Joint Legislative Budget Committee
Staff Memorandum

1716 West Adams *Telephone: (602) 926-5491*
Phoenix, Arizona 85007 *Facsimile: (602) 926-5416*

DATE: December 3, 2008

TO: Members, Joint Legislative Income Tax Credit Review Committee

FROM: Tim Everill, Assistant Director

SUBJECT: 2008 INCOME TAX CREDIT REVIEW

This memo transmits background materials for the December 9**,** 2008 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 2008 include:

- Research and Development Tax Credit
  A.R.S. § 43-1074.01 (Individual)
  A.R.S. § 43-1168 (Corporate)
- Pollution Control Equipment Tax Credit
  A.R.S. § 43-1081 (Individual)
  A.R.S. § 43-1170 (Corporate)
- Taxes Paid for Coal Consumed in Generating Electrical Power Credit
  A.R.S. § 43-1178 (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.

The Committee last reviewed these 3 credits in 2003.

<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 generally be compiled manually from actual hard-copy tax returns, corporate tax credit data is currently available only through tax year 2006 and individual tax credit data through tax year 2007. The 2006 and 2007 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. Chapter 238, however, requires any new credit to include a clause that explains the rationale and objective of the credit (A. R. S. § 43-223).

2008 Review

Attached are summaries for each of the income tax credit categories that are included in the 2008 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 reviewed summaries and minutes of committee and subcommittee hearings that were held prior to adoption of the credits. Various state agencies were contacted, including DOR and the Department of Environmental Quality.

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Research and Development Credit

Research and Development Tax Credit

Summary

- The cost of the corporate credit was $46.7 million in tax year 2006, the last year for which data is available.
- The cost of the individual credit was $3.6 million in tax year 2006, the last year for which data is available.
- The corporate credit had a limited carry forward of $404.5 million and an unlimited carry forward of $167.8 million in tax year 2006. Corporations may have insufficient tax liability, however, to ever claim most of the carry forward credits.
- The individual credit had a limited carry forward of $0.5 million and an unlimited carry forward of $3.4 million in tax year 2006.
- A total of 453 corporations and 348 individuals claimed the credit between 1993 and 2006.

Statute

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

Description

The Research and Development (R&D) credit is a corporate and individual income tax credit for increased research activities in a taxable year. The starting point for computing the tax credit is:

- *Qualified research expenses* 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 that is:

– Technological in nature.

– Useful in the development of a new or improved business component, such as inventions, computer software, and production processes.

– Experimental, as it relates to a new or improved function, performance, reliability or quality.

- *Basic research payments* as defined in Section 41(e)(l)(a) of the Internal Revenue Code. Basic research includes any original investigation for the advancement of scientific knowledge not having a specific commercial objective. Basic research payments typically include payments made to a qualified university or scientific research organization.

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)(l)(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 tax year 2001 and $2.5 million for tax year 2002. For tax years beginning from and after December 31, 2002, the tax credit amount is not limited.

Laws 2008, Chapter 290 increases the amounts of the corporate and individual income tax credits that are allowed to be claimed for qualified research expenses and payments. The changes to the R&D credit provided in Chapter 290 are summarized in the table below.

Tax Year	If Expenses ≤ $2.5 million, R&D Credit is:	If Expenses > $2.5 million, R&D Credit is:
2010	22% of amount up to $550,000	$550,000 plus 13% of amount exceeding $2.5 million.
2011 - 2017	24% of amount up to $600,000	$600,000 plus 15% of amount exceeding $2.5 million.
2018 -	20% of amount up to $500,000	$500,000 plus 11% of amount exceeding $2.5 million.

As indicated in the table above, the current percentages used in the R&D credit calculation will be increased to 22% and 13%, respectively, in 2010 and 24% and 15%, respectively, in 2011 through 2017. Beginning in 2018, the credit will be calculated based on the same percentages as under current law.

Refundable

The credit is not refundable.

Carry Forward

The credit, which is calculated based on qualifying expenses, may be carried forward for up to 15 years. Credit carryovers from years beginning before January 1, 2003 are limited. The amount carried forward from these years is the lesser of the taxpayer's liability or $500,000 minus the new credit created in the current year. Credit carryovers established in 2003 and subsequent years are not limited by statute. However, in practice, carry forwards from these years are still constrained in the sense that these amounts cannot exceed the taxpayer's liability. For a more detailed discussion on credit carry forwards, see *Revenue Impact* section below.

History and Rationale

The corporate R&D credit was first passed and signed into law in July 1992 (Laws 1992, Ch. 296) 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 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 January 2008 study published by the Iowa Department of Revenue, 38 states are currently providing some type of research and development tax credit. Seventeen of these states are offering a credit modeled after the federal R&D credit. A recent study published in *State Tax Notes* concludes that Arizona offers the second most favorable R&D credit in the nation after California. The ranking was based on a complex methodology that controls for the difference in corporate income tax rates among states. According to the author of this study, this was the first time this particular methodology had been used for interstate comparisons of R&D tax incentives. While the study may have informational value, it is not necessarily definitive in terms of interstate comparisons.

Revenue Impact

Corporate

Based on preliminary data provided by the Department of Revenue (DOR), 141 corporations claimed the credit in 2006, the last year for which data is available. These corporations claimed $746.9 million in qualified research and development expenses (an average of $5.3 million per company) on their tax credit forms. This amount translated into a total tax credit cost of $46.7 million to the state General Fund.

At the time of the last credit review in 2003, preliminary data showed a credit cost of $5.7 million in 2001. As shown in the table below, this figure has subsequently been revised to $11.1 million as a result of more complete taxpayer information. The table provides a history of the credit in terms of claimants, research and development expenses, credit usage, and carry forward amounts.

Tax Year	# of Claimants	Total Expenses & Payments	New Credit Available	Total Credit Available	Credit Used	Limited Carry Forward	Unlimited Carry Forward
1993	23	$5,558,699	$617,710	$617,710	$403,663	$494,032	N/A
1994	89	$156,284,525	$5,206,158	$5,445,055	$3,062,056	$26,466,029	N/A
1995	85	$161,933,770	$8,595,822	$9,559,521	$6,149,046	$49,857,808	N/A
1996	111	$332,189,906	$13,461,458	$15,758,856	$9,881,387	$100,583,439	N/A
1997	133	$275,026,626	$17,352,202	$19,483,124	$11,089,063	$82,219,251	N/A
1998	129	$482,316,974	$17,873,965	$19,369,112	$8,963,229	$191,337,518	N/A
1999	140	$649,466,689	$18,989,822	$20,552,034	$10,457,350	$295,172,070	N/A
2000	128	$953,911,915	$22,878,888	$24,812,543	$9,458,919	$427,234,696	N/A
2001	145	$593,243,882	$37,941,109	$42,353,063	$11,088,820	$482,291,261	N/A
2002	155	$500,152,246	$38,096,312	$50,992,744	$11,812,734	$527,738,348	N/A
2003	168	$554,063,810	$71,297,048	$88,439,855	$31,696,851	$534,322,933	$41,532,599
2004	185	$680,218,168	$86,746,357	$120,949,126	$36,733,974	$531,442,391	$92,691,456
2005	179	$765,617,448	$96,491,958	$194,973,694	$47,714,678	$516,738,487	$143,953,501
2006	141	$746,887,922	$92,276,785	$208,304,493	$46,676,231	$404,464,102	$167,774,458

# of Claimants- the number of taxpayers who claimed the credit in each year.
Total Expenses and Payments- eligible research and development expenses reported by taxpayers on their credit tax form.
New Credit Available – the amount of new tax credits identified in each year.
Total Credit Available– 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.
Credit Used– the total value of credits claimed in each year.
Limited Carry Forward – any carry forward established prior to 2003 is limited in that the new credit established plus the carry forward cannot exceed $500,000 per tax year. For example, if the new credit identified in 2001 is $300,000, the carry forward that year is limited to $200,000 since this would bring the total credit to the maximum amount of $500,000.
Unlimited Carry Forward- beginning with tax year 2003, the carry forward amount is not limited in future years.

