605,988 | $15,312,903 |
| **Total credit** | $9,559,521 | $15,358,856 | $19,462,303 | $18,566,480 | $18,516,226 | $19,900,992 | $29,216,092 |
| **Used** | $6,297,972 | $9,637,067 | $11,212,168 | $8,298,441 | $9,044,648 | $6,624,306 | $5,686,557 |
| **Expense carry forward** | $249,289,041 | $502,917,196 | $407,687,481 | $948,902,216 | $1,443,765,076 | $1,588,341,199 | ---- |
| **Credit value of expense carry forward** | $49,857,808 | $100,583,439 | $81,537,496 | $189,780,443 | $288,753,015 | $317,668,240 | $104,638,904 |
| **NEW carry forward** | | | | | | | $22,888,560 |

*# of claimants* - the number of taxpayers who claimed the credit in each year.
*Total expenses and payments* - the total dollar value of equipment purchased that qualifies for the credit.
*New credit* – the new tax credits identified 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.
*Expense carry forward* - the total qualifying expenses identified but not claimed in each year. The full carry forward may not be reflected in the following year's estimate. For example, a company could have $1 million in qualified expenses identified in tax year 2000, claim $400,000 of it in 2000 (leaving $600,000 as a carry forward). If that company didn't identify or claim those expenses in 2001, the $600,000 carry forward would not be included in the carry forward total for 2001.
*Credit value of expense carry forward* – the tax credit value calculated from the formula described in the statute that is derived from the amount of qualifying expenses.
*NEW carry forward* - Beginning with tax year 2001, the new carry forward amount is not limited in future years. The old carry forward, however, continues to be limited.

Individual

No data is available yet on the revenue impact of the individual R & D credit. It was not in effect until the 2001 tax year, and the Department of Revenue has yet to identify any individual taxpayers taking the credit.

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 research and development activity has expanded in recent years and that many companies 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. The credit helped Arizona to remain competitive in attracting and retaining research activities, since many other states have a comparable credit.

Since 1992, several significant large-scale research and technology facilities have located or expanded in Arizona. In the 2001 tax year, 59 corporations claimed research and development income tax credits to date. As many as 132 taxpayers have claimed the credit in previous years.

**Other**

Large firms engaged in research and technology manufacturing assert that their presence in the state generates a supply chain of smaller firms providing them with essential materials and services.

Complexity

The R & D credit is unusually complex in its description, calculation and application. Qualified expenses are defined by federal regulations and not by Arizona law. Even if the R & D expenses have already been calculated for the taxpayers' federal returns, the record-keeping requirements to track expense carry forwards over 15 years may impose a burden. The carry forward provisions also make this credit difficult to administer and verify.

Potential Performance Measures

Performance measures could include:

1. Total research dollars spent in Arizona each year.

2. Number of persons employed in research activities.

3. Total research payrolls.

4. Number of other states where a business receives a comparable credit.

## Coal Consumption Corporate Income Tax Credit

**Statute**

A.R.S. § 43-1178

Description

An income tax credit is allowed for taxpayer purchases of coal consumed in generating electricity in Arizona. The credit is equal to 30% of the amount paid by the seller or purchaser as transaction privilege or use tax with respect to the coal sold to the taxpayer.

Refundable

This credit is not refundable.

Carry Forward

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

History and Rationale

The credit was added by Laws 1998, Ch. 137 and applies retroactively to taxable years beginning January 1, 1998. The bill was introduced in order to encourage the state's electric power plants to purchase coal in Arizona, as well as provide an incentive to take delivery in Arizona of coal from sources outside the state, which would shift the related tax liability and potential revenue to Arizona from other states.

Coal purchased in Arizona is subject to a 3.125% transaction privilege tax (TPT). The state TPT collected on coal purchases is subject to the distribution formula that allocates a portion of revenue collected to counties within the state. The amount distributed to each county is determined by a formula that averages the county's population relative to the state's total population and the county's share of state TPT collected relative to total state collections. In addition to the state TPT, counties within the state impose an excise tax, which is generally based on 10% of the state rate. For example, in Apache and Navajo counties, the tax rate on coal purchases is 3.4375% (3.125 + 0.3125).

Coal purchased outside of Arizona is subject to the state's use tax (5.6%). All Arizona use tax revenue is retained by the state. The city of Tucson imposes a 2% use tax, which is applied to coal used at Tucson Electric Power's (TEP) Irvington power plant. If the purchaser pays a sales tax to another state on the purchase of coal, the tax paid can be credited against the purchaser's Arizona use tax liability.

