REPORT OF THE LEGISLATIVE TAX EXPENDITURE COMMITTEE
TO THE LEGISLATIVE COUNCIL
June 25, 2018

I. Committee Proceedings

The Legislative Tax Expenditure Committee conducted one meeting at the Statehouse during the 2017 interim on Monday, November 27, 2017.

II. Tax Expenditure Review

The committee received presentations and conducted a review of the following:

A. Targeted Jobs Withholding Tax Credit

Mr. Paul Stueckradt, Iowa Economic Development Authority (IEDA), summarized the targeted jobs withholding tax credit (TJC), which was enacted in 2006 as a pilot program to help Iowa border cities, within the city's urban renewal areas, compete with cities in neighboring states in attracting business investment and creating new jobs. The program allows up to 3 percent of gross wages paid by an eligible employer to be directed to pilot cities on a quarterly basis for up to 10 years. An eligible employer must be relocating to Iowa from another state and creating jobs at or above the hourly wage threshold for the city, or must be an existing Iowa business creating or retaining at least 10 jobs at or above the hourly wage threshold for the city, or must be an existing Iowa business making a qualifying investment of $500,000 within a pilot city.

Funds are to be used by the pilot city for "a project related to the employer." Typically, the funds are returned to the business for use in an expansion or relocation project. An amount of the credit must be matched by a private donor, the pilot city, the business, or a combination of the three. If the project will increase the city's tax revenues, the pilot city is required to contribute at least 10 percent of the required match.

The pilot project had an initial sunset date for new agreements of 2010, but was later extended to June 30, 2013. Changes to the program in 2009 included a requirement that the maximum amount of withholding tax credits awarded be specified in the withholding agreement and cannot exceed the qualifying investment, an IEDA authorization to approve or deny a withholding agreement if the agreement fails to meet the statutory requirements of the program, a prohibition on cities using the program to compete for jobs against other Iowa cities, and reporting requirements for cities detailing the amount of payments, jobs created or retained, and investment by the employer. In 2011, the program was expanded to allow an award of credits to businesses for retained jobs. Additional changes to the program in 2013 included elimination of the requirement that the employer be located within an urban renewal area, increased oversight by IEDA, and extension of the sunset to June 30, 2018.

According to Mr. Stueckradt, the most significant changes to the program have involved increased oversight by IEDA including a requirement that the IEDA Board approve awards, authorization for IEDA to negotiate the terms of the award, the requirement that IEDA be a party to the agreement, and IEDA's responsibility for assessing compliance for retained jobs after 18 months and for created jobs and investment after three years. Program agreements in the past were 10 years in length but following recent changes the length of the agreements are now negotiated and are typically between five and 10 years.

Dr. Zhong Jin, Senior Fiscal Policy Analyst, Tax Research and Program Analysis Section, Iowa Department of Revenue (IDR), summarized comparable programs from other states. Dr. Jin noted that the results of IDR's analysis are preliminary and that final results would be in a forthcoming report by IDR. In determining whether another state's program is comparable, Dr. Jin looked to whether the program is refundable or otherwise not limited by the business's income tax liability, whether the program includes a jobs component, and whether the tax credit is calculated as a percentage of the payroll of the associated jobs. Using those criteria, Dr. Jin identified 17 states that have similar programs, including neighboring states Nebraska, Missouri, and Illinois. Nebraska offers a credit of between 3 and 6 percent of the gross wages of the qualified employees, and Missouri provides a credit based on 100 percent of the individual income tax withheld for qualified employees.

Dr. Jin provided data on the TJC awards during the program's history, provided data on the number of jobs and the amount of investment pledged by participating businesses in each of the pilot cities, and provided a case study on the competition for health care investment in Sioux City. Dr. Jin also summarized an incidence analysis as to which persons receive the tax savings or share in the benefits resulting from the credit.

B. Innovation Fund Investment Tax Credit

Ms. Jenny Klein, Legislative Liaison and Compliance Counsel, IEDA, provided an overview of the Innovation Fund Investment Tax Credit Program. The tax credit is available to investors who invest in a certified innovation fund. The investment must be in the form of cash for equity. The credit amount is 25 percent of the investor's equity investment. The program has a total of $8 million available every fiscal year, under the $170 million IEDA tax credit cap. A tax credit issued under the program is transferable one time and has a five-year carryforward. Additionally, investors are not permitted to receive a credit for the same investment in a qualifying business.