R&D Expenses and Payments

According to DOR, 453 corporations used the R&D credit between 1993 and 2006. During this 14-year period, these companies claimed a total of $6.9 billion in R&D expenses for an average of $15.1 million per taxpayer. During the "dot-com bubble," which last approximately between 1995 and 2000, qualified R&D spending in the state grew at an average annual rate of 42.6%. After the high-tech bubble burst in the early part of 2001, R&D spending fell precipitously. By 2002, qualified R&D spending had declined by 47.5% from its level two years prior. The amount of R&D expenses in 2006, the last year for which data is available, was still 22% below the amounts claimed in 2000. This means that in spite of more favorable credit provisions beginning in 2001, R&D spending has not yet returned to its 2000 level when the credit was limited to no more than $0.5 million per taxpayer.

Credit Available and Credit Used

Whenever a company files for the R&D credit, it is required to calculate the amount of the *new credit available* for the current year. This is a simple calculation based on the amount of qualified research expenses and payments. For example, if this amount is $2,000,000, the new credit available is 20% of $2,000,000, or $400,000.

Total credit available is the sum of new credit available and any unused credits carried over from prior years. As noted previously, the amount of carry forward depends on when the credit was created (on or before December 31, 2002, or after this date) and the amount of tax liability and new credit in the current year. For example, for a company with a new credit of $400,000 and a tax liability of $750,000, the pre-2003 carry forward amount would be limited to $100,000 (the lesser of $750,000 or $500,000 minus $400,000) whereas the post-2002 carryover could be no greater than $350,000 ($750,000 or $400,000). In this example, total credit available is $850,000, or the new credit plus the sum of the pre-2003 and post-2002 carryovers ($400,000 plus $100,000 plus $350,000).

Credit used is the amount of a corporation's total available credit that is actually used to offset its tax liability. This amount is not only constrained by the taxpayer's liability but also the extent to which the company is claiming other nonrefundable credits. For example, if the total available credit for all the company's nonrefundable credits is $1,400,000 ($850,000 in R&D credit plus $550,000 in other nonrefundable credits), it may choose to use $350,000 of this amount for the R&D credit and $400,000 for the other nonrefundable credits. Regardless of how this company chooses to allocate its available credits, the total amount cannot exceed the company's tax liability of $750,000. In this example, the amount of credit used (for R&D credit) is $350,000.

As the table above indicates, both total and new credit available and credit used have increased rapidly since 2002, the last year in which the R&D credit was capped. For example, the amount of credit used increased from $11.8 million in 2002 to $46.7 million in 2006. Over the same period, qualified R&D expenses increased by less than 50%. The disparity in growth between credit claimed and R&D spending can likely be attributed to the removal of the credit cap and the greater carryovers beginning in 2003.

Carry Forward

As noted previously, any corporation that files for the R&D credit is required to make a separate calculation of credit carryovers before and after December 31, 2002. This is the reason the table above distinguishes between limited and unlimited carry forward. (Pre-2003 and post-2002 carryovers are referred to as, respectively, limited and unlimited carry forward.) As shown in the table above, although the amount of limited carryovers declined by almost $130 million between 2003 and 2006, corporate taxpayers still had more than $400 million in unused credits in 2006. A recent report by DOR suggests that a significant portion of these carryovers may never be used. The reason for this is that pre-2003 carryovers cannot by statute exceed $500,000 per year. This amount is further reduced if new credit is created in the current year. (Under the example used previously, the new credit of $400,000 reduced the limited or pre-2003 carryover to $100,000.)

Unlimited or post-2002 carryovers increased more than fourfold between 2003 and 2006 (from $41.5 million in 2003 to $167.8 million in 2006). In spite of the large accumulation of post-2002 carryovers, these carry forwards may not result in commensurate revenue losses in future years. A company's ability to use the R&D credit is limited by its tax liability. According to DOR, most companies that use the R&D credit are able to fully offset their tax liability. Specifically, data furnished by DOR shows that more than 75% of R&D credit claimants in 2006 were able to reduce their tax liability to zero. Another 8% of credit claimants were able to decrease their tax liability by between 51% and 99.9%. This suggests that as long as the R&D credit remains nonrefundable and nontransferable, few companies will be able to use all of their credit carryovers.

Claimants

The number of corporations claiming the R&D credit increased from 23 in 1993 to 141 in 2006. The largest number of claims was made in 2004 when 185 companies used the credit to offset tax liability. The table below, which was provided by DOR, shows the number of companies claiming the credit between 1993 and 2006 by the size of the credit.

Number of Corporations Claiming the Credit Each Year by the Amount Claimed

Tax Year	$0 to $50,000	$50,000 to $100,000	$100,000 to $250,000	$250,000 to $500,000	$500,000 to $750,000	$750,000 to $1 million	Over $1 million	# of Claimants
1993	6	15	2	0	0	0	0	23
1994	20	53	15	1	0	0	0	89
1995	16	52	5	11	1	0	0	85
1996	24	57	14	12	4	0	0	111
1997	33	68	14	9	9	0	0	133
1998	45	61	8	10	5	0	0	129
1999	56	56	11	4	13	0	0	140
2000	63	41	7	11	6	0	0	128
2001	71	54	11	2	3	0	4	145
2002	84	52	10	2	4	0	3	155
2003	98	47	11	4	5	0	3	168
2004	97	60	15	4	5	1	3	185
2005	73	73	12	8	9	0	4	179
2006	54	54	8	8	9	2	6	141

Most companies tend to claim relatively modest amounts. On average 90% of the companies that claimed the credit between 1993 and 2006 used $250,000 or less of the credit. Preliminary data indicates that only 6 of 141 companies (4.3% of claimants) claimed over $1 million in R&D credits in 2006.

As noted previously, 453 corporations have claimed the credit since it was established in 1993. Most companies (245 out of 453) filed for the credit in 3 taxable years or less. As shown in the table below, only one corporation used the credit in each year between 1993 and 2006.

