Tax Credit Reform Glass Half-Full? Maybe Some Moisture

At a time demanding great strides in Iowa budget reform, tax-credit legislation passed by the Iowa House and Senate at best offers only baby steps. The legislation has been promoted as way to save more than $115 million through tax credit reforms. However, the legislative fiscal note on the original Senate bill confirmed Iowa Fiscal Partnership analysis that any containment of current tax credits, beyond continued suspension of the already suspended film tax credit, is quite small. The final version of the bill, as passed March 22 by the Senate, stripped provisions that would have limited spending on two tax credits, further reducing the impact of the bill. While much of the rest of the budget was cut substantially this year, and will be cut further for the next fiscal year, the five largest business tax credits (aside from the suspended film credit) will be allowed to continue to grow.

Given a scandal in Iowa’s high-profile film tax credit program and unprecedented shortfalls in state revenues, the timing remains optimal for reform. Recommendations by the Governor’s Tax Credit Review Panel for curbing the growth of tax expenditures, and analyses by the Iowa Fiscal Partnership and other experts, demonstrate the excessive nature of many business tax credits and their lack of transparency, accountability and public purpose. It is difficult to imagine a better time for fiscally sustainable reforms of tax credits and other tax expenditures than lawmakers have in the closing weeks of the 2010 session.

Through a largely closed-door legislative process, however, legislators crafted for a bill without public testimony or expert review and makes very minimal changes to current law. While the Governor called for action on the Tax Credit Review Panel’s recommendations to build $52 million in savings into his proposed Fiscal Year 2011 budget, the legislative package rejects almost all of that panel’s recommendations.

According to the Legislative Services Agency’s fiscal note on the Senate bill (before House amendments), the legislation will have no impact in either of the next two state fiscal years in costs to the state for the five largest tax credits — the Research Activities Credit (RAC), the Iowa Industrial New Jobs Training Program (260E), the High Quality Jobs Program, the Enterprise Zone Program, and the Historic Preservation Tax Credit. The Department of Revenue’s March 2010 Contingent Liabilities Report estimates claims for these credits in FY2011 will be $203 million and grow to $210 million in FY2012.

These five tax credits are not even subject to a 10 percent cut as was the overall state budget. In fact, two of these programs remain uncapped (the regular portion of the RAC and the 260E program) and others (High Quality Jobs, Enterprise Zones, and the Supplemental RAC) are under a global cap that will remain much higher than projected.
claims for at least the next two years, rendering the cap meaningless. The Historic Preservation Tax Credit’s cap is reduced 10 percent (from $50 to $45 million) though this is not expected to produce any savings until FY2014.

Major recommendations of the Tax Credit Review Panel were to:
- Provide a five-year sunset on all tax credits;
- Eliminate the refundability of the Research Activities Credit (RAC) for large companies;
- Eliminate the film tax credit;
- Eliminate of the transferability of other credits;
- Place all business credits under a $185 million cap;
- Reduce the rate for the School Tuition Organization Tax Credit and lower the cap; and
- Impose an income test for the Tuition and Textbook Tax Credit.

By comparison, the Senate bill, SF2380, as sent to the Governor, would:
- Establish a statutory panel of legislators to review a set of tax credits in each of the next five years;
- Reduce the size of the supplemental Research Activities Credit (but not the regular RAC) for large companies while increasing it for smaller ones;
- Suspend the film tax credit until July 2013;
- Reduce the credit cap for the five business credits under the $185 million cap and for the Venture Capital Fund of Funds;
- Reduce the cap on the Historic Preservation Tax Credit from $50 million to $45 million; and
- Reduce caps by 10 percent for select other business credits, but neither the School Tuition Organization Tax Credit nor the Agricultural Land Transfer Tax Credit, both of which would have had new caps in the Senate bill before it was amended by the House and ultimately passed.

**Statutory Panel**

As passed, SF2380 establishes a 10-member panel of legislators to review a set of tax credits over a schedule over the next five years, but not based upon sound tax principles — a provision that had been in the original Senate bill but removed in the House. While the goal is greater oversight and transparency of tax credits and expenditures, the legislation provides no additional access to information about tax credits and expenditures than exists today. A number of states have adopted transparency legislation that would make the recipients of tax credits a public record in order to determine who benefits from the credits and assess their public benefit to the state. Last session, the General Assembly took an initial step in this direction by requiring that recipients of RACs receiving more than a $500,000 credit to be made public, but the bill advancing in the Statehouse goes no further in providing transparency. To expect the legislative panel to conduct a serious review of tax credits also will require significant research and staffing, which are not part of the legislation.

