Joint Legislative Budget Committee
Staff Memorandum

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DATE: December 6, 2007

TO: Members, Joint Legislative Income Tax Credit Review Committee

FROM: Tim Everill, Assistant Director

SUBJECT: 2007 INCOME TAX CREDIT REVIEW

This memo transmits background materials for the December 11**,** 2007 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. The credits scheduled for review in 2007 include:

- Employment by Qualified Defense Contractor Tax Credit
  - A.R.S. § 43-1077 (Individual)
  - A.R.S. § 43-1165 (Corporate)
- Property Taxes Paid by Qualified Defense Contractor Tax Credit
  - A.R.S. § 43-1078 (Individual)
  - A.R.S. § 43-1166 (Corporate)
- Increased Employment in Military Reuse Zones Tax Credit
  - A.R.S. § 43-1079 (Individual)
  - A.R.S. § 43-1167 (Corporate)
- Construction Costs of Qualified Environmental Technology Facility Tax Credit
  - A.R.S. § 43-1080 (Individual)
  - A.R.S. § 43-1169 (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 generally be compiled manually from actual hard-copy tax returns, corporate tax credit data is currently available only through tax year 2005 and individual tax credit data through tax year 2006. The 2005 and 2006 data respectively is preliminary, and as such is subject to revision.

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).

2007 Review

Attached are summaries for each of the income tax credit categories that are included in the 2006 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. In addition, research conducted by the Governor's Citizens Finance Review

Committee was reviewed. Various state agencies were contacted, including DOR, Arizona Department of Education, the Charter Schools Board, and the School Facilities Board.

And finally, in order to get a perspective on the credits from those who actually claim the credit, various business and non-profit organizations, as well as industry and government representatives were contacted.

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Defense Contractor Credit

Defense Contractor Tax Credit

Summary

- The credit is limited to taxpayers that were certified by the Arizona Department of Commerce as qualified defense contractors by June 30, 2001.
- Since the certification is only valid for 5 years, no new credits are allowed to be claimed after tax year 2006.
- Existing credits can be carried forward until tax year 2012.
- The cost of the credit was $1.9 million in tax year 2000, the last year for which data is available.
- The total carry-forward amount reported in tax year 2000 was $32.8 million, but the current amount is unknown.
- A total of 6 different taxpayers have claimed the credit since 1993.

Statute

A.R.S. § 43-1165 &1166 (Corporate Income Tax) and A.R.S. §43-1077 & 1078 (Individual Income Tax)

Description

The tax credit is limited to companies that were certified by the Arizona Department of Commerce as qualified defense contractors by June 30, 2001. The certification is only valid for 5 years and for this reason no new credits can be claimed after tax year 2006.

Prior to tax year 2007, a defense contractor certified by the Arizona Department of Commerce could qualify for the credit due to: (1) net employment increases under a United States Department of Defense contract, or (2) net employment increases from transferring employment from exclusively defense related activities to exclusively private commercial activities, or (3) property taxes paid on class 1 (commercial or industrial) property if there was new defense related employment during the taxable year.

The credit for a net increase in employment is $2,500 for the first year, $2,000 for the second year, $1,500 for the third year, $1,000 for the fourth year, and $500 for the fifth year of full-time employment.

The credit for property tax paid is 40% of the property tax if more than 900 new full-time equivalent positions are created, 30% for 601 to 900 positions, 20% for 301 to 600 positions, and 10% for up to 300 positions.

Note that while the credit is listed under different statutes; A.R.S. § 43-1077 and 43-1165 for the employment related part of the tax credit, and A.R.S. § 43-1078 and 43-1166 for the property tax related part, taxpayers report all credit claims on the same tax form. Thus for reporting purposes, the two statutory tax credits are actually treated as a single credit (one each for corporate and individual income tax).

Refundable

The credit is not refundable.

Carry Forward

The unused portion of the credit may be carried forward until tax year 2012.

History and Rationale

The tax credit was created by Laws 1992, Chapter 295 and became effective July 1, 1993. The purpose of the credit was to keep Arizona's defense-related companies competitive and closed military bases operational. The legislation addressed 3 issues of great concern to the state in the early 1990's: (1) the decline in federal defense spending, (2) the need for defense contractors to make the transition from military to commercial markets, and (3) the closing of military bases.