Number of Corporations Claiming the Credit by the Total Number of Tax Years Claimed														
# of years claimed	1	2	3	4	5	6	7	8	9	10	11	12	13	14
# of corporations	109	69	67	51	46	31	23	8	14	12	10	7	5	1

Individual

As noted previously, the R&D credit became available to individual taxpayers for the first time in tax year 2001. Since this time, the cost of the individual credit has risen from $0.5 million in 2001 to $3.6 million in 2006. According to DOR, a total of 348 individual taxpayers claimed the credit between 2001 and 2006. The impact of the individual income tax credit by year is summarized in the table below.

Tax Year	# of Claimants	New Credit Available	Total Credit Available	Credit Used	Limited Carry Forward	Unlimited Carry Forward
2001	56	$911,273	$911,273	$506,038	$405,235	N/A
2002	99	$1,356,710	$1,732,996	$783,928	$949,068	N/A
2003	121	$2,432,360	$2,378,030	$1,109,211	$908,028	$1,360,791
2004	143	$2,567,619	$4,747,079	$1,452,305	$862,364	$2,432,410
2005	165	$3,427,118	$6,675,395	$2,963,936	$636,751	$3,074,708
2006	223	$3,923,049	$7,497,115	$3,617,562	$488,270	$3,391,283

# of Claimants- the number of taxpayers who claimed the credit in each year.
Total Expenses and Payments- eligible research and development expenses reported by taxpayers on their credit tax form.
New Credit Available – the amount of new tax credits identified in each year.
Total Credit Available– 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.
Credit Used– the total value of credits claimed in each year.
Limited Carry Forward – any carry forward established prior to 2003 is limited in that the new credit established plus the carry forward cannot exceed $500,000 per tax year. For example, if the new credit identified in 2002 is $300,000, the carry forward that year is limited to $200,000 since this would bring the total credit to the maximum amount of $500,000.
Unlimited Carry Forward- beginning with tax year 2003, the carry forward amount is not limited in future years.

Economic Benefits

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

Economists’ rationale for government incentives, such as the R&D credit, is that research produces “positive externalities.” In the context of R&D, this means that the benefits of research accrue not only to the companies that bear the cost of producing or discovering new technology but also to those that are “external” to such R&D spending. As a result, companies may be reluctant to engage in R&D.. To correct this type of “market failure,” economists may prescribe an R&D tax credit to lower the effective price of research.

State policymakers also enact R&D credits to entice corporations to locate or expand facilities and employment within their borders. States’ success in achieving this objective is not clear. Most empirical evaluations of the R&D credit have been for the federal research credit. A relatively small number of academic studies of state R&D studies have been conducted and those that were reviewed showed varied results. For example, one study concluded that state-level R&D credits have been more successful in shifting research dollars among states than expanding existing research facilities. Other studies have shown that the enactment of R&D credits has resulted in increased research expenditures in such states. A recent study at the University of Illinois concluded that R&D credits have significant and positive effects on the growth of the high-tech sectors in states with such incentives.

The impact of the R&D credit on economic development, new investment, and the creation or retention of jobs in Arizona has not been formally evaluated. We are unaware of studies from other states on the employment and income impacts. The reason for not including such economic measures, according to the author of one study, is that the effect of research on employment and income is likely to be long-term since there is often a significant lag between initial R&D spending and the output of new goods or services. Additionally, it is also difficult to measure the extent to which the growth in employment and income is directly attributable to in-state R&D spending as opposed to "technological spillover" from other states.

It is believed that the Arizona R&D credit has helped the state to remain competitive in attracting and retaining research activities especially since many other states offer comparable credits. Additionally, large companies 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. The introduction of new products.

Prior Review

The Research and Development tax credit was last reviewed by the JLITCRC in 2003. The Committee recommended to continue the credit without any changes or modifications, and to place the credit back on the income tax credit review schedule for 2008.

Pollution Control Equipment Credit

Pollution Control Equipment Tax Credit

Summary

- The cost of the corporate credit was $1.3 million in tax year 2006, the last year for which data is available. Since tax year 1995, the corporate credit cost of the credit has totaled $36.2 million.
- The corporate credit had a limited carry forward of $522,700 in tax year 2006.
- A total of 91 corporations claimed the credit between 1995 and 2006.

Statute

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

Description

The pollution control equipment 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 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 in a taxable year. 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 a 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 $1.3 million in TY 2006, the last year for which data is available. The cost of the credit has declined by approximately 50% from $2.7 million in TY 2001. The following table summarizing the corporate income tax impact of this credit was provided by the Department of Revenue.

Tax Year	# of Claimants	Cost of Property	New Credit Available	Total Credit Available	Credit Used	Carry Forward
1995	21	$79,797,815	$5,205,329	$5,205,329	$3,110,818	$2,094,511
1996	29	$54,365,441	$4,332,277	$6,937,066	$4,498,473	$2,438,593
1997	27	$44,302,215	$2,041,197	$3,891,947	$2,202,316	$1,948,756
1998	26	$70,399,042	$4,317,076	$8,707,493	$4,241,078	$4,382,127
1999	36	$106,566,052	$6,542,905	$12,259,058	$6,879,188	$6,362,017
2000	39	$48,740,822	$4,225,446	$11,289,394	$3,860,440	$7,428,954
2001	35	$53,766,046	$3,054,988	$7,041,120	$2,696,972	$4,344,148
2002	31	$23,419,654	$2,123,842	$6,660,082	$1,716,687	$4,943,395
2003	29	$28,690,140	$2,585,748	$7,554,913	$2,412,182	$4,989,084
2004	23	$25,049,128	$2,206,582	$6,169,361	$1,174,943	$4,669,445
2005	23	$39,112,593	$2,175,516	$6,797,788	$2,100,899	$4,144,624
2006	15	$29,090,851	$1,167,065	$2,018,837	$1,344,448	$522,734

# 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 Available – the amount of new tax credits identified in each year.
Total Credit Available– 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.
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 estimates. For example, a company could have $1 million in a particular credit identified in tax year 2007, use $400,000 of it in 2007 (leaving $600,000 as a carry forward). If that company didn't identify or claim that credit in 2008, that $600,000 carry forward would not be included in the carry forward total for 2008.

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

Economic Benefits

Corporate:

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.

Other

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.

Complexity

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.

Potential Performance Measures

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.

Prior Review

The Pollution Control Equipment tax credit was last reviewed by the JLITCRC in 2003. The Committee recommended to continue the credit without any changes or modifications, and to place the credit back on the income tax credit review schedule for 2008.

Tax Paid for Coal Consumed in Generating Electrical Power Credit

Coal Consumption Corporate Income Tax Credit

Summary

- The cost of the credit was $929,098 in tax year 2006, the last year for which data is available.
- The credit had a carry forward of $2.0 million in tax year 2006, the last year for which data is available.
- A total of 5 corporations claimed the credit between 1998 and 2006.

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

The credit is not refundable.

Carry Forward

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

History and Rationale

The credit was added by Laws 1998, Chapter 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 and provide an incentive to take delivery in Arizona of coal from sources outside the state.

Coal purchased in Arizona is subject to a 3.125% TPT. The state TPT collection 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, most 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 a 5.6% use tax and virtually all use tax revenue is retained by the state. In addition to the state's use tax, the city of Tucson imposes a 2% use tax, which is applied to coal used at Tucson Electric Power (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.
Arizona counties where the coal purchases occur would benefit from retained or increased sales tax revenues.

