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Legislative Tax Expenditure Committee

November 16, 2011

MEMBERS PRESENT:

Senator Joe Bolkcom, Co-chairperson
Senator William Dotzler
Senator Herman Quirmbach
Senator Roby Smith
Senator Brad Zaun

Representative Thomas Sands, Co-chairperson
Representative Erik Helland
Representative Dave Jacoby
Representative Jeff Kaufmann
Representative Sharon Steckman

MEETING IN BRIEF

Organizational staffing provided by: Michael Duster, Legal Counsel, (515) 281-4800

Minutes prepared by: Michael Mertens, Legal Counsel, (515) 281-3444

I. Procedural Business

Call to Order. The first meeting of the Legislative Tax Expenditure Committee (committee) was called to order at 10:03 a.m. on November 16, 2011, in Room 116 of the State Capitol Building.

Adoption of Rules. Rules of the committee were adopted unanimously by a voice vote.

Adjournment. Upon conclusion of the presentations and discussion by the committee, the meeting was adjourned at 3:25 p.m.

II. Background on Senate File 2380 and the Legislative Tax Expenditure Committee

Mr. Michael Duster, Legislative Services Agency, Legal Services Division, provided background information on the legislation that established the committee including information on the committee's composition, purpose, and duties. Mr. Duster explained that the committee is composed of 10 members and is tasked with reviewing all tax credit, withholding credit, and revenue division programs in order to facilitate the reauthorization of successful programs at a cost that can be accommodated by the state's annual budget. The committee is required by statute to establish and maintain a system to provide the public with information regarding the effectiveness of tax expenditures and the extent to which the tax expenditures comply with the original intent of the legislation that enacted them. The committee is required to submit a report to the Legislative Council for each tax expenditure reviewed. The committee is also required, in conjunction with the Legislative Services Agency and the Department of Revenue, to estimate the cost of each individual tax expenditure and the total cost of all tax expenditures, then provide those estimates by December 15 to the Governor and the General Assembly.

III. State Tax Credits Contingent Liabilities Report

Mr. Jeff Robinson, Legislative Services Agency, Fiscal Services Division, gave a presentation on the history and purpose of the Tax Credit Contingent Liabilities Report. The report was initially created by the Department of Revenue in 2007 for the benefit of the Revenue Estimating Conference. The report is prepared three to four times per year prior to meetings of the Revenue Estimating Conference.

To create the report, the Department of Revenue uses the Iowa tax return credit schedules to calculate actual tax credit redemptions and make future year projections. Mr. Robinson explained the three different methods used to track and project tax credit awards and redemptions. First, tax credits can be tracked by fiscal year based on whether the credits are automatic or awarded by an agency. Second, a contingent liabilities projection can be made based on the assumption that 100 percent of the available credits will be awarded and redeemed. Third, a contingent liabilities projection can be made based on the amount of tax credits that will actually impact each fiscal year. Unlike the projection based on the assumption that 100 percent of available credits will be awarded and redeemed, this third method considers tax credits that are available but never awarded, earned but never redeemed, and earned but not redeemed until a later fiscal year. Mr. Robinson described how the third calculation is the most valuable to the Revenue Estimating Conference due to its reliance on actual fiscal impacts.

IV. Report on the Maximum Aggregate Tax Credit Limit for Certain Economic Development Programs

Mr. Tim Whipple, Legal Counsel, Iowa Economic Development Authority (IEDA), summarized the report he prepared on the maximum aggregate tax credit cap for awards issued by IEDA, formerly the Iowa Department of Economic Development (IDED). The report covered fiscal years 2009-2010, 2010-2011, and 2011-2012.

A. FY 2009-2010

Legislation enacted in 2009 placed a $185 million aggregate cap on specified tax credits and economic development programs. The 2009 legislation placed the following programs and credits under the maximum aggregate tax credit cap: High Quality Jobs; Enterprise Zone and Housing Enterprise Zone; Film Promotion Tax Credit; Corporate Research Credit under the Enterprise Zone Program; and the Assistive Device Credit. For FY 2009-2010, the IDED Board allocated the total amount between the programs, and then later revised its allocation as a result of the suspension of the Film Promotion Tax Credit Program. Mr. Whipple noted that the actual awards for FY 2009-2010 were $104.4 million, which was lower than the statutory $185 million cap.

