Joint Legislative Budget Committee
Staff Memorandum

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DATE: December 7, 2010

TO: Members, Joint Legislative Income Tax Credit Review Committee

FROM: Hans Olofsson, Chief Economist

SUBJECT: 2010 INCOME TAX CREDIT REVIEW - OPEN SESSION

This memo transmits background materials for the December 14**,** 2010 meeting of the Joint Legislative Income Tax Credit Review Committee. This memo includes information specific to the only credit scheduled for a review in 2010 that does not include confidential taxpayer information: Credit for Contributions to Qualifying Charitable Organizations (A.R.S. § 43-1088). All credits with confidential taxpayer information are reviewed in a separate memo.

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. While the Charitable Tax Credit will be reviewed in open session, the following credits will be discussed in executive session due to confidential information.

- Credit for Motion Picture Production Costs
  - A.R.S. § 43-1075 (Individual)
  - A.R.S. § 43-1163 (Corporate)
- Credit for Motion Picture Infrastructure Projects
  - A.R.S. § 43-1075.01 (Individual)
  - A.R.S. § 43-1163.01 (Individual)
- Credit for Employing National Guard Members
  - A.R.S. § 43-1079.01 (Individual)
  - A.R.S. § 43-1167.01 (Corporate)
- Credit for Employment of Temporary Assistance for Needy Families (TANF) Recipients
  - A.R.S. § 43-1087 (Individual)
  - A.R.S. § 43-1175 (Corporate)
- Credit for Water Conservation Systems
  - A.R.S. § 43-1090.01 (Individual)
- Credit for Water Conservation System Plumbing Stub Outs
  - A.R.S. § 43-1182 (Corporate)

As a result of a new law enacted by the Legislature in 2010 (Laws 2010, Chapter 225), the Department of Revenue (DOR) is now authorized to disclose confidential statistical information gathered from taxpayers. Prior to Chapter 225, DOR did not disclose credit information unless a certain minimum number of taxpayers had claimed the credit. The non-disclosure of credit information in such cases was intended to ensure taxpayer confidentiality.

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.

(Continued)

The Committee last reviewed the charitable organizations credit in 2005.

<u>Limitations</u>

There are several limitations that affect the evaluation of income tax credits. For example, the timeliness of data is one such limitation. Because tax credit data must generally be compiled manually from actual hard-copy tax returns, corporate credit data is currently available only through tax year 2008. Both 2008 corporate tax credit data and 2009 individual tax credit data are preliminary and thus subject to revision.

A second limitation is the 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).

Finally, the evaluation of tax credits is often hampered by the difficulty of measuring their costs and benefits. For example, the water conservation credits may have a positive impact on the environment insofar as they induce taxpayers to reduce water usage that would not occur in the absence of the credits. However, due to both limited credit use and lack of data on water usage before and after credit enactment, it is not possible to measure such impact.

<u>2010 Review</u>

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.

Transferable – whether or not any unused portion of the credit can be sold or otherwise transferred to other taxpayers. Two of the credits included in the current review – motion picture production and motion picture infrastructure projects – are transferable.

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.

(Continued)

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 Commerce.

HO:lm
Attachment
xc: Michael Hunter, Senior Policy and Operations Advisor, Senate
Carolyn Speroni, Policy Advisor, Senate
Katy Yanez, Research Analyst, Appropriations Committee, Senate
Lorenzo Romero, Director of Fiscal Policy, House
Mark Bogart, Senior Economist, House
Daniel Gonzalez-Plumhoff, Assistant Research Analyst, House

Charitable Organizations Credit

Contributions to Qualifying Charitable Organizations Tax Credit

Summary

- The cost of the credit was $12.9 million in tax year 2009, the last year for which data is available.
- The credit was claimed by 45,438 taxpayers in tax year 2009 at an average of $284 per claim.
- The credit is restricted to individual income taxpayers who itemize their deductions.
- The credit was expanded in 2009 to include charitable organizations that serve chronically ill or disabled children.
- The requirement to establish a baseline year for purposes of establishing credit eligibility was eliminated in 2009.
- There are currently more than 400 charitable organizations that qualify for credit eligible donations.
- The self-certification by charitable organizations was replaced in 2009 by a new certification process that requires the Department of Revenue (DOR) to verify eligibility based on information provided by the charities.
- Beginning in 2010, individuals are allowed to make contributions to qualifying charities through payroll withholding deductions.