According to a document ("The Arizona Defense Restructuring Assistance Program") issued by the Arizona Department of Commerce in July 2000, the primary goals of the tax credit program were to:

- Assist qualified defense contractors in the state to maintain and attract available contracts with the United States Department of Defense.
- Encourage qualified defense contractors to diversify into commercial markets and consolidate facilities in the state.
- Encourage qualified defense contractors in the state to adopt new manufacturing processes and technologies.

Revenue Impact

Corporate:
Due to confidentiality concerns, the last year for which the Department of Revenue (DOR) released tax credit information was tax year 2000 when 3 corporate taxpayers in the state used $1.9 million worth of credits to offset their tax liability. According to DOR, there was $32.8 million in unused tax credits allowed to be carried forward that year. A total of 6 corporate taxpayers have claimed the credit since its inception in 1993.

Tax Year	# of Claimants	Credit Used	Carry Forward
1993	2	N/R	N/R
1994	2	N/R	N/R
1995	4	N/R	N/R
1996	4	$3,551,214	$28,988,456
1997	4	$748,841	$39,112,016
1998	4	$116,500	$39,840,466
1999	4	$833,724	$36,297,743
2000	3	$1,859,951	$32,832,511
2001	2	N/R	N/R
2002	2	N/R	N/R
2003	2	N/R	N/R
2004	2	N/R	N/R
2005	1	N/R	N/R

N/R – Data not releasable due to confidentiality concerns.
# of Claimants – the number of taxpayers who claimed the credit in each year.
Credit 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 $200,000 of the credit identified in tax year 2001, use $100,000 of it in 2001 (leaving $100,000 as a carry forward). If that taxpayer did not identify or claim the credit in 2002, that $100,000 carry forward would not be included in the carry forward total for 2002.

Individual:
No individual income taxpayer has claimed the credit.

Economic Benefits

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

According to DOR's August 2000 report "Income Tax Credits in Arizona," this credit is one of several tax credits in statute that were created to promote economic development in the state. However, since no empirical evaluation of the credit has been conducted to date, the actual economic benefits of the program remain unknown. In theory, however, the incentive program has benefited the Arizona economy insofar as it has succeeded in creating jobs that would not have occurred in the absence of the credit.

Complexity

Certification process is not complex based on information from the business community. Since 3 different state agencies (Department of Commerce, Department of Economic Security, and Department of Revenue) are involved in monitoring and administrating the credit, some additional complexity may result. The Department of Revenue reports that the tracking of employees by name is a little burdensome for both the taxpayer and auditing oversight. The Department also reports that the apportionment issues of defense contracts associated with the property tax credit create some difficulties.

Potential Performance Measures

Since no initial tax credits can be claimed after tax year 2006, there may be no need for measures.

Military Reuse Zone Employment Credit

Military Reuse Zone Credit

Summary

- The credit is limited to taxpayers that are certified by the Arizona Department of Commerce.
- The cost of the credit was $109,400 in tax year 2001, the last year for which data is available.
- The total carry-forward amount reported in tax year 2001 was $21,900, but the current amount is unknown.
- A total of 5 different taxpayers have claimed the credit since 1993.
- An estimated 206 jobs have been created under the credit.

Statute

A.R.S. § 43-1167 (Corporate) & A.R.S. § 43-1079 (Individual)

Description

This corporate income tax credit is based on the net increase of full-time employees that are employed on former military bases, otherwise known as “military reuse zones”. Companies must be certified by the Department of Commerce before they are eligible to receive credits. Certified companies receive credits based on the number of new full-time employees primarily engaged in the aviation or aerospace industry so long as the facility within which they work is located in a military reuse zone. Companies can only claim credits on net increases to the number of individuals employed full-time in aerospace or aviation positions after they become certified by Commerce. The certified company may claim credits on the same individual for a five year period.

Credits are split into two categories, one of which is for dislocated military base employees that are civilians who previously had permanent full-time civilian employment on the military facility at the date of the closure of the facility. The other category of credit is allowed for non-dislocated military base employees.

The amount of the tax credit varies depending on the type of employee and the term of their tenure. Employees are categorized as either “dislocated” or “non-dislocated” for reasons of this credit. *Table 1* reflects the impact of tenure on the credit amount for dislocated employees and *Table 2* reflects the amount of credit per non-dislocated employee.