The rationale for establishing the incentive as an income tax credit, rather than a sales tax credit, is to allow the county to retain its TPT revenue. The company that purchases coal in Arizona will pay a TPT to the state and, if applicable, an excise tax to the county. The total tax liability (TPT and income tax combined) to the company is reduced by the income tax credit. It provides the taxpayer an incentive to pay the TPT to Arizona (and to local governments) rather than pay a use tax to Arizona because the TPT rate is lower than the use tax rate.

The Arizona counties where the coal purchases occur would benefit from retained or increased sales tax revenue. Apache County and TEP were present in support of the bill when it was heard. Since the law was passed, five taxpayers have used this tax credit.

Revenue Impact

The cost of the credit was $803,476 in 1999, the last year for which data is available. The following table summarizing the corporate income tax impact of this credit was provided by the Arizona Department of Revenue.

| | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|
| **# of claimants** | 4 | 4 | | |
| **TPT or use tax paid** | $3,031,060 | $3,607,134 | Data | Data |
| **New credit** | $ 909,319 | $1,067,569 | Not | Not |
| **Total credit** | $ 909,319 | $1,305,513 | Releasable | Releasable |
| **Used** | $ 671,375 | $ 803,476 | | |
| **Carry forward** | $ 237,944 | $ 502,037 | | |

*# of claimants* - the number of taxpayers who claimed the credit in each year.
*TPT or use tax paid* - the total dollar value of sales and use taxes paid for coal consumed to generate electrical power in Arizona.
*New credit* - the new tax credits identified 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 tax credit identified but not claimed in each year. The full carry forward may not be reflected in the following year's estimate. For example, a company could have $1 million in credits identified in tax year 2000 and claim $400,000 of it in 2000 (leaving $600,000 as a carry forward). If that company didn't identify or claim those credits in 2001, the $600,000 carry forward would not be included in the carry forward total for 2001.

The years labeled "Data Not Releasable" indicate that release of the data would violate confidentiality laws.

Economic Benefits

Given the confidentiality of the tax credits claimed, the specific benefits of the tax credit cannot be determined. To the extent that coal purchases have shifted from other states to Arizona, some of the lost corporate income tax revenue would be offset by increased sales and use tax revenue.

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

We are unaware of any measurable economic development, new investments, or jobs created or retained as a direct result of this tax credit. However, by enhancing revenue in counties where coal purchases are made, the counties are able to maintain or improve their tax base. According to a report published by the Governor's Citizens Finance Review Committee, Colorado, which is one of the states supplying coal to Arizona power plants, offers a similar credit.

*Other*

The coal consumption companies typically negotiate long-term contracts to ensure supplies and control price risks. Elimination of the tax credit would increase the cost of the coal used and could lead these companies to seek cheaper alternatives when the existing supply contracts expire.

<u>Complexity</u>

This tax credit appears to be relatively easy and simple to administer.

<u>Potential Performance Measures</u>

Performance measures could include:

1. Estimates by the affected counties of the credit's net fiscal impact on their budgets.

2. Annual estimates and the dollar value of coal purchased for electrical generation in Arizona.

## Pollution Control Tax Credit

**Statute**

A.R.S. § 43-1170 (Corporate) and A.R.S. § 43-1081 (Individual)

Description

The pollution control tax credit is provided for purchases of equipment used in the taxpayer's business to control or prevent pollution. To receive the credit, the pollution control equipment must meet or exceed the rules or regulations regarding air, water, or land pollution of the US Environmental Protection Agency, the Department of Environmental Quality, or a political subdivision. The amount of the credit is 10% of the equipment's purchase price, up to a maximum credit of $500,000. This credit is provided against both the corporate income tax and the individual income tax.

Refundable

Not refundable

Carry Forward

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

History and Rationale

The credit was created in 1994 for the purpose of providing incentives to Arizona businesses to purchase pollution control or pollution prevention equipment. In addition, this credit represented the final part of the incentive package requested by Intel for locating a new facility in Arizona, as stated in a 1994 memorandum by the Arizona Association of Industries to the members of the House of Representatives.

Revenue Impact

Corporate
The cost of the credit was $890,624 in 2001, the last year for which data is available. The following table summarizing the corporate income tax impact of this credit was provided by the Department of Revenue.