Statute

A.R.S. § 43-1088 (Individual Income Tax)

Description

This credit is provided to taxpayers that make voluntary contributions to qualifying charitable organizations.

To qualify for credit eligible contributions, the charity must be either a tax-exempt 501(c)(3) charitable organization or a designated community action agency that receives community services block grant monies. Additionally, the organization is required to spend at least 50% of its budget on services to Arizona residents who either: (1) receive temporary assistance for needy families (TANF) benefits, (2) are low income persons, or (3) chronically ill or disabled children. (Statute defines “services” as cash assistance, medical care, child care, food, clothing, shelter, job placement, job training, or any other assistance that meets immediate basic needs.)

To qualify for credit eligible donations, the charity is required to provide DOR with a written certification that it meets all of the statutory requirements of a qualifying charitable organization. The written certification, which is signed under penalty of perjury, must include copies of the organization’s financial statements and federal (501)(c)(3) tax-exempt letter (or status as a community action agency receiving block grant monies).

The credit is available to individuals but not to corporations. Partnerships cannot pass the credit through to their partners and S corporations cannot pass through the credit to their shareholders. The maximum tax credit is $200 for individuals filing as single or head of household and $400 for married couples filing joint returns. The credit is only available to filers that itemize their deductions.

Refundable

The credit is not refundable.

Carry Forward

The tax credit may be carried forward for 5 taxable years.

History and Rationale

This credit was created by Laws 1997, Chapter 300 and became effective on January 1, 1998. According to historical records, the credit was added as an amendment in Conference Committee to the omnibus welfare bill (SB 1357) that redesigned Arizona’s welfare system to comply with federal welfare reform laws enacted in 1996.

Laws 2005, Chapter 334 increased the maximum credit for married taxpayers filing joint returns from $200 to $400. The maximum credit for single and head of household filers was left unchanged at $200.

Laws 2009, Chapter 80 expanded the credit to include donations to charitable organizations that provide services to chronically ill or disabled children. Additionally, the act restricted the credit to taxpayers itemizing their deductions and eliminated the requirement that a baseline year be established before the credit can be claimed. To qualify for the credit prior to 2009, taxpayers had to itemize their deductions (and specifically include deductions for charitable contributions) on a prior year's state tax return at least once in order to establish a "baseline" year and amount. The credit was calculated based on charitable contributions over and above the baseline amount.

Chapter 80 established a new certification process for qualifying charitable organizations as outlined in the *Description* section above. Prior to 2009, charities were not required to submit any supporting documents to DOR, such as financial statements or verification of tax-exempt status. Instead, charities "self-certified" themselves by merely sending a letter to DOR stating that they met all the criteria of a qualifying charitable organization. According to information made available on DOR's web site, there are currently more than 400 qualifying charitable organizations in the state. (Prior to Chapter 80, there were almost twice as many charities that qualified for credit donations.)

Laws 2009, Chapter 167 provided that individual income taxpayers can authorize their employers to reduce their withholding tax amounts by the amount of the credit claimed. The act became effective in 2010.

Revenue Impact

As noted above, this credit is only available to individual income tax filers. The cost of the credit was $12,915,531 in 2009, the last year for which data is available. (This figure is still preliminary and thus likely to be revised.) The table below, which was provided by DOR, summarizes the tax revenue impact of the credit.

Tax Year	# of Claimants	Total Credit Available	Credit Used	Carry Forward
1998	2,894	$481,037	$476,691	$4,346
1999	6,725	$1,168,515	$1,154,768	$13,747
2000	10,654	$1,829,205	$1,729,123	$35,581
2001	12,538	$2,257,673	$2,196,043	$41,852
2002	14,226	$2,687,900	$2,676,946	Not Available
2003	17,467	$3,286,100	$3,259,400	Not Available
2004	20,736	$3,884,600	$3,851,700	Not Available
2005	25,587	$6,637,500	$6,589,000	Not Available
2006	29,202	$7,988,039	$7,939,507	Not Available
2007 [1/]	18,280	$5,877,831	$5,860,953	Not Available
2008	36,568	$11,077,991	$11,059,408	Not Available
2009	45,438	$12,950,388	$12,915,531	Not Available

Note: 1/ According to DOR, credit data for 2007 appears to be understated. This figure will likely be revised as more information becomes available.