Revenue Impact

Based on preliminary data provided by the Department of Revenue (DOR), 3 corporations claimed the credit in tax year 2006, the last year for which data is available, for a total cost of $929,098 to the state General Fund. Use of the tax credit has declined over the last five reported years from a peak of $1.6 million in tax year 2001. The following table summarizing the corporate income tax impact of this credit was provided by DOR.

Tax Year	# of Claimants	TPT or Use Tax Paid	New Credit Available	Total Credit Available	Credit Used	Carry Forward
1998	4	$3,053,275	$915,983	$915,983	$678,039	$237,044
1999	4	$3,607,134	$1,067,569	$1,305,513	$803,476	$502,037
2000	3	$3,716,675	$1,115,002	$1,617,039	$778,015	$839,024
2001	3	$6,388,155	$1,916,447	$2,755,471	$1,556,016	$1,199,455
2002	3	$5,417,396	$1,865,219	$3,064,674	$1,504,851	$1,559,823
2003	3	$5,285,088	$1,585,520	$3,145,343	$1,229,020	$1,744,443
2004	3	$4,312,183	$1,293,658	$3,038,101	$908,990	$1,799,254
2005	3	$4,175,437	$1,252,631	$3,051,885	$843,909	$1,870,939
2006	3	$4,581,990	$1,374,597	$3,245,536	$929,098	$1,956,070

# 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 Available – the amount of new tax credits identified in each year.
Total Credit Available– 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.
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 estimates. For example, a company could have $1 million in a particular credit identified in tax year 2006, use $400,000 of it in 2006 (leaving $600,000 as a carry forward). If that company didn't identify or claim that credit in 2007, that $600,000 carry forward would not be included in the carry forward total for 2007.

According to DOR, since the law was passed, 5 corporations have used this tax credit.

Economic Benefits

Given the confidentiality of the tax credits claimed, the specific benefits of the tax 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

The impact of the coal consumption tax credit on economic development, new investments, or jobs created or retained in the state of Arizona is not known. However, by enhancing revenue in counties where coal purchases are made, the counties are able to maintain or improve their tax base.

Other

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.

Complexity

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

Potential Performance Measures

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.

Prior Review

The Coal Consumption tax credit was last reviewed by the JLITCRC in 2003. The Committee recommended to continue the credit without any changes or modifications, and to place the credit back on the income tax credit review schedule for 2008.

2008 Income Tax Credit Review

Joint Legislative Income Tax
Credit Review Committee

December 9, 2008

JLBC

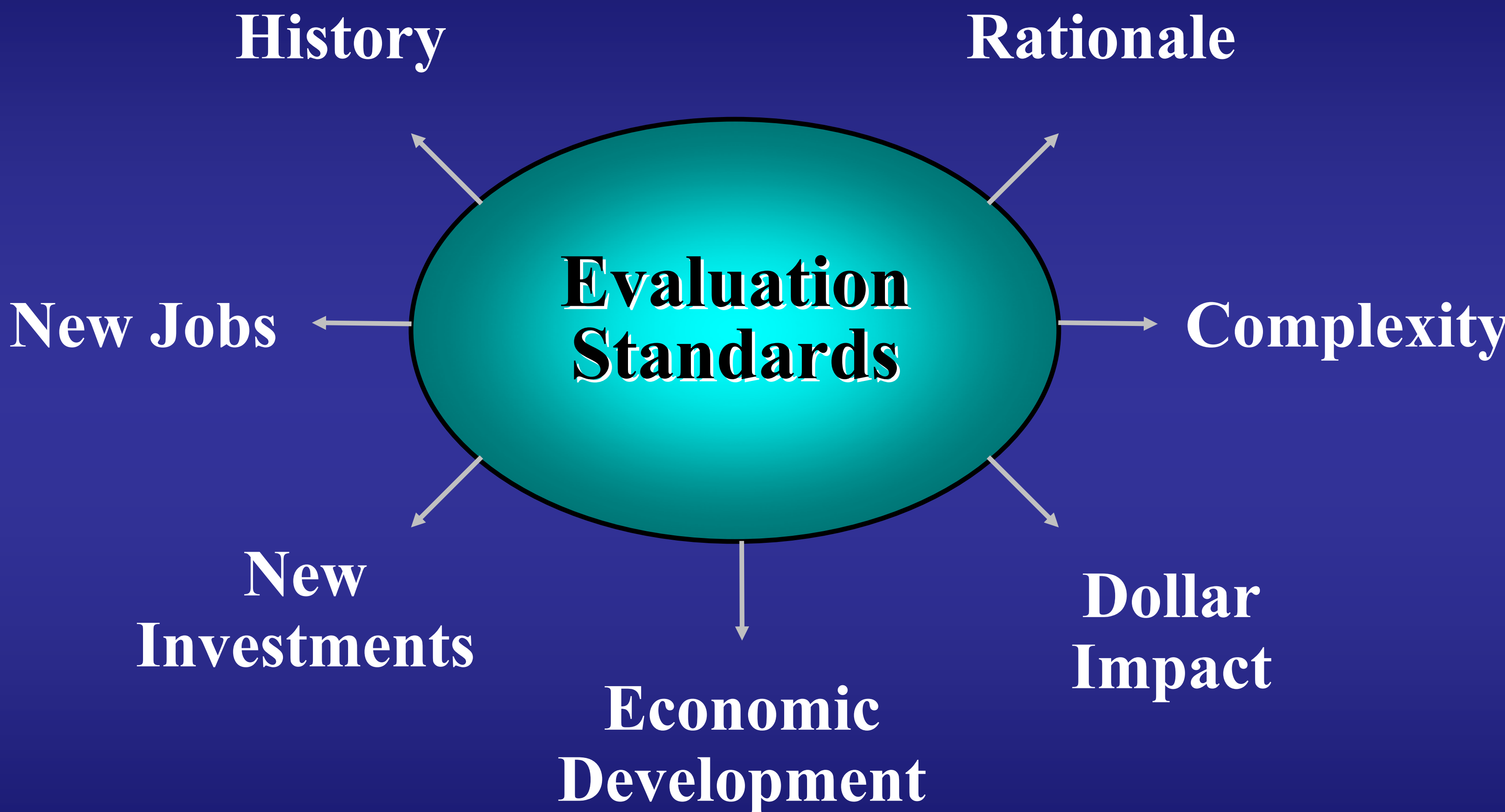
Joint Legislative Income Tax Credit Review Committee

- Annually reviews credits as determined in statute.
- This year's review includes:
  - Research and Development Credit
  - Pollution Control Equipment Credit
  - Coal Consumption Credit
- Last reviewed in 2003.

Role of the Committee

- Determine original purpose of tax credit.
- Establish standards for evaluating and measuring success or failure.
- Recommend changes.

Statute Provides Possible Standards



Issues Affecting Evaluation

- Confidentiality.
- Timeliness of data.
- Lack of performance measures.