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|
| **# of claimants** | 29 | 25 | 23 | 32 | 32 | 11 |
| **Cost of property** | $54,365,441 | $44,001,477 | $70,098,623 | $104,017,999 | $41,179,040 | $33,069,299 |
| **New credit** | $ 4,332,277 | $ 2,011,094 | $ 4,287,035 | $ 6,288,100 | $ 3,469,268 | $ 1,037,031 |
| **Total credit** | $ 6,937,066 | $ 3,861,844 | $ 8,746,561 | $ 12,797,002 | $10,472,253 | $ 1,487,080 |
| **Used** | $ 4,498,473 | $ 2,172,166 | $ 4,211,037 | $ 6,761,571 | $ 3,806,949 | $ 890,624 |
| **Carry forward** | $ 2,438,593 | $ 1,948,803 | $ 4,451,236 | $ 6,317,628 | $ 6,665,304 | $ 596,456 |

*# of claimants* – the number of taxpayers who claimed the credit in each year.
*Cost of property* – the total dollar value of equipment purchased that qualifies for the credit.
*New credit* – the new tax credits identified 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 company 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 company didn't identify or claim that credit in 2001, that $600,000 carry forward would not be included in the carry forward total for 2001.

<u>Individual</u>
Unknown. The Department of Revenue has not released data on the individual income tax impact of this credit due to confidentiality concerns.

<u>Economic Benefits</u>

<u>Corporate:</u>

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

We cannot measure these impacts with available data. To some extent, the credit enhances Arizona's competitiveness relative to other states by defraying a current cost of business. A comparable credit is offered in only one of Arizona's competitor states (Oregon), according to research done by the Governor's Citizens Finance Review Commission.

**<u>Other</u>**

This credit may have a positive impact on the environment. If the credit induces firms to exceed environmental regulations or it causes some firms to comply with environmental standards that would not otherwise have been able to afford to comply, then the environment is better off as a result of the credit. However, to the extent that businesses purchase pollution control equipment to meet (but not exceed) environmental regulations, the credit merely provides a cost subsidy to industry but does not improve the environment.

<u>Complexity</u>

The application form and the administration of the credit are relatively simple. However, it can be difficult for the Department of Revenue (DOR) to verify that equipment purchased by taxpayers actually qualifies for the pollution control tax credit, since this determination requires a certain level of scientific knowledge that DOR's auditors may not possess.

<u>Potential Performance Measures</u>

Performance measures could include:

1. Type of equipment purchased and its related environmental impact.

2. Number of other states where a business receives a comparable credit.

## Underground Storage Tank Tax Credit

**Statute**

A.R.S. § 43-1173 (Corporate) and A.R.S. § 43-1085 (Individual)

Description

This tax credit is provided for expenses incurred by an individual or corporate taxpayer for corrective actions taken with respect to the release of a regulated substance from an underground storage tank (UST).
Note that the credit is only allowed to a taxpayer that is not liable or responsible for the corrective actions as an owner or operator of the underground storage tank.

The amount of the credit is 10% of the amount spent by the taxpayer during the taxable year for corrective actions that have been certified by the Department of Environmental Quality (DEQ). A credit is not allowed for any amount reimbursed to the taxpayer by DEQ.

Refundable

Not refundable

Carry Forward

No

History and Rationale

The UST tax credit was created in 1994. According to former state senator Lester Pearce, who sponsored the legislation, this credit was designed to alleviate the financial burden borne by independent gas-station owners, ranchers, and farmers for environmental cleanups resulting from UST leaks. Mr. Pearce emphasized that the credit was primarily targeted to individuals and small business owners.

Revenue Impact

Corporate
The cost of this credit was $0 in 2001, the last year for which data is available. Since the creation of this credit in 1994, 3 taxpayers have claimed the credit. However, too few of them have claimed the credit in any given year to allow the amounts to be reported on annual basis. The cumulative amount claimed since 1994 is $32,500.

Individual
No claims have been made after 1994. Too few taxpayers claimed the credit in 1994 to allow DOR to release any information.

Economic Benefits

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

We cannot measure these impacts with available data. To some extent, the credit enhances Arizona's competitiveness relative to other states by defraying a current cost of business. However, according to the Governor's Citizens Finance Review Commission, of the 10 states identified as Arizona's competitors, only Florida offers similar credits.

Other

Generally, the credit may have a positive impact on the environment insofar as it induces taxpayers to remove contaminants from an area that otherwise would not be removed. However, since so few taxpayers have claimed the UST credit so far, it is believed that its impact on the environment has been minimal. The credit probably does not create a substantial incentive for environmental cleanups since it only reduces the cost by 10%.

Complexity

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

Potential Performance Measures

Performance measures could include:

1. Environmental impact of corrective actions.

2. Number of other states with comparable credit.

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