# of Claimants- the number of taxpayers who claimed the credit 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 estimate. For example, a taxpayer could have $400 in a particular credit identified in tax year 2005, use $300 of this amount in 2005 and leave $100 as a carry forward. If this taxpayer did not identify or claim the credit in 2006 the $100 carry forward would not be included in the credit carry forward total for 2006.

As shown in the table above, the use of the credit has increased significantly over time; from $0.5 million in 1998 to almost $13 million in 2009. The increase of the maximum credit for married couples from $200 to $300 in 2005 and from $300 to $400 in 2006 is evident from the more than 100% increase in credit use over the same 2-year period. Similarly, the elimination of the baseline requirement (for purposes of calculating the credit) in 2009 appears to have resulted in another large increase in credit usage.

Economic Benefits

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

This credit is not directly designed to promote economic development or spur new investments that would result in new jobs. Instead, according to DOR's August 2000 report "Income Tax Credits in Arizona," this credit is one of several tax credits in statutes primarily intended to encourage cash contributions to certain target groups in society, such as the working poor or students in private or public schools.

Although this credit was not directly intended to promote economic growth, it may still provide some economic benefits to society insofar as it generates funding to help move individuals from underemployment to economic self-sufficiency. There is no data currently available, however, to quantify such benefits.

Complexity

The credit does not seem to be unnecessarily complex in terms of its application, administration, and approval process. The elimination of the baseline year requirement in 2009 appears to have simplified the use of the credit considerably.

Potential Performance Measures

Performance measures could include:
1. A requirement to report on the number of Arizona residents (TANF recipients, low-income persons, and chronically ill or disabled children) that benefit from the services provided as a result of the credit donations.
2. A requirement to report on the specific type of services provided (e.g., cash assistance as opposed to job training) and the amounts allocated to such services from the credit donations.

Prior Review

The credit was last reviewed by the JLITCRC in 2005. The Committee recommended at that time that the credit be continued and placed on the 2010 review schedule with the following modifications: (1) elimination of the baseline year requirement and (2) establishment of a new certification process for charitable organizations to notify DOR in writing and under penalty of perjury that they meet all the statutory requirements. As noted above, both changes were enacted into law.