Prior to the 2013 Legislative Session, no innovation funds sought certification and no credits were issued. The 2013 statutory changes increased the tax credit from 20 percent to 25 percent, allowed taxpayers to claim the tax credit for the tax year in which the investment is made rather than waiting for three tax years after the investment was made, made the credit transferable one time, and added additional eligibility requirements for innovation fund certification. To be eligible, a fund must invest in businesses with a principal place of business in Iowa that are early-stage companies or innovation businesses (advanced manufacturing, biosciences, or information technology). The fund must also seek to secure private funding sources for its investments, must provide multiple rounds of funding and early-stage private sector funding to innovative businesses with a high growth potential, and must focus on businesses that show a potential to produce commercially viable products or services within a reasonable period of time.

Additional requirements for potential certified funds include a requirement for a rigorous evaluation approach of all prospective investments, a collaborative relationship with the Regents institutions, and a collaborative relationship with IEDA and other state and local development entities. Finally, the fund must obtain at least $15 million in binding investment commitments within a year of certification and it must invest at least $15 million in Iowa companies. Currently, the two certified innovation funds are Next Level Ventures Fund I, LLLP and River Glen Capital Partners. River Glen Capital Partners has met the certification requirements but has yet to receive the $15 million in minimum investment.

IEDA proposed extending the sunset date for certification of new funds five years from June 30, 2018, to June 30, 2023, and proposed shifting some of the $8 million per fiscal year allocation to angel investor tax credits (Iowa Qualifying Business Investment Tax Credit).

Mr. Aaron Barker, Fiscal and Policy Analyst, Tax Research and Program Analysis Section, IDR, provided an overview of the venture capital market in the United States and of similar active investment tax credits offered by other states. Mr. Barker also outlined the current Iowa qualifying business investment tax credit (also referred to as the angel investor tax credit). Mr. Barker then provided the committee information on investments by certified innovation funds and data on innovation fund tax credit awards, transfers, and claims. Finally, Mr. Barker described a state-by-state analysis of investment incentive tax credits.

C. Iowa Fund of Funds Program

Dr. Amy Rehder Harris, Administrator and Chief Economist, Tax Research and Program Analysis Section, IDR, provided a history of the Iowa Fund of Funds Program, described the structure of the program, and updated the committee on the program's current status. The program was established in 2002 to encourage venture capital investment, increase business development in Iowa, create jobs, diversify the state's economy, and leverage funds for venture capital investment with state backing through tax credits.

The Fund of Funds is invested in a portfolio of private venture capital funds. Dr. Rehder Harris noted the difference in investment structure compared to the Innovation Fund Investment Tax Credit Program, which invests directly in businesses. Each portfolio fund made a commitment to consider equity investments in Iowa businesses and maintain a physical presence within Iowa, while innovation funds must invest in startups with a principal place of business in Iowa. The fund of funds tax credits were contingent, while the innovation fund tax credits result from every investment.

The program consisted of several entities and actors. The Iowa Capital Investment Board, a public entity with five voting and four nonvoting members, was responsible for establishing the contingent tax credits to back investments in the Iowa Fund of Funds, Fund A, LLLP (Fund). The Iowa Capital Investment Corporation, a 501(c)(3) tax-exempt entity, acted as the general partner of the fund, selected the fund manager (Cimmaron Capitol Associates I, LLC), received returns for reinvestment, and had no financial interest but was eligible for annual management fees. Finally, Iowa Designated Investor, Inc., was a preferred limited partner within the fund and was the entity which made the investments in the fund and held the contingent tax credits.

The amount of $100 million in contingent tax credits was originally authorized, with not more than $20 million being redeemable in any single fiscal year. The contingent tax credits were limited to an amount equivalent to any difference between the scheduled rate of return authorized by the Iowa Capital Investment Board and the actual return received. To date, $26 million has been invested for the fund in venture capital funds. The investments were funded by a revolving loan with contingent tax credits as collateral. In 2010, the tax credit cap was reduced from $100 million to $60 million. In February 2011, $57 million in contingent credits were issued to secure the $40 million revolving line of credit with a February 22, 2012, maturity date.