Research and Development Credit

Summary

Cost – $46.7 million in tax year 2006 for the corporate credit and $3.6 million for the individual credit.

- In total, 454 corporate taxpayers and 348 individual taxpayers have claimed the credit since it's inception.

Purpose – attract high-tech industry and remain competitive with other states.

Complexity – unusually complex in calculation and administration – record-keeping requirements can be burdensome.

Performance Measures – none in statute.

Research and Development Credit

Description of Credit

- Uses federal credit as starting point to establish base qualifying credit amount.
- Credit is based on the amount that exceeds base amount.
- Following table provides credit percentages by year:

Tax Year	If Expenses ≤ $2.5 million, R&D Credit is:	If Expenses > $2.5 million, R&D Credit is:
2009	20% of amount up to $500,000	$500,000 plus 11% of amount exceeding $2.5 M
2010	22% of amount up to $550,000	$550,000 plus 13% of amount exceeding $2.5 M
2011 - 2017	24% of amount up to $600,000	$600,000 plus 15% of amount exceeding $2.5 M
2018 - beyond	20% of amount up to $500,000	$500,000 plus 11% of amount exceeding $2.5 M

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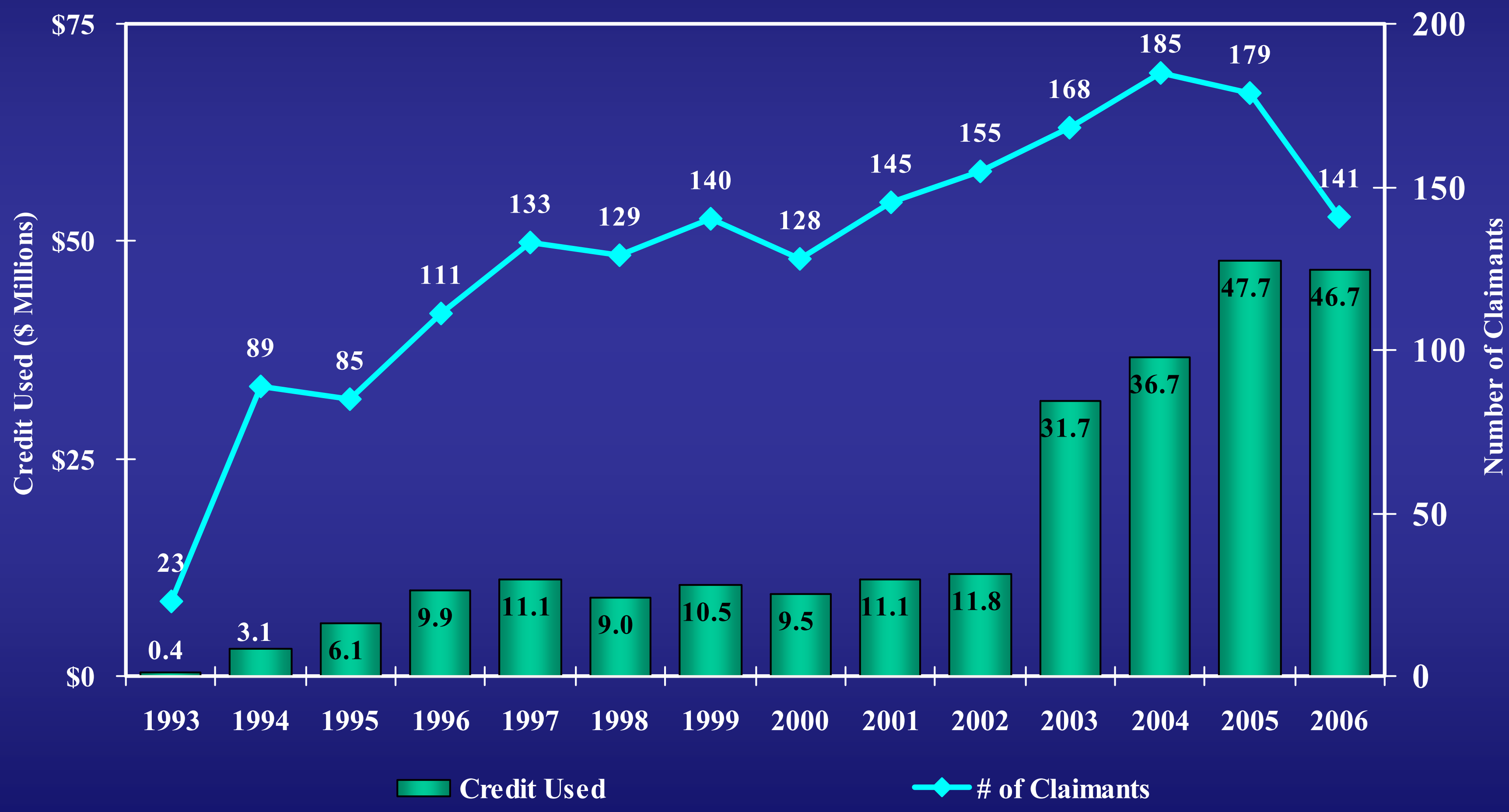
Research and Development Credit

Description of Credit (Cont.)

- Credit is nonrefundable.
- Credit has a 15-year carry forward provision.
- Carry forwards before 2003 are limited to $500,000.
- Carry forwards from and after 2003 are not limited.
- Unlimited carry forwards cannot exceed taxpayer's liability.

Research and Development Credit (Corporate)