**Research Activities Credit**

The Governor’s Tax Credit Review Panel recommended ending the refundability of the Research Activities Credit (RAC) for firms with $20 million or more in gross annual sales (refundability means that any amount of the RAC over what a recipient would owe in taxes is paid out as a direct subsidy). RAC refunds are projected to cost around $50 million over each of the next four years, based on the latest Department of Revenue projections, with most of these refunds going to very large corporations. Eliminating the refundability for corporations with gross sales over $20 million or capping the credit at $250,000 for any one corporation would save the state $20 million or more in FY2012 and twice that in FY2013.

As passed, SF2380 reduces by 54 percent the size of the supplemental RAC for companies with gross sales over $20 million, while increasing it 54 percent for smaller companies, but it does not make any changes to the far larger automatic RAC. The net effect of these changes, according to the Legislative Services Agency, will be zero in fiscal years 2011 and 2012, and only $3.0 million in net savings in FY2013.

**Film Tax Credit**

While the Governor’s Tax Credit Review Panel called for repeal of the film tax credit, the final bill sent to the Governor would simply suspend the film credit until July 2013. This is unlikely to have much additional impact, as the scandals, subsequent suspension, and the Attorney General’s determination that the current credit was only 25 percent of eligible costs have largely stopped new applications for funding. There still will be costs associated
over the next several fiscal years with the film tax credit for films that received approval prior to the suspension. The suspension, rather than repeal, however, requires the General Assembly to take action in the future if the credit is to be repealed or further modified.

**Credit Caps**

Proposed changes that appear to be behind much of the claim that lawmakers’ plan “saves” the state money or reduces liability relates to the reduction, but not restructuring, of two of the existing caps. Neither of those caps currently is close to being reached. The cap of $185 million on five credits that was instituted last year would be reduced to $120 million, but revenue projections of claims for the five credits (which include the suspended film tax credit) are far below that figure. The analysis by the Legislative Services Agency projects a small savings beginning in FY2013, based on the assumption that the Iowa economy rebounds in 2011 and 2012, generating much larger awards under the High Quality Jobs and Enterprise Zone programs. The reduction of the Venture Capital Fund of Funds cap from $100 million to $60 million is for a credit that has yet to be claimed on a tax return, and the credit is not projected by the Department of Revenue to generate any claims in the next four years. Although these two provisions reduce caps by $105 million, they are largely cosmetic and have no impact in at least the next two fiscal years. A third program, the Historic Preservation Tax Credit, would have its cap reduced by 10 percent, which will begin to save the state modest amounts ($2 million to $5 million) by FY2013-14.

**Other Credits**

The tax credit bill makes a few other revisions to much smaller tax credits, but the changes have little effect.

The Governor’s Tax Credit Review Panel recommended that the School Tuition Organization Tax Credit be reduced to 40 percent and capped at $5 million. The original Senate bill would only have reduced the cap to $6.5 million, and the House amendments stripped even this small change from the final version of the bill that passed both Houses. The Senate bill would have cut the cap for the Agriculture Asset Transfer Tax Credit by half, but this provision also was stripped by the House and is not in the final version that passed.

The only significant source of revenue is achieved by repealing the Refundable Investment Tax Credit for Value-Added Agriculture Products, currently provided as refundable tax credits largely to ethanol plants, which received substantial subsidies. Repeal would save an estimated $4 million annually.

**Conclusion**

While the legislative panel may offer recommendations in the future for curbing tax credits, the final bill as passed by both Houses is more cosmetic than real in taking a balanced approach to the state budget. Meanwhile, a number of tax reforms — such as closing corporate tax loopholes through combined reporting and limiting the total exclusion of capital gains income from the individual income tax — are not addressed. These provisions would close tax loopholes and eliminate special provisions that shelter profits from any state income tax liability. Coupled with significant reforms to the RAC and adoption of other recommendations from the Governor’s Tax Credit Review Panel, such reforms could produce real state savings of $115 million or more in FY2012 and future budget years.

It is not too late for Iowa lawmakers address these issues and include some water in the tax credit reform glass.

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1 The legislation also projects potential savings from a non-tax-credit change, involving a restoration of the state estate tax only for purposes of capturing a share of the federal estate tax, but the federal policy changes that would be necessary for that to happen are highly unlikely. Due to the uncertainty of federal action on the estate tax and the unlikely prospect that the federal government would allow states to capture revenues from it in any event, and to the fact that we are examining tax-credit reforms here, we do not address the prospects for those savings for Iowa.

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**Iowa Fiscal Partnership**

The Iowa Fiscal Partnership is joint budget policy analysis initiative of two nonpartisan, nonprofit Iowa-based organizations, the Iowa Policy Project in Iowa City and the Child & Family Policy Center in Des Moines. IFP reports are at www.iowafiscal.org.