However, in fall 2011, the fund's board learned that lenders might not renew the line of credit. Administrative rules relating to the requirements for issuance of the credits went into effect following a challenge by the banks. Following a maturity date extension and the fund defaulting on the line of credit, the lenders and the fund entered into negotiations. IDR and the Iowa Attorney General's Office assisted in the agreement negotiations. The resulting agreement cures the loan default, avoids an immediate call on the full $57 million in contingent credits at $20 million per year, includes a seven-to-nine-year restructuring of financing for the existing investment portfolio, preserves the $26 million investment portfolio, caps future fund expenses, and creates a second lien in favor of the state for redeemed tax credits.

In addition, the agreement provides for no new partners in the fund, no new portfolio investments, no expansion of investments as of December 2011, and provides for distributions to lenders to satisfy loans. The agreement provides that a total of $25.6 million in tax credits will be redeemed, but the redemption is limited to $4 million each year. The fund will expire no later than December 2027, instead of 2052.

As part of the winding down process for the Iowa Fund of Funds, $11.3 million in tax credits was issued and transferred in FY 2012-2013, $12.8 million in tax credits was issued and transferred in FY 2013- 2014, and $1.1 million in tax credits was issued and transferred in both FY 2015-2016 and FY 2016- 2017. In December 2016, the last tax credit certificate was issued and transferred. Starting in July 2017, the bank loan was retired and the state's repayment period began. The state's lien against the Fund is $30.5 million, accounted for as $25.2 million in tax credits, $0.3 million in fees, and $5.0 million to date in interest. The future payouts from funds will accrue to the state; however, there is uncertainty in venture capital markets and whether the state will be made whole.

D. School Tuition Organization Tax Credit

Dr. Anthony Girardi, Senior Fiscal and Policy Analyst, Tax Research and Program Analysis Section, IDR, summarized Iowa's school tuition organization (STO) tax credit that was enacted in 2006 and provided data on the tax credits and tuition grants awarded to date. The nonrefundable tax credit is awarded to taxpayers who make voluntary cash contributions to one of 12 qualifying STOs that provide tuition grants for private schools to specified low-income students in Iowa. An STO is required to represent more than one school. A contribution cannot, however, directly benefit any student designated by the taxpayer. The tax credit equals 65 percent of the contribution.

STO tax credits are capped at a total of $12 million for tax year 2017 and subsequent tax years. The cap has been raised three times since the program's first full year of existence. The overall tax credit cap is allocated among STOs based on enrollment at represented schools. Tax credit claims are allowed against the individual income tax and, since 2009, the corporation income tax. The law allows each STO to award up to 25 percent of allocated tax credits to corporate donors. The tax credits are nontransferable and nonrefundable, but do allow a five-year carryforward. Persons claiming the tax credit who are nonresident or part-year residents must apportion the credit and any portion of the tax credit apportioned to out-of-state income cannot be claimed or carried forward. The STO tax credit is the only awarded tax credit with this treatment. In 2015, there were 24 awards to nonresident individuals totaling $111,000; tax credits subject to this treatment totaled $44,000.

Under Iowa law, each STO must be a 501(c)(3) charitable organization, allot at least 90 percent of the annual revenue to tuition grants, and register with IDR. As of 2017, there were 12 STOs representing 146 schools with a total enrollment of 33,740. The STOs represent about 99 percent of the private school children in Iowa.

Dr. Girardi provided information on similar tax credit programs in other states, provided a history of the issuance of tuition grants, and provided data and analysis on tuition grant recipients and on the historical trends for the share of tuition grant dollars provided to categories of income and the average amount of tuition grants based on income category. Finally, Dr. Girardi examined whether tuition grants funded through state tax credits save state money through lower public education spending by calculating the estimated net fiscal impact.

E. Funding of Urban Renewal Projects with Increased Local Option Sales and Services Tax Revenues

Dr. Girardi provided an overview of the structure and use of funding of urban renewal projects by cities with increased local sales and services tax revenues, commonly referred to as Local Option Sales Tax (LOST) Tax Increment Financing (TIF). To be eligible, a city must have a LOST ordinance in effect and must have established an urban renewal area. Generally, an urban renewal area is a slum area, blighted area, economic development area, or combination of the areas which the local governing body designated as appropriate for an urban renewal project. Other states that authorize similar programs include Colorado, Connecticut, Illinois, Kansas, Kentucky, Mississippi, Missouri, New Jersey, Oklahoma, Pennsylvania, Tennessee, Texas, Utah, and Washington, as well as the District of Columbia.