Table 1	**Dislocated Employees**
Year of Employment	**Amount of Credit Per Qualified Employee ($)**
1	$1,000
2	1,500
3	2,000
4	2,500
5	3,000

Table 2	**Non-Dislocated Employees**
Year of Employment	**Amount of Credit Per Qualified Employee ($)**
1	$500
2	1,000
3	1,500
4	2,000
5	2,500

Refundable

The credit is not refundable.

Carry Forward

Carry forward of credits is allowed for a term of 5 years.

History and Rationale

This credit was created by Laws 1992, Chapter 295 and became effective in on January 1, 1993. The credit was created in conjunction with several other tax provisions in HB 2201 that were aimed at lessening the economic impact of military base closures through tax incentives to attract aerospace and aviation industry to the sites.

The state's first military reuse zone was established in July 1996 at the Williams Gateway Airport (formerly Williams Air Force Base), which had its designation renewed in October 2006. There is currently, only one other active military reuse zone in the state, which is located at Phoenix/Goodyear Airport (formerly a U.S. Naval Air Facility).

Revenue Impact

Since 1993, $638,000 in credit has been created. However, due to the nature of the credit, it is difficult to ascertain the exact cost of the credit due to confidentiality concerns associated with the low number of firms that are eligible and utilizing the credit. Based on available data, the credit has cost at least $394,100 since its inception in tax year 1993. The last known amount of credit available was $21,900 in FY 2001. Due to confidentiality concerns in FY 2002 – FY 2004 and data that is not finalized in FY 2005, the exact amount of credit used and available is unknown.

Tax Year	# of Claimants	Credit Used	Carry Forward
1993	0	$0	$0
1994	0	$0	$0
1995	0	$0	$0
1996	3	$4,731	$13,269
1997	3	$11,888	$23,000
1998	3	N/R	N/R
1999	3	$170,634	$4,702
2000	3	$97,440	$16,262
2001	3	$109,373	$21,939
2002	1	N/R	N/R
2003	2	N/R	N/R
2004	2	N/R	N/R
2005	Unknown	Unknown	Unknown

N/R – Data not releasable due to confidentiality concerns.
# of Claimants – the number of taxpayers who claimed the credit in each year.
Credit 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 $200,000 of the credit identified in tax year 2001, use $100,000 of it in 2001 (leaving $100,000 as a carry forward). If that taxpayer did not identify or claim the credit in 2002, that $100,000 carry forward would not be included in the carry forward total for 2002.

Economic Benefits

New Investments
Creation of New Jobs or Retention of Existing Jobs
Commercial Infrastructure Development

This credit was created to mitigate the negative economic impacts of military base closures while aiding to spur job creation and enhance the aerospace and aviation industry within Arizona. In conjunction with the other tax credits created by Laws 1992, 2nd Regular Session, Chapter 295 (HB 2201), which provided reductions in applicable property taxes, and exemptions from transaction privilege taxes for prime contractors for the construction of certain facilities, the military reuse tax credit provided incentives to develop commercial infrastructure.

Additionally, by supporting investment in old military bases, the tax credit is also helping to sustain the network of employment surrounding the base that was dependent on military personnel to be profitable. This affect helps to keep unemployment down and allows for continued growth in the community.

During the period from the program's inception in 1996 to October 2006, the Williams Gateway Airport military reuse zone is credited with creating 1,431 jobs and attracting 39 companies.

Complexity

Based on information form the business community, the Department of Commerce reports that this credit is not deemed complex in its application, administration, and approval process. The Department of Revenue reports that the record keeping associated with this credit is not difficult

Potential Performance Measures

Performance measure could include a comprehensive report of the actual number of new jobs created as a result of the credit.

Environmental Technology Facility Credit

Environmental Technology Facility Credit

Summary

- The credit is limited to taxpayers certified by the Arizona Department of Commerce by June 30, 1996.
- The cost of the credit was $1.1 million in tax year 2001, the last year for which data is available.
- The total carry-forward amount reported in tax year 2001 was $36.0 million, but the current amount is unknown.
- A total of 7 different taxpayers have claimed the credit since 1993.
- A total of 1,500 jobs have been created or retained as result of the construction of new environmental technology facilities under the credit.