B. FY 2010-2011

Legislation enacted in 2010 lowered the maximum aggregate tax credit cap from $185 million to $120 million. The actual awards for FY 2010-2011 were $68.6 million. Actual awards during that year were also significantly lower than the allocated amounts for each program.

C. FY 2011-2012

2011 Iowa Acts, ch 118, (HF 590), reorganized and renamed the Department of Economic Development as the Economic Development Authority. Although the maximum aggregate tax credit cap was not changed from $120 million, several new programs were placed under the cap, including the Redevelopment Tax Credit under the Brownfield Program, the Innovation Fund Credit, and the Community-Based Seed Fund Credit. Mr. Whipple noted that through October 2011, $24.9 million in awards have been issued by the Economic Development Authority.

D. Committee Questions and Discussion

Several members of the committee expressed concern that the credits were being underutilized and questioned why the actual amounts awarded under these specific programs are significantly lower than the maximum aggregate tax credit cap of $120 million. Mr. Whipple explained that many of the credits approved by IEDA are declined by applicants for various business reasons. An applicant is required to enter into a contract and meet certain requirements to receive an award. According to Mr. Whipple, businesses are typically aware of the requirements before they begin contract negotiations because they are spelled out in the statutes and administrative rules. However, Mr. Whipple said, many end up reluctant to commit because of overall weak economic conditions and because such businesses do not believe the contract will allow them enough flexibility to make future changes to their businesses.

In response to questions regarding the disparity in the amount of actual awards and the maximum aggregate tax credit cap, Mr. Whipple noted that IEDA has suspended awards under the Film

Promotion Tax Credit Program and recently stopped offering awards for ethanol and biodiesel projects. Consequently, this has expanded the capacity available for the other credits under the maximum aggregate tax credit cap.

V. Searchable Tax Incentive Database Demonstration

Ms. Vicky Clinkscales and Ms. Tina Hoffman, IEDA, provided a demonstration of the Searchable Tax Incentive Database available on the IEDA website. The demonstration detailed the search capabilities and limitations of the website and conducted searches for the committee to demonstrate the types of information provided for each tax incentive recipient. The database provides a description of the source, status, obligations, performance projected, budget, and expenditures for each award. Ms. Clinkscales and Ms. Hoffman stated that the main audience for the IEDA website is outside businesses interested in making an investment in Iowa, but that the website is also important to provide accountability and transparency to Iowa's citizens and the General Assembly. The database is searchable through the use of several different categories such as year, project status, lead program, lead funding source, city, county, or company name. The database currently has information on awards from July 2003 to June 2010.

VI. Review of the Iowa Earned Income Tax Credit

Mr. Zhong Jin, Iowa Department of Revenue, presented information on both the federal and Iowa earned income tax credits. The federal Earned Income Tax Credit was introduced in 1975 as a way to offset the payroll tax for low-income households. The federal Earned Income Tax Credit has gone through several changes since its inception. The credit is currently refundable and computed using specific criteria including earned income, filing status, and number of dependents. The amount of the credit increases based on the credit's criteria, up to certain amounts of income then decreases until it completely phases out at higher income levels. In tax year 2009, there were 26.5 million households that claimed the federal Earned Income Tax Credit for a total of $59 billion.

Iowa enacted an earned income tax credit in 1989 as a way to supplement income for working families. It was originally a nonrefundable credit of 5 percent of the federal credit. In 1991, the Iowa earned income tax credit was increased to 6.5 percent of the federal credit. In 2007, the Iowa earned income tax credit was made refundable and increased to 7 percent of the federal credit.

