Perks for the Most Profitable

Research Credits: Iowa Tax Policy Gone Awry

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Iowa Fiscal Partnership

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Iowa Fiscal Partnership

The Iowa Fiscal Partnership is a joint initiative of the Iowa Policy Project and the Child & Family Policy Center, two nonprofit, nonpartisan Iowa-based organizations that cooperate in analysis of tax policy and budget issues facing Iowans. IFP reports are available at http://www.iowafiscal.org.

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Introduction

Tip of the Iceberg: *The General Assembly's Microsoft Tax Package*

Iowa legislators have just enacted a new tax package that seeks to lure Microsoft to the state with sales tax and property tax exemptions. The Iowa Fiscal Partnership recently reported on the explosive growth of such tax credits in Iowa, indicating that state government needs to be very selective in the adoption of new credits and to exert more scrutiny on the use of existing ones. Since 2000, Iowa has adopted over 20 new tax credits, costing the state treasury literally hundreds of millions of dollars and potentially eroding the state's long-term ability to fund essential services. (See: *Giving Away the Farm*, <http://www.iowafiscal.org/2008docs/080226-giveaways-bgd.pdf>.)

Tax exemptions for Microsoft come in addition to several existing and troubling tax credits already on the books in Iowa. The actual credits made available by this Microsoft legislation could be only the tip of the iceberg of the tax credits that Microsoft will eventually receive, since the company will also be eligible for other tax credits such as the Research Activities Credit (RAC). The Microsoft tax package points to the need to re-examine the use of RACs, in particular, and to place some limits on the refundability of that credit (See: *No More Secret Checks*, <http://www.iowafiscal.org/2008docs/080130-RAC-bgd.pdf>.)

Lurking Below the Surface

The Research Activities Credit

As IFP has reported, in 2005 the Research Activities Credit (RAC) as applied to corporations cost the state treasury $37.1 million, with the 10 largest corporate claims receiving $31.6 million, or 85 percent of that amount. Iowa is nearly alone among states in providing for "refundability" of this credit, so corporations do not need to owe any Iowa taxes to receive RAC benefits. In fact, those 10 corporations combined owed less than $2 million in corporate income taxes in Iowa,[1] so these corporations not only had any taxes they owed forgiven, but they each received on average a cool $3 million check in what amounts to a direct public subsidy. Since such tax information is confidential, this amounts, in essence, to writing "secret checks" to these corporations from the state treasury, with no accountability or assurance that they meet a public purpose.

The only information that currently can be obtained regarding the beneficiaries of these credits is that corporations can apply for, and receive, a supplemental RAC credit (allowing a total credit up to double the size of the regular credit) through the Iowa Department of Economic Development (IDED). When corporations receive a supplemental credit, IDED information on that supplemental credit becomes public record. Two corporations that have received such supplemental research activities credits are discussed as case examples here — Whirlpool Corporation and Rockwell Collins.

Whirlpool Corporation and the RAC

Case Example No. 1

In August of 2005, Whirlpool Corporation announced a merger agreement with Maytag Corporation, located in Newton, Iowa. The Iowa Department of Economic Development worked with Whirlpool Corporation managers on a package of tax breaks and incentives, designed to encourage Whirlpool to continue operation of Maytag activities in Iowa. Among these incentives was a supplemental RAC of up to $1.5 million that would match regular qualifying RAC benefits of at least an equal amount. Whirlpool Corporation completed a $2.6 billion acquisition of Maytag Corporation in March 2006.

According to its 2006 annual report, Whirlpool then “took action to rapidly restore the competitiveness of Maytag brands, driving an integration process that allowed continuing performance improvements while better aligning our brands, products and markets we serve domestically and globally.” In effect, this “integration process” resulted in closing the Newton Maytag operation, at a loss of at least 1,200 Iowa jobs. Whirlpool later reported that this integration process resulted in operational savings of more than $400 million annually. Maytag did, however, maintain its production facilities in Amana, employing approximately 2,000 individuals there.

Between 2003 and 2007, with the acquisition of Maytag Corporation playing a significant role, Whirlpool Corporation’s net sales increased from $12.2 billion to $19.4 billion. Its after-tax earnings also increased dramatically, from $414 million to $647 million, a 56 percent increase over that period. In his letter to shareholders in the 2007 annual report, Board Chairman and ECO Jeff Fettig stressed the keys to Whirlpool’s current and future growth — business expansion through international growth, innovation and expansion to adjacent businesses. The emphasis upon innovation fits with well with RACs, which provide federal and state tax incentives for such activities. Unfortunately for Iowa, some of that innovation was the “integration process” that resulted in the closure of the Iowa Maytag operations, including the Newton-based research and development center.

