REPORT OF THE LEGISLATIVE TAX EXPENDITURE COMMITTEE TO THE LEGISLATIVE COUNCIL
June 2012

Meeting: Members of the Legislative Tax Expenditure Committee of the Legislative Council met on November 16, 2011.

Tax Expenditure Review: The committee received presentations and conducted a review of all of the following:

I. Legislative Tax Expenditure Committee Creation and Duties

Mr. Michael Duster, Legislative Services Agency, Legal Services Division, provided background information on the 2010 legislation that created the committee including information on the committee's composition, purpose, and duties. Code section 2.48 required the committee to review the Iowa earned income tax credit, the Iowa franchise tax credit, the High Quality Jobs Program, and specified research activities tax credits in 2011.

II. 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.

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

Mr. Tim Whipple, Legal Counsel, Iowa Economic Development Authority (IEDA), presented and 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.

IV. 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.

V. 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 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 claimants of the credit. It was originally a nonrefundable credit equal to 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 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.

VI. 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 and is imposed 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. The tax credit is equal to the lesser of Iowa tax liability on the pass-through financial institution income or the shareholder's share of franchise tax paid. The credit 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 per year.

VII. Review of the High Quality Jobs Program

Mr. Whipple, Legal Counsel, IEDA, summarized the IEDA report on the High Quality Jobs Program. 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 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. 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. Fourth, the business must provide a sufficient package of benefits for new jobs, as set by the IEDA board. 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. 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.

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.

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. 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.

Mr. Whipple provided an explanation and analysis of the High Quality Jobs Program’s performance. Mr. Whipple then proposed a method for calculating the state’s return on investment 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 and benefits to the state.

VIII. Review of Research Activities Tax Credits

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 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 conducted 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. 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.

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. Iowa's credit claims have increased since 2002 when the credit was made available to individuals in addition to C corporations. However, 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) refund requests and refunds paid.

Research activities credit claims are concentrated by filing type, 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.

Ms. Harris also 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.

Respectfully submitted,

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Senator Joe Bolkcom, Co-chairperson

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Representative Thomas R. Sands, Co-chairperson

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