In addition to Iowa, 21 other states and the District of Columbia currently offer an earned income tax credit. Of these, all but Delaware, Maine, and Virginia offer a refundable credit. The rates of such credits range from 3.5 percent to 43 percent of the federal credit. The median rate and median annual credit amount are 19 percent and $1,048, respectively. The rates for Iowa's four closest neighbors offering an earned income tax credit are 6 percent in Illinois, 33 percent in Minnesota, 25 percent in Nebraska, and a varying rate of 4 to 43 percent in Wisconsin.

The committee was also provided with the statistical composition of Iowa's earned income tax credit claims for the tax year 2009. There were 208,342 Iowa households that claimed the credit. The total amount of those claims was $28.5 million. The major reason claimants begin or cease claiming the earned income tax credit is because of a change in earned income. The presentation emphasized that while taxpayers with a single filing status made up 26 percent of the total household claims, they received only 10 percent of the total dollar amount. It was also noted that the percentage of claims by income group is skewed toward the middle of the income distribution curve, with almost 60 percent of all claimant households falling within the $10,000 to $24,999 income range. The 2007 statutory change to the Iowa earned income tax credit had the result of doubling both the total amount of claims and the number of claimants of the credit. This change also resulted in an estimated $14.6 million increase in claims in 2009, largely the result of the credit becoming refundable. Mr. Zhong Jin also provided information on the credit's impact on poverty. For the 2009 tax year, 103,752 of the 208,342 claimant households were considered in poverty according to federal poverty guidelines. While the Iowa earned income tax credit reduced a claimant's total amount below poverty, on average it only raised claimants in the $15,000 to $19,999 income range out of poverty.

The committee engaged in a discussion of the benefits, consequences, and limitations of the earned income tax credit. Members stated that the refundable nature of the credit has the consequence of removing a certain number of people from the state's tax rolls, but also provides incentive and support to working taxpayers because it is tied to earned income.

VII. Review of the Iowa Franchise Tax Credit

Ms. Angela Gullickson, Iowa Department of Revenue, presented information on the Iowa franchise tax credit. The credit was created in 1997 to prevent double taxation on shareholders of certain financial institutions. The Iowa franchise tax is a tax imposed on financial institutions conducting business in Iowa at a rate of 5 percent of net income. Some financial institutions are organized as S corporations, which pass through their income to shareholders who pay tax at the individual level. In order to prevent double taxation on these taxpayers, the franchise tax credit is allowed and equal to the smaller of Iowa tax liability on the pass-through financial institution income or the shareholder's share of franchise tax paid. It is available against corporate and individual income taxes and is nonrefundable, nontransferable, and cannot be carried forward to future tax years. Since 2006, the credit has been claimed an average of 2,420 times per year for an average total amount of credits of $12.25 million. This $12.25 million average represents approximately 40.3 percent of the total net franchise tax revenues for the state. The majority of credit claims are made against individual income tax. An average of 11.4 percent of the available credits are unclaimed and expire each year, most often because the taxpayer has insufficient income to claim against the credit or because the taxpayer is unaware they qualify for the credit.

VIII. Review of the High Quality Jobs Program

Mr. Whipple, Legal Counsel, IEDA, summarized the IEDA report on the High Quality Jobs Program. The full report, which was provided to the committee, is broken down into several different sections.

A. History

The High Quality Jobs Program is a flexible program allowing IEDA to provide various forms of tax incentives to eligible businesses that meet certain job creation and capital investment requirements. Mr. Whipple stated that the High Quality Jobs Program is not the first program in the state to connect tax incentives for businesses with job creation and capital investment. The New Jobs and Income Program, created in 1994, is considered to be the predecessor to the High Quality Jobs Program. In 2005, the New Jobs and Income Program was revised and eventually came to be known as the High Quality Jobs Program.