Statutes

A.R.S. § 43-1080 (Individual) and A.R.S. § 43-1169 (Corporate)

Description

This credit is provided to taxpayers for the expenses of constructing a qualified environmental technology manufacturing, producing, or processing facility. Statute defines environmental technology to mean solar and other renewable energy products or recycled materials.

The credit is equal to 10% of plant construction costs in a tax year, but shall not exceed 75% of the taxpayer's total tax liability for the year.

A company must have been certified as an environmental technology manufacturer, producer, or processor by the Arizona Department of Commerce prior to June 30, 1996 to qualify for the credit. Once certified, companies can continue to claim credits on qualified construction within 10 years after beginning construction unless the Department of Commerce revokes certification. Companies that had not begun construction prior to the certification deadline may begin construction at any time and then claim credits. The certification may be transferred to successive taxpayers that have acquired and continue to operate a qualifying facility.

To become certified, and to maintain certification, a company shall not import hazardous waste from another state or country into Arizona. In addition, the company shall locate or make an additional capital investment in a facility in Arizona that is either owned, or leased for a term of at least 5 years, by a qualified environmental technology manufacturer, producer, or processor. The expected costs of the project shall be at least $20 million within 5 years after beginning construction or starting to make improvements. The facility shall be used predominantly to prepare, manufacture, or process any one of the following:

- Finished products consisting of at least 90% recycled materials;
- Finished products that are powered with solar or other renewable energy;
- Raw materials or intermediate product that are produced through a hydrometallurgical process where at least 85% of the solution used to make the finished product is recycled on-site for additional production; and
- Paper products that consist of at least 80% recycled material.

Currently, 8 corporations are certified for the credit and 7 of the 8 corporations have claimed a credit.

Given the structure of the credit, there is no limit on when credit can be claimed.

Refundable

The credit is not refundable.

Carry Forward

The unused portion of the credit may be carried forward for a maximum of 15 consecutive years.

History and Rationale

The credit was created in 1993 to induce out-of-state businesses to locate in Arizona. Specific companies targeted at the time include Fort Howard Inc., Fletcher Challenge recycling, and North Star Steel manufacturing. This credit was part of a package of property, sales, and income tax incentives targeting this industry. Fort Howard, the largest of the companies targeted for the credit, did not build a plant in the state. The Department of Commerce certification process ended in 1996, after which time no new projects could qualify for the credit.

Revenue Impact

Corporate:
Between 1993 and 2001, $22 million in credit was used. The actual amount used may exceed $22 million; however, the amount after 2001 is unknown due to taxpayer confidentiality concerns. The carry-forward as of 2001 is $36 million.

Tax Year	# of Claimants	Credit Used	Carry Forward
1993	1	N/R	N/R
1994	4	$2,329,800	$13,916,100
1995	5	$15,821,500	$29,533,000
1996	6	$2,556,500	$33,092,800
1997	3	$0	$34,966,700
1998	4	$365,300	$36,155,200
1999	3	$69,900	$36,766,900
2000	3	$26,700	$36,740,300
2001	3	$1,084,600	$36,003,600
2002	2	N/R	N/R
2003	2	N/R	N/R
2004	2	N/R	N/R
2005	Unknown	Unknown	Unknown

N/R – Data not releasable due to confidentiality concerns.
# of Claimants – the number of taxpayers who claimed the credit in each year.
Credit 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 $200,000 of the credit identified in tax year 2001, use $100,000 of it in 2001 (leaving $100,000 as a carry forward). If that taxpayer did not identify or claim the credit in 2002, that $100,000 carry forward would not be included in the carry forward total for 2002.

Individual:
No revenue impacts since no claims for this credit have been submitted by taxpayers.

Economic Benefits

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

According to the Department of Commerce, more than $980 million in qualified plant construction has occurred in the state. A total of 1,500 jobs have been created or retained due to the new construction.

Complexity

The certification process is not complex based on information from the business community. The Department of Revenue reports that tracking asset values after applying the credit creates some complexity.

Potential Performance Measures

Performance measures could include a comprehensive report of the number of jobs created and total investment generated by the credit.

This information is currently available.