Amount of Credit Used & Number of Claimants



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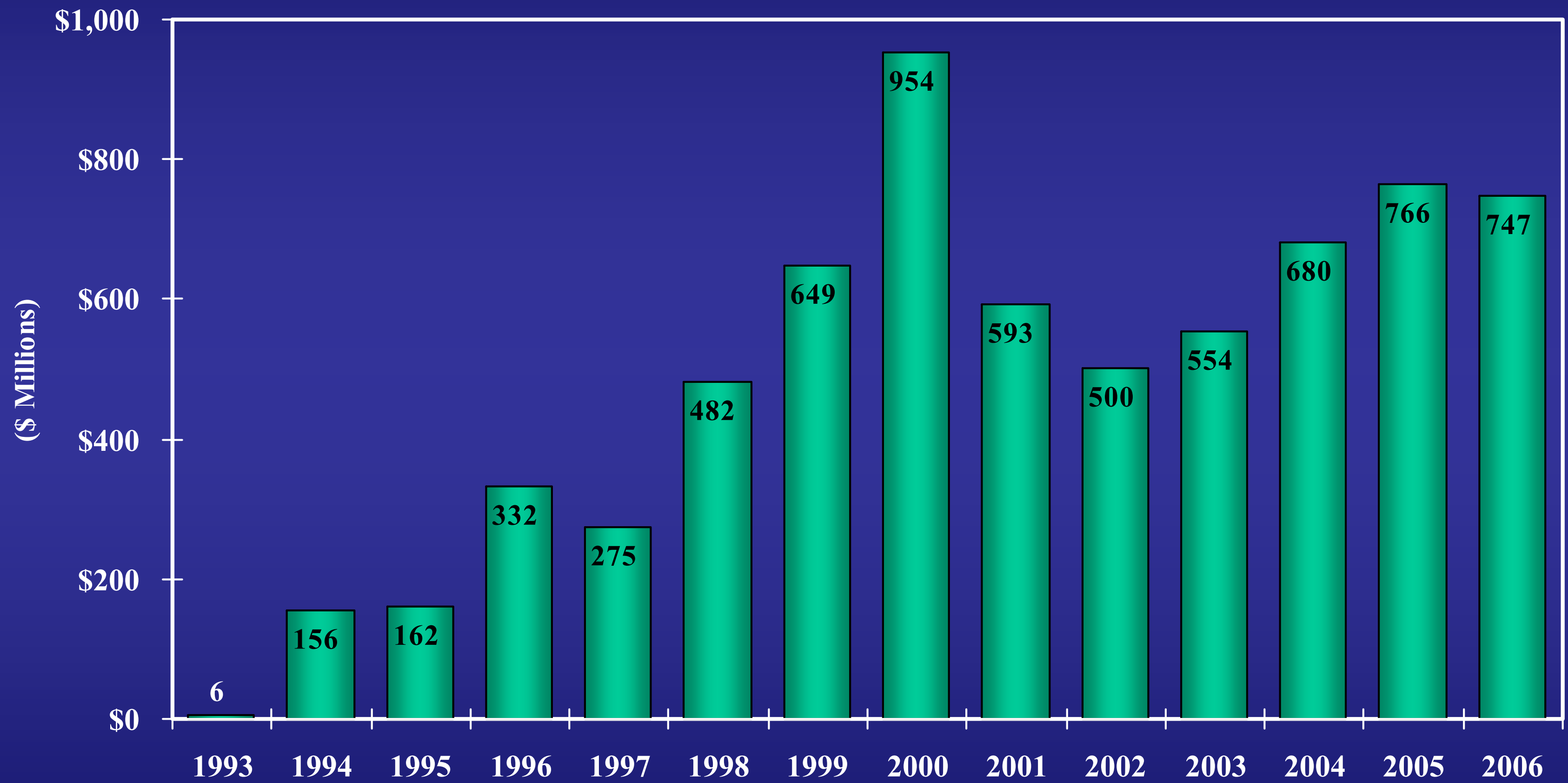
Research and Development Credit (Corporate)

Amount of Qualified R&D Expenses



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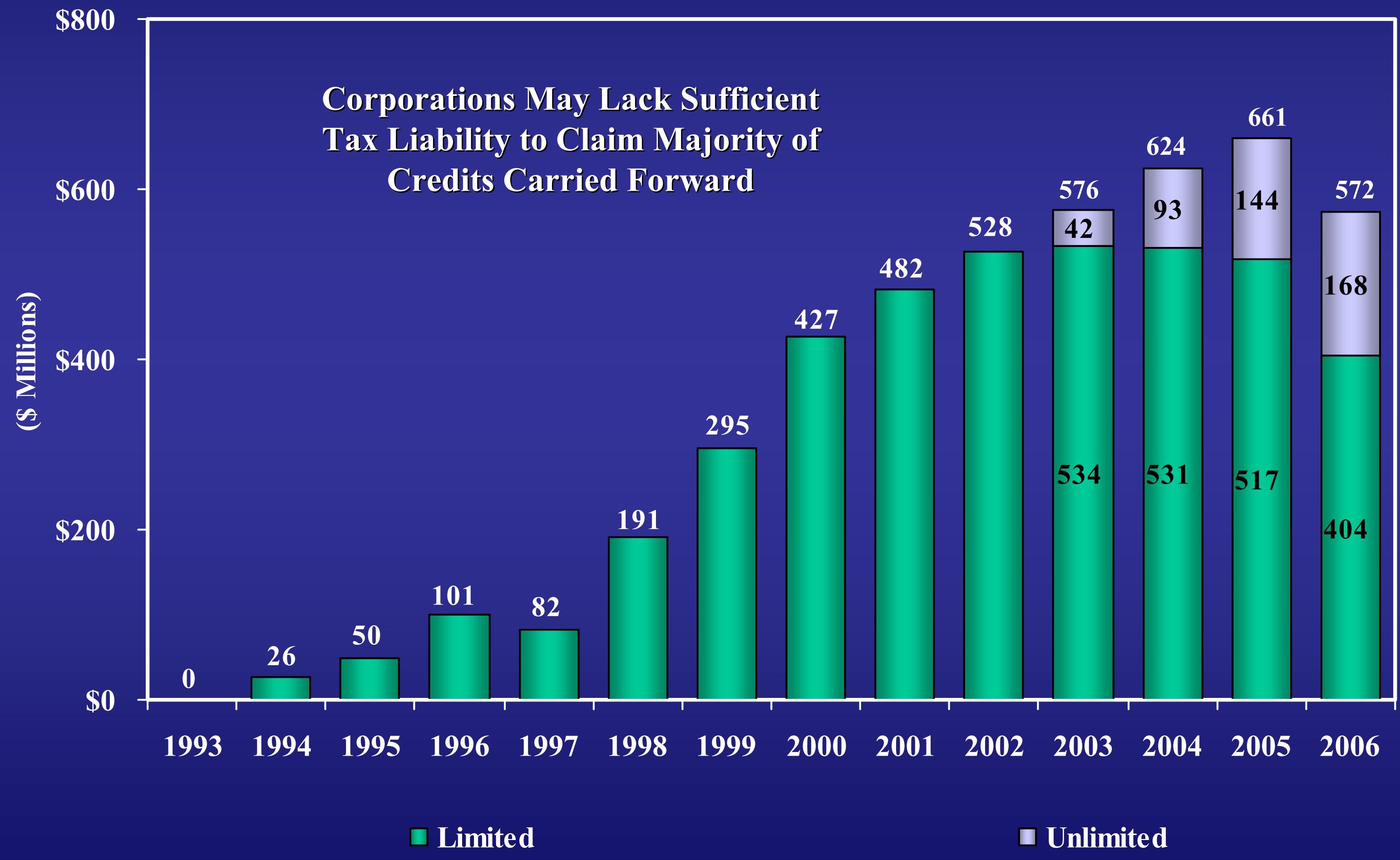
Research and Development Credit (Corporate)