A city may, by ordinance of the city council, create a LOST TIF district for the purpose of funding projects located within an urban renewal area. However, since 2012, a city must have prior approval of the county. The city council designates the amount of increased LOST revenue collected from the area to be used, which may be all or a portion of total increased LOST revenues. A LOST TIF remains in effect until the urban renewal area designation ends, or 20 years after the base year, whichever is earlier. The LOST distribution for the county based on the statutorily prescribed formula based on population and specified historical property tax revenue collected is reduced by the amount of the increment. The other cities and unincorporated area of the county imposing the LOST will continue to receive only the base year amount from sales in the LOST TIF district as long as the LOST TIF is in effect.

The cities of Spencer, Davenport, Stuart, and Red Oak have established a LOST TIF in Iowa. Dr. Girardi provided the current distribution percentages for LOST revenue for those counties in Iowa that have a LOST TIF. Dr. Girardi explained the administration of a LOST TIF and provided a hypothetical example of distribution of LOST revenue and the impact of a LOST TIF. The amount of LOST revenue diverted for urban renewal projects has grown during the years of 2014 through 2017, but remains a small percentage of the total LOST revenue in those counties.

Cities with LOST TIFs report various purposes for the revenue, including attracting new retail development as part of a broader strategy of mixed economic development, attracting new tenants to vacant retail space, and helping with the renovation of existing retail stores. Dr. Girardi identified some of the criticisms of the program from the Iowa State Association of Counties and the Iowa Policy Project. Dr. Girardi stated that cities generally regard LOST TIF as a helpful tool in a broader development strategy.

F. Tuition and Textbook Tax Credit

Mr. John Good, Fiscal and Policy Analyst, Tax Research and Program Analysis Section, IDR, summarized Iowa's Tuition and Textbook Tax Credit. The tax credit is equal to 25 percent of the first $1,000 of eligible education expenses per dependent. Qualified expenses include tuition, textbooks, fees, and equipment; however, homeschooling expenses do not qualify. To be eligible, the dependent must be in grades kindergarten through 12th grade at an accredited Iowa school. The tax credit is nonrefundable and there is no carryforward.

During the period of time from 1999 through 2005, the number of claimants and the total amount of tax credits claimed rose steadily, but both have leveled off for the 10 years since 2005. In 2015, there were 118,348 households (258,409 eligible dependents) that claimed the tax credit for a total of $15.5 million in tax credits. The average tax credit claim was $131 per household and 8.2 percent of those households claimed the $250 maximum per dependent, accounting for $4.3 million or 27.7 percent of 2015 tax year tax credits. Mr. Good analyzed the distribution of tax credit claims by household income level, number of dependents, and geographic distribution. Mr. Good noted that 33.8 percent of households claim the tax credit among all Iowa households with dependents between age five and age 21. Although many of those households may not have eligible students, still many households may likely be missing the tax benefit. The highest utilization rates of the tuition and textbook tax credit appear to coincide with the location of private schools. The school district area with the highest utilization rate (56.3 percent) is Pella. The school district area with the highest number of tax credit claims (5,932) is Des Moines. The school district area with the highest average tax credit amount ($354) is Rock Valley. The school district area with the highest average tax credit amount per pupil ($163) is Boyden-Hull.

III. 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 "Committee Documents" link on the committee's Internet Site: www.legis.iowa.gov/perma/051120171679

1. Innovation Fund Tax Credit 2017, Department of Revenue.
2. Innovation Fund Tax Credit 2017, Economic Development Authority.
3. Iowa Fund of Funds Program 2017, Department of Revenue.
4. Local Option Sales Tax Increment Financing 2017, Department of Revenue.
5. School Tuition Organization Tax Credit 2017, Department of Revenue.
6. Targeted Jobs Withholding Tax Credit 2017, Economic Development Authority.
7. Targeted Jobs Withholding Tax Credit 2017 REVISED, Department of Revenue.
8. Tuition and Textbook Tax Credit 2017, Department of Revenue.
9. Tuition and Textbook Tax Credit Brief, Department of Revenue.
10. Volunteer Firefighter, EMS, & Reserve Peace Officer Tax Credit Brief, Department of Revenue.
11. Farm to Food Donation Tax Credit Brief, Department of Revenue.

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Respectfully submitted,

Senator Randy Feenstra,
Co-chairperson

Representative Guy Vander Linden,
Co-chairperson