B. Core Eligibility Requirements

Mr. Whipple explained the seven core eligibility requirements for participation in the High Quality Jobs Program. First, the business must have a willing local community as a partner. In the case of projects with a capital investment of $10 million or more, the community must approve the location and expansion. Second, the business must not be engaging in an intrastate relocation, meaning it cannot close or substantially reduce its operations in one area of the state in order to move to another area. Third, the business must meet certain wage threshold and job creation or retention requirements. More specifically, each business enters into a contract with IEDA to create or retain a certain number of jobs. These created and retained jobs must be maintained at specified wage levels depending on the type of job and the project's proximity to completion. Fourth, the business must provide a sufficient package of benefits for new jobs, as set by the IEDA board. Currently, a sufficient benefits package is either 80 percent of a single health insurance plan's premium cost or 50 percent of a family health insurance plan's premium cost. A package is also considered sufficient if it provides some sort of medical insurance coverage and furnishes the monetary balance of the amounts above in the form of other benefits. Fifth, the project must provide a sufficient "fiscal impact ratio" to justify the incentives. Mr. Whipple provided a short history of how the "fiscal impact ratio" was developed and how it is used. In short, it is a forward-looking metric which is calculated by estimating the amount of taxes to be received from a business over the next 10 years and dividing that estimate by the amount of financial incentives to be provided to the business. Sixth, the business cannot be a retail business or have a history and practice of violating state laws. Seventh, IEDA considers the overall quality of the project by evaluating the quality of the jobs created, the impact of the project on other businesses in competition with the project, and the current and future economic impact to the state.

C. Available Incentives

Mr. Whipple summarized the six different tax incentives available under the program. First, a business may receive a refund of the sales and use taxes it pays on certain qualifying items. Second, a business may qualify for a third-party sales tax credit for certain sales taxes paid by certain third-party developers with whom the business has a relationship. Third, a participating community may exempt any business improvements from property taxation for a period of up to 20 years. Fourth, a business may qualify for an investment tax credit on a certain percentage of new investment directly related to the project's jobs. Fifth, businesses subject to the insurance premiums tax may be eligible for an insurance premiums tax credit equal to a certain percentage of a new investment directly related to the program's jobs. Sixth, if the business is increasing research and development activities in the state, it may be eligible for a supplemental research activities tax credit in addition to the other Iowa research activities credit.

D. Incentive Schedule and Administration

Mr. Whipple explained the schedule used to determine the amount of total incentives that may be awarded for a project and how IEDA administers each project. In general, the more jobs that are created and the more capital invested, the more incentives a business is eligible to receive. IEDA reviews potential projects for compliance with the program's requirements and completes a fiscal impact analysis for each potential project, then negotiates and contracts with each business to determine the total incentive package. In determining whether to accept a project, IEDA considers the level of need, the quality of the jobs including what percentage of the jobs are high-quality jobs, the economic impact, and the return on investment to the state using the calculated fiscal impact ratio.

IEDA also attempts to ensure there is some form of local match supporting the project so local communities have a stake in the project's success. The local match may come from a variety of different entities and may be in many forms, though tax increment financing is used in the majority of projects funded by the program.

After a contract is signed the business enters into a three-year performance period during which it performs its obligations and receives an annual tax credit certificate. After the end of the third year a compliance determination is made. This is followed by a two-year maintenance period during which the business is required to maintain its obligations under the contract and receives annual tax credit certificates. At the end of the two-year maintenance period another compliance determination is made by the IEDA and the business may be issued a letter of default and referred to the Iowa Department of Revenue for failing to fully perform its contractual obligations.

E. Evaluating the Performance of the High Quality Jobs Program

Mr. Whipple provided an explanation and analysis of the High Quality Jobs Program's performance, which is required to be reviewed by the committee under Iowa Code section 2.48. In order to provide a background and a historical context, Mr. Whipple discussed the Declaration of Policy for the New Jobs and Income Act, the predecessor of the High Quality Jobs Program. He stated that the Declaration of Policy was still relevant to any consideration of the current program's performance.