Amount of Limited and Unlimited Carry Forward



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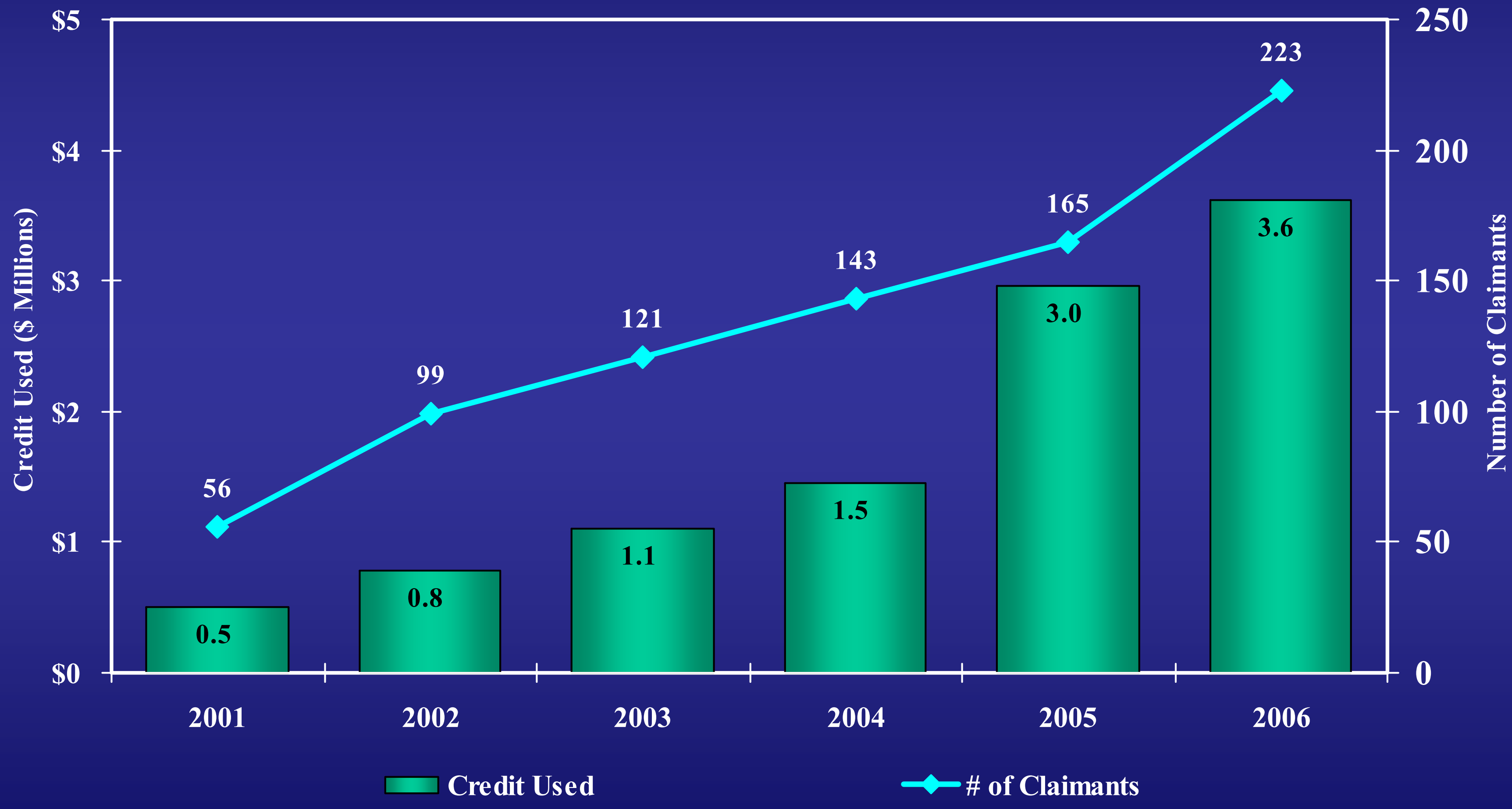
Research and Development Credit (Individual)

Amount of Credit Used & Number of Claimants



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Research and Development Credit

Benefits to the Arizona Economy

- Tax incentive may have benefited the Arizona economy insofar as it has resulted in capital investments and job creation that would not have occurred in the absence of the credit.
- However, no empirical evaluation of the credit has been conducted to date.
- Academic studies of R&D credits at the state-level show varied results.
- *State Tax Notes* study concludes Arizona has second most favorable R&D credit (behind California).

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Research and Development Credit
Potential Performance Measures

- Total research dollars spent in Arizona each year.
- Numbers of persons employed in research activities.
- Total research payrolls.
- The introduction of new products as a result of research and development.
- Last reviewed in 2003
  - Committee recommended the continuation of the credit with no changes or modifications.

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Pollution Control Equipment Credit
Summary

Cost – $1,344,448 in tax year 2006, with a carry forward of $522,734.

- In total, 91 taxpayers have claimed the credit since it's inception.

Purpose – To encourage investment in pollution control or prevention equipment.

Complexity – Not complex in administration and record keeping is not difficult.

Performance Measures – none in statute.

Pollution Control Equipment Credit

Description of Credit

- The credit is applicable to pollution control equipment required by the EPA, DEQ, or other political subdivision.
- The credit in a taxable year is equal to the lesser of 10% of the purchase price of pollution control equipment or $500,000.
- Credit is nonrefundable.
- Carry forward is 5 years.

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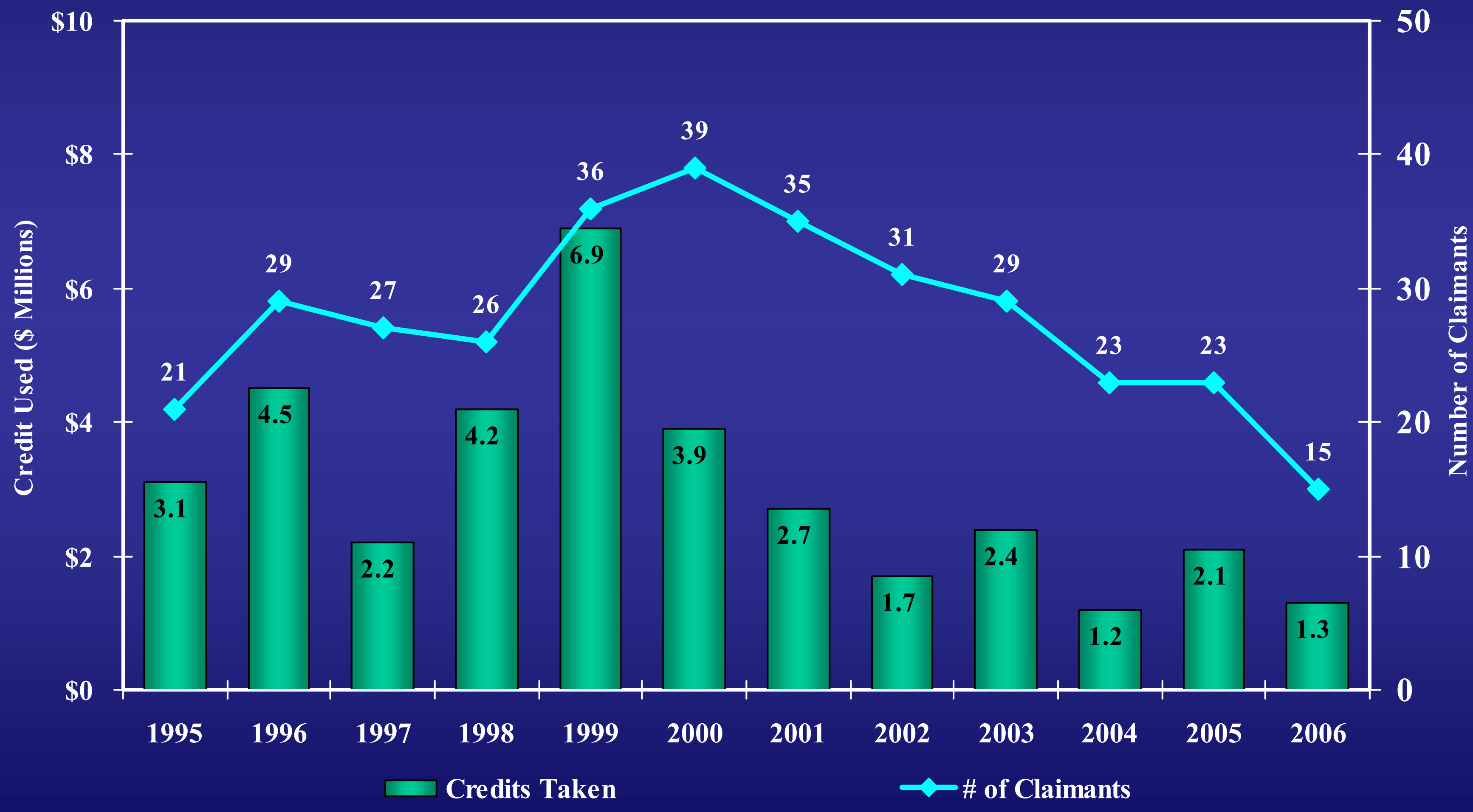
Pollution Control Equipment Credit (Corporate)