During this period of closure, Whirlpool Corporation still was eligible to receive the supplementary as well as regular RACs from Iowa for which it would qualify under the tax code — applied to any of its research activities in Iowa. This could have been in the millions of dollars, even at the time that the closure was going into effect. The confidentiality rules regarding corporate tax records currently do not allow for the release of information about which corporations received them, even when they are in the form of “refund” checks, so it is not possible to report on Whirlpool’s actual use of the Iowa RAC.

Clearly, the presence of this tax incentive and the other incentives Iowa offered to Whirlpool Corporation were not sufficient to affect its business decisions regarding the Maytag closure in Newton. Any cost to the state treasury from Whirlpool Corporation’s use of the RAC could hardly be justified as achieving a primary Iowa public purpose. As evidenced in the awarding of a supplemental RAC to Whirlpool Corporation, the danger of providing such tax incentives as opposed to direct subsidies or grants is that they cannot be made contingent upon particular corporate activities. Once in the tax code, such tax credits may be used by any corporation meeting the legal requirements to use them, wherever they occur and whether or not there is a real benefit to the state. Further, if Whirlpool Corporation’s closing of Maytag facilities in Iowa and three other states and consolidation of those activities within other Whirlpool operations saved Whirlpool $400 million, it is hard to see how any tax incentive Iowa might have offered would have had much impact upon Whirlpool’s decision. This is one of the difficulties with state tax incentives; they seldom can be of a size to materially impact market-based business decisions, but they often can be attractive enough that corporations will actively pursue them as an additional benefit to increase their profitability, once their decision has been made.

Rockwell Collins and the RAC

Case Example No. 2

Whirlpool Corporation has not been the only corporation in Iowa to receive supplemental RACs, nor did it receive the largest RAC. Over the last four years (2003-07), Rockwell Collins has received several supplemental RACs, in addition to other tax credits, and has been the single largest beneficiary of supplemental RACs.

In sharp distinction to Whirlpool Corporation, there is no question that Rockwell Collins is an Iowa success story. The Cedar Rapids-based manufacturer had 2007 sales of $4.4 billion. A leader in the design, production and support of communication and aviation electronics, Rockwell's clients include both government (primarily defense) and civilian customers. Number 542 on the Fortune 1,000 list of America's largest corporations in 2007, Rockwell Collins is Iowa's second-largest corporation, behind only Principal Financial Group.

According to its 2007 Annual Report, Rockwell Collins has also been very profitable. From 2003 to 2007, its sales have grown by 74 percent (from $2.54 billion to $4.42 billion), and after-tax profits (net income) have soared by 127 percent (from $258 million to $585 million). Worldwide employment has grown from 12,000 to 19,500 employees over the last decade, and in the last three months Rockwell Collins has announced expansions in India and Texas of 800 additional jobs. The company's Iowa employment also expanded during this period.

Since almost all of Rockwell Collins' sales are outside Iowa and Iowa's single-factor system bases corporate income tax strictly on sales within the state, very little of Rockwell Collins' profits is subject to Iowa income tax. At the same time, Rockwell Collins and its employees depend upon Iowa public services – including Iowa's educational system – to support its Iowa plant and make it an attractive place for its employees to live and raise their children.

As a "high tech" corporation, Rockwell Collins employs highly skilled and well-compensated employees and engages in a large amount of research and development to keep itself at the top of its field, which means that investing in research activities is part of its business and necessary to enable it to be as profitable as it is.

Information received from the Iowa Department of Economic Development on the RAC shows IDED awarded four large supplemental research activities credits to Rockwell Collins over the last four years, totaling up to $20.7 million. Each of these credits is spread over a five-year period. If Rockwell Collins makes use of the full amount of supplemental credits for which it has applied, that would mean that Rockwell Collins could receive about $41.4 million in RACs (the $20.7 million from the supplemental credit and an estimated $20.7 million-plus from the standard credit) over a five-year period. It is virtually certain that Rockwell Collins is one of the 10 corporations receiving the largest RACs from the state and therefore also virtually certain that its corporate income tax liability in Iowa is much less than $2 million annually and has been erased by the RAC.

Doing the math, this means that Rockwell Collins could be receiving an annual RAC benefit of over $8 million, even though its corporate income tax liability is well below $2 million. In short, Rockwell Collins could be receiving rebate checks averaging $6 million or more per year from Iowa.

Rockwell Collins is an exemplary Iowa corporation, and a very profitable one. It is not a start-up corporation with an unproven record for whom tax credits arguably could make some sense. It is a high-growth company at the top of its field, and its sales and profits are expanding. It is imperative for it to invest in research in order to continue to profit and expand; it does not need tax breaks to do so.

Providing Rockwell Collins with such rebates appears to make no economic sense at all, when viewed from the perspective of free-market economics.