2010 Income Tax Credit Review

Joint Legislative Income Tax
Credit Review Committee

December 14, 2010

JLBC

Joint Legislative Income Tax Credit Review Committee

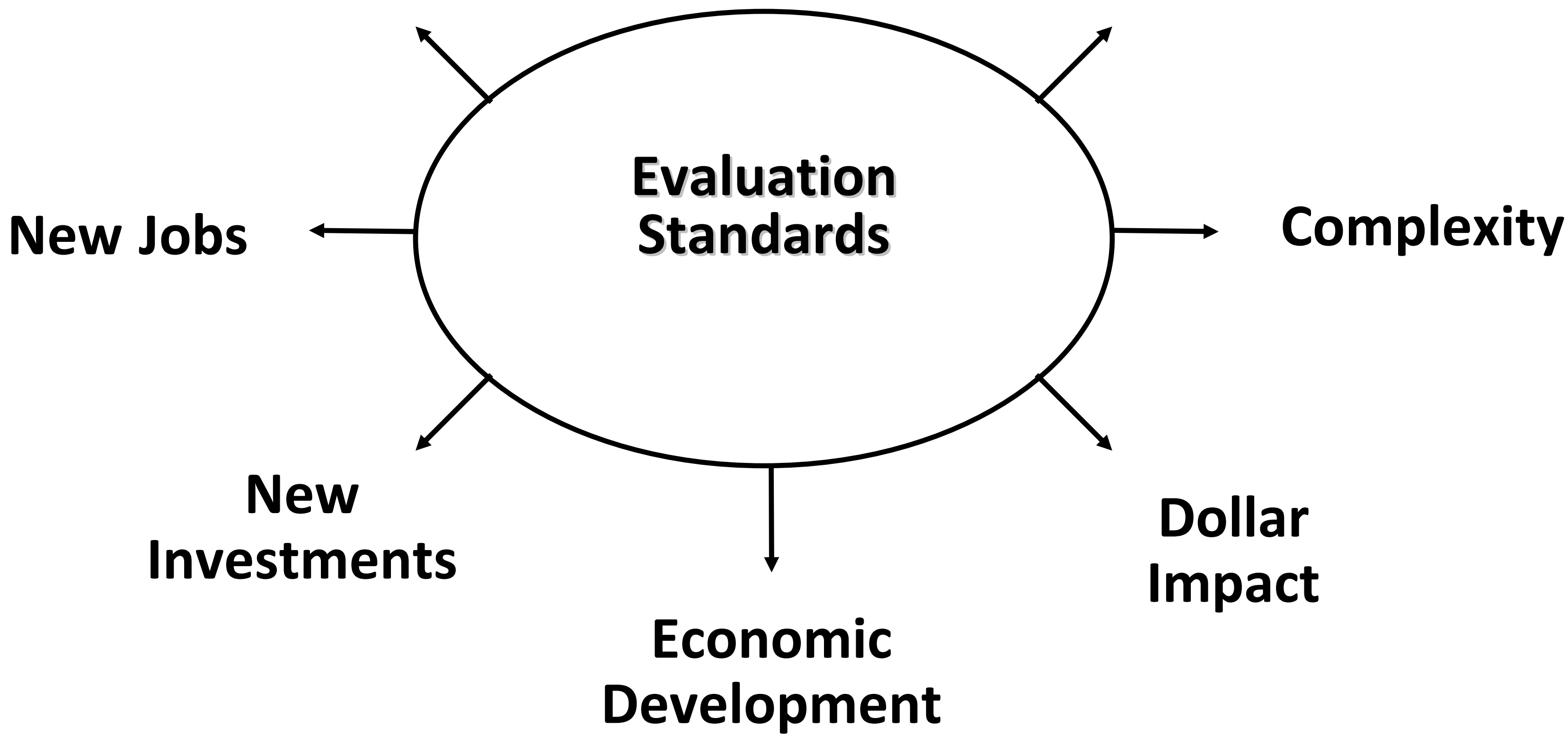
- Annually reviews credits as determined in statute.
- This year's review includes:
  - Charitable Organizations Credit
  - Motion Picture Production & Infrastructure Credits
  - Employment of National Guard Members Credit
  - Employment of TANF Recipients Credit
  - Water Conservation Systems Credits
- Charitable organizations and TANF credits were last reviewed in 2005.

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

History | **Rationale**



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New Disclosure Provision in 2010

- New law enacted in 2010 authorizes DOR to disclose confidential "statistical information" gathered from taxpayers to the Committee and JLBC Staff.
- Previously, DOR did not disclose credit information unless a certain minimum numbers of taxpayers had claimed the credit.

Issues Affecting Evaluation

- Timeliness of data.
- Lack of performance measures.
- Certain costs and benefits can be difficult to quantify.

Charitable Organizations Tax Credit
– Summary

- Cost – $12.9 million in tax year 2009.
  – 45,438 claims at an average of $284 per claim.
- Purpose – encourage increased cash contributions to charities that help the working poor, or chronically ill or disabled children.
- Complexity – simple to use and administer.
- Performance Measures – none in statute.