Amount of Credits Taken & Number of Claimants



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Pollution Control Equipment Credit

Benefits to the Arizona Economy

- Tax incentive may have benefited the Arizona economy insofar as it has resulted in capital investments, job creation, and mitigation of pollution that would not have occurred in the absence of the credit.
- However, no empirical evaluation of the credit has been conducted to date.

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Pollution Control Equipment Credit

Potential Performance Measures

- Type of equipment purchased and its related environmental impact.
- Number of other states where a business receives a comparable credit.
- Last reviewed in 2003
  - Committee recommended the continuation of the credit with no changes or modifications.

Coal Consumption Credit
Summary

Cost – $929,098 in tax year 2006, with a carry forward of $2.0 million.

- In total 5 taxpayers have claimed the credit since it's inception.

Purpose – To encourage purchase and delivery of coal in Arizona, and maintain tax base in rural counties.

Complexity – Simple to use and administer..

Performance Measures – none in statute.

JLBC

Coal Consumption Credit
Description of Credit

- 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.
- The credit is non-refundable.
- The tax credit may be carried forward for the next five consecutive taxable years.

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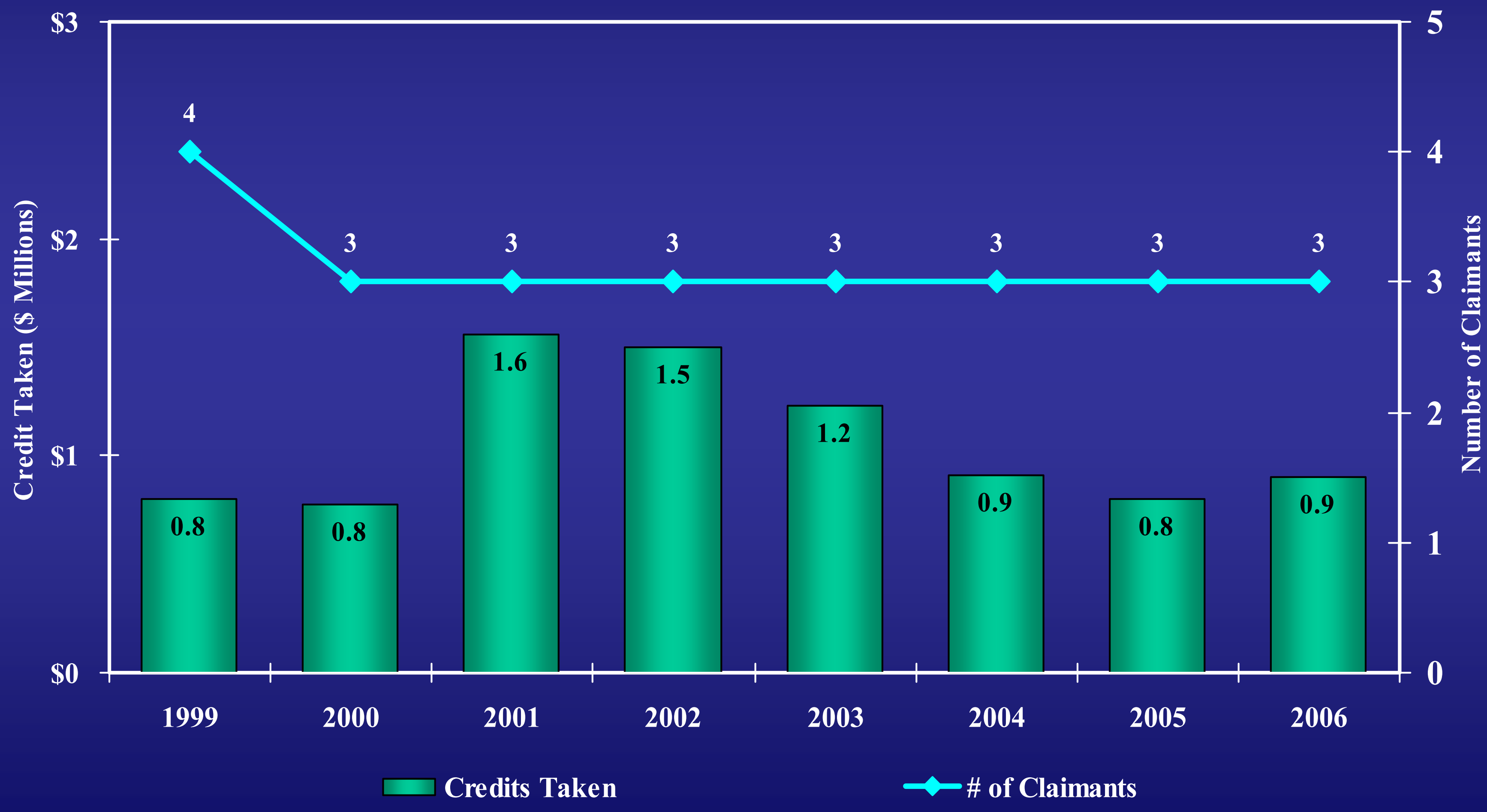
Coal Consumption Credit

Amount of Credits Taken & Number of Claimants



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Coal Consumption Credit

Benefits to the Arizona Economy

- Given the confidentiality of the tax credits claimed, the specific benefits of the tax 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.
- The impact on economic development, new investments, or jobs created or retained as a direct result of this tax credit is unknown. However, by enhancing revenue in counties where coal purchases are made, the counties are able to maintain or improve their tax base.

Coal Consumption Credit
Potential Performance Measures

- Estimates by the affected counties of the credit's net fiscal impact on their budgets.
- Annual estimates and the dollar value of coal purchased for electrical generation in Arizona.
- Last reviewed in 2003
  - Committee recommended the continuation of the credit with no changes or modifications.

JLBC