Mr. Whipple then proposed a method for calculating the state's return on investment, which by statute must be done by analyzing both the cost to the state and the benefits realized by the state. According to Mr. Whipple, however, many factors make it difficult to accurately measure the cost to the state, but suggested using the total awards granted. Mr. Whipple believes using this metric is a conservative approach because it represents the upper limit on the potential cost of the program. The total awards granted under the program between 2004 and September 2011 was $581,803,723.48.

Mr. Whipple also discussed the difficulty in determining the benefits to the state because of the numerous factors involved. Mr. Whipple stated that one possible method is to use the sum of the total contracted amount of capital investment, wage levels, and jobs created and retained. Mr. Whipple believes these numbers represent the most reliable and least speculative measure of the benefits accruing to the state. To date, projects under this program have made $7,426,264,452 in capital investments and created 13,820 jobs with an average wage level of $21.71. In order to calculate the return on investment using these figures, Mr. Whipple suggested taking the cost of the incentives as a proportion of the capital investment and jobs created. According to this formula, the High Quality Jobs Program has leveraged $19.26 in capital investment for every dollar of tax incentives provided. Although this formula produces a reliable figure, Mr. Whipple does not believe it accurately measures a complete cost or return or investment to the state.

Alternatively, Mr. Whipple proposed using an aggregate of the fiscal impact ratio discussed above. Mr. Whipple stated that the aggregate fiscal impact ratio for all active or completed projects through June 2011 was 1.95 to 1. In other words, IEDA estimates that for every $1 of incentives provided under the High Quality Jobs Program, $1.95 has been returned to the state treasury in increased tax revenues. Finally, Mr. Whipple directed the committee to the report's two appendices which provide a detailed list of the High Quality Jobs projects and information on the creation of the fiscal impact ratio model.

F. Committee Discussion and Questions

Certain committee members questioned the assumption made in the fiscal impact ratio's calculation that a project will not be completed unless state assistance is provided. Committee members expressed concern that such an assumption may lead to an inaccurate result because some projects may in fact be completed without state assistance. Some committee members believe that a more accurate calculation may be to determine the marginal benefit of the state's assistance. Mr. Whipple acknowledged that the fiscal impact ratio is not a full economic impact analysis; it is used instead to compute the impact to state revenue. Mr. Whipple stated that a true economic impact calculation may be difficult because some of the tax incentive programs have a social responsibility component and are not quantifiable in dollars. As an example, he referenced the Brownfield Redevelopment Program, which provides economic development assistance for environmentally contaminated areas.

IX. Review of Iowa Research Activities Tax Credit

Ms. Amy Rehder Harris, Iowa Department of Revenue, gave a presentation on the federal research activities credit and the Iowa research activities credit. The federal research activities credit was introduced in 1981 as a nonrefundable, automatic credit. The federal research activities credit is temporary, but has been renewed by Congress 14 times. The credit is equal to 20 percent of a taxpayer's incremental qualified research expenditures, which is calculated using eligible expenditures above a specified base for research that is experimental, technological, or done with the goal of developing a new product or process. In the alternative, taxpayers may calculate their credit using the simplified method, which is equal to 14 percent of qualified research expenditures that exceed 50 percent of the taxpayer's average qualified research expenditures over the previous three years.

Iowa introduced a research activities credit in 1985 to encourage research activity in the state and benefit from the economic activity that follows. In contrast to the federal credit, Iowa's credit is refundable, which has the consequence of providing support to businesses engaging in research in Iowa even if they have no state tax liability. The credit was made permanent in 1991. It is calculated using the definitions found in the federal research activities credit and is equal to 6.5 percent of incremental qualified research in Iowa. Like the federal research activities credit, taxpayers may instead claim the alternative simplified credit under Iowa Code section 15.335, with percentages based on the amount of gross revenue.