Charitable Organizations Tax Credit
– Description of Credit

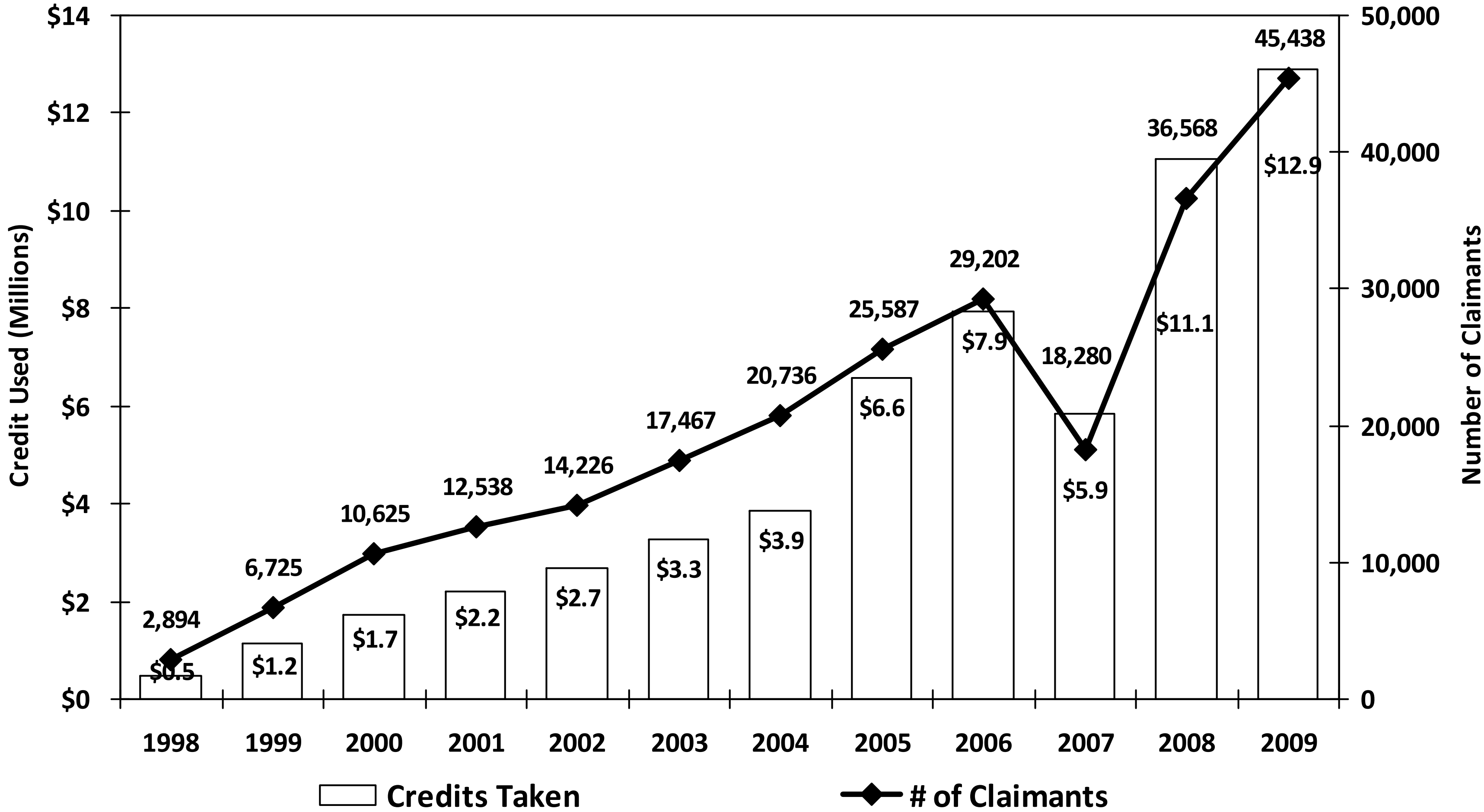
- Credit is available to individuals who make cash contributions to qualifying charities.
- Qualifying charity is required to:
  - be a 501(c)(3) or designated community action agency
  - spend ≥ 50% of its budget on services to welfare recipients, low-income persons, chronically ill or disabled children
- More than 400 charitable organizations are currently listed on DOR’s web site.

Charitable Organizations Tax Credit
– Description of Credit (cont.)

- Credit is only available to individual filers who itemize their deductions.
- Maximum credit is $200 for singles and heads of household and $400 for married couples.
- Credit is nonrefundable.
- Credit carry-forward is 5 years.

Charitable Organizations Tax Credit

– Amount of Credits Taken & Number of Claimants



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Charitable Organizations Tax Credit
– Benefits to the Arizona Economy

- Available data does not indicate to what extent donations to qualifying charities represent new or additional giving.
- Credit may encourage some donors to reallocate their contributions for tax purposes.

Charitable Organizations Tax Credit
– Potential Performance Measures

- Number of Arizona residents benefitting from services provided as a result of credit donations.
- Type of services provided and amounts allocated to such services.
- Last reviewed in 2005.
  - Committee recommended: (1) elimination of baseline requirement and (2) establishment of new certification process. Both recommendations were enacted.