This analysis does not imply that, by seeking and using the RAC break, Rockwell Collins is doing anything unethical or unscrupulous. Rockwell Collins is pursuing recognized business practice in taking advantage of the tax benefits available to it.

The question is whether those tax breaks should be available and whether they serve a public purpose. Clearly, Iowans would like to see Rockwell Collins continue to grow within the state, which will require that Iowa develop and attract the type of workforce Rockwell Collins needs for its growth. This means a strong educational system and, particularly in the case of research and development, highly educated professionals. Continued growth of Rockwell Collins within Iowa is more likely to be dependent upon successful efforts to build such a workforce and make Iowa an attractive location for professionals to locate, with good schools, safe communities, cultural and recreational opportunities, and sound infrastructure, than it is to be dependent upon "refund" checks from the Research Activities Credit. These amenities can only be maintained through a state tax base that helps to finance them, which the RAC's unlimited refundability is already eroding.

Rockwell Collins and Whirlpool are by no means the only large, profitable corporations benefiting from the Iowa RAC. In the four years from 2003 to 2007, at least four other corporations received very large supplemental RACs from IDED. Wells Dairy and Sauer-Danfoss received over $1.5 million each in supplemental RACs, while John Deere received in excess of $6.5 million and HNI Corporation over $4 million. Figuring the total cost of the RAC to the state treasury in these cases means that these figures should be at least doubled, as they are on top of the regular RACs that these corporations would be eligible to receive.

As the table at right shows, the six corporations awarded the largest supplemental RAC awards have also been very profitable, with over $3.2 billion in after-tax earnings (profits), according to their 2007 annual reports (Wells Dairy is a privately held corporation, so its overall sales are shown).

Largest Iowa Supplemental RAC Awardees and 2007 After Tax Earnings

	Supplemental RAC Award(s)	2007 After-Tax Earnings
Rockwell Collins	$ 20.7 million	$ 585 million
Deere and Company	$ 6.5 million	$ 1,822 million
HNI Corporation	$ 4.0 million	$ 120 million
Whirlpool Corporation	$ 1.5 million	$ 647 million
Sauer-Danfoss	$ 1.5 million	$ 47 million
Wells Dairy	$ 1.5 million	$ 1.1 billion in sales
	$ 35.7 million	$ 3.2 billion +

***Note**: The $35.7 million is only the supplemental portion of the RAC,* so the amount these corporations receive is at least double this amount, if they use all their RAC award. The after-tax earnings were taken from each corporation's annual report.

Again, the issue is not whether these corporations contribute to Iowa's economy and economic prosperity, it is an issue of whether Iowa lawmakers should be providing direct subsidies to them, in addition to forgiving any Iowa corporate income tax liability they have.

Iowa's largest corporations are, in essence, receiving huge subsidy checks at the same time that the state is a tight budget and having to make hard choices about funding essential services. A handful of corporations are receiving multimillion-dollar RAC checks from the state while tens of thousands of hard-working Iowa families making between $20,000 and $40,000 per year are paying substantial state income taxes even though they have no federal income tax obligations.

Limiting RAC Refundability

Beginning Tax Reform in 2008

At a minimum, as Iowa lawmakers examine Iowa's tax code, they should limit the overall size of RAC subsidy checks that any one corporation can receive in a year. Even capping regular RAC checks at $100,000 annually and limiting future supplemental award checks to $100,000 annually would reduce state costs by $15 million to $20 million annually. This limit would not affect 95 percent of the companies that have claimed rebates under the program. The start-up ventures that promoters of the RAC generally point to as the primary intended beneficiaries would not see any loss of credit dollars.

It should be noted limiting RAC refundability is not a tax increase but simply an elimination of a form of state spending that currently has almost no public accountability. Iowa lawmakers could then decide how to use the recovered revenue — making deliberate choices on economic development investments, providing real tax reform by expanding the state earned income tax credit, or making other investments in essential public services. Such decisions would be open to public scrutiny and review regarding their beneficiaries and their public purpose.

Again, these limitations are particularly urgent given that, if Microsoft does choose to locate in Iowa, Microsoft will be eligible for the same RAC as Rockwell Collins — and its draw-down on state funds through the credit, over and above any other tax credits the state provides, could be huge. As the country's 11th most profitable corporation, Microsoft simply does not need Iowa "corporate welfare." The Governor and General Assembly need to take action to get control over the Research Activities Credit program. They cannot afford to wait until 2009 to start the process of tax reform; they can start by closing identified tax loopholes and giveaways this session, before they grow even larger in cost.

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[1] Iowa Department of Revenue, *Iowa's Research Activities Tax Credit, Tax Credits Program Evaluation Study*, January 2008, accessed at http://www.state.ia.us/tax/taxlaw/IDRTaxCreditEvalJan2008.pdf.