To put Iowa's credit in perspective, Ms. Harris provided statistics on the 36 states that currently offer a research credit. Twenty states, including Iowa, rely on the federal credit rules. The credit rates range from a low of 1.25 percent to a high of 25 percent, with the most common rate being 10 percent. Besides Iowa, only Louisiana, Minnesota, Nebraska, New York, and Virginia offer refundable credits. In terms of total research conducted, Iowa ranks 31st nationally and fifth out of the seven closest neighboring states. Iowa's credit claims have increased since 2002 when the credit was made available to individuals in addition to C corporations. However, in terms of dollars, the overwhelming majority of credit claims are still made by C corporations. Ms. Harris noted that since 2006, over 90 percent of credit claims by C corporations are made as refund requests, with between 60 and 70 percent of all corporate claimants receiving some refund. Such percentages are significantly lower for individual claimants, with the percentage being between 20 and 30 percent for both figures.

Research activities credit claims are not only concentrated by filing type, they are also concentrated by industry and size. Since 2006, almost 80 percent of credit claims come from large companies with 500 or more employees. Also, almost 90 percent of claims come from the manufacturing industry, with the three biggest subgroups being machinery, transportation equipment, and chemical manufacturing.

Total annual research expenditures since 2006 have averaged almost $1.19 billion, which equates to an average of $50.7 million in annual credits, or $0.043 of credit per research dollar. Claimants' research expenditures are concentrated as follows: 66.8 percent in wages, 22.8 percent in supplies, 0.3 percent in computers, and 10.1 percent in contract research. Ms. Harris confirmed that contract research must be conducted in Iowa to qualify for the credit.

Next, Ms. Harris shared the results of a 2011 research activities credit survey conducted by the Iowa Department of Revenue. Ms. Harris explained with whom the survey was conducted, what questions were asked, and what answers were received. In general, the survey looked at reasons why some companies conducting research were not claiming the credit, the employment characteristics and research decisions of those claiming the credit, where multistate companies were conducting other research, and the relationship of Iowa research to Iowa production and sales.

Finally, Ms. Harris presented a hypothetical firm analysis intended to demonstrate how an average large research firm would benefit from research activities credits in other states as compared to Iowa. Comparison states were chosen based on their proximity and relationship to Iowa as well as their use of the research activities credit. The analysis compared such things as total corporate tax liability, credit availability, and wage levels. Analysis of a firm with high wage expenditures found that, when comparing wage levels and research credits with other states, Iowa provided more cost savings than all comparison states except South Dakota.

The committee then engaged in a discussion about the research activities credit. The committee questioned whether a state research activities credit actually promotes additional research by Iowa companies. Ms. Harris replied that analysis suggests state research activities credits do not increase research on a national level, but instead foster competition between the states for available business.

Some members voiced their support for the credit and stated that it, along with Iowa's highly educated and skilled workforce, provides a valuable incentive to do business in the state. The committee also questioned if more should be done to focus the credit on start-up businesses and other small research companies.

X. Committee Discussion

Committee members discussed the possibility of scheduling another meeting to review the statutorily required tax expenditures because of the credits' high cost and importance. Finally, the committee discussed the committee's requirement to submit tax expenditure reports to the Legislative Council and cost reports to the Governor and General Assembly. The committee noted that the cost estimates already being provided by the Legislative Services Agency and the Department of Revenue in connection with the meetings of the Revenue Estimating Conference and the state budgeting process are largely duplicative of that which is required of the committee under Iowa Code section 2.48.

XI. Materials Filed with the Legislative Services Agency

The following materials listed were distributed at or in connection with the meeting and are filed with the Legislative Services Agency. The materials may be accessed from the link on the committee's website:

http://www.legis.iowa.gov/Schedules/committee.aspx?cid=511

1. Background on S.F. 2380—Legislative Services Agency
2. Tax Credits Contingent Liability Report—Legislative Services Agency
3. Report on Maximum Aggregate Tax Credit Limit—Economic Development Authority
4. Earned Income Tax Credit Report—Iowa Department of Revenue
5. Franchise Tax Credit Report—Iowa Department of Revenue
6. High Quality Jobs Program Report—Economic Development Authority
7. High Quality Jobs Program Presentation—Economic Development Authority
8. Research Activities Tax Credit Report—Iowa Department of Revenue

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