

**Joint Legislative Income
Tax Credit Review
Committee**

Final Report

December 15, 2002

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Joint Legislative Income Tax Credit Review Committee



Final Report

December 15, 2002

MEMBERS

Representative Steve May, Co-Chairman
Representative Henry Camarot
Representative Ken Chevront
Representative Laura Knaperek
Representative Barbara Leff

Senator Ed Cirillo, Co-Chairman
Senator Jack Brown
Senator Scott Bundgaard
Senator Lori Daniels
Senator Ramon Valadez

Committee Authorization:

The Joint Legislative Income Tax Credit Review Committee was established by Laws 2002, Chapter 238 (HB 2186). The Committee is comprised of five members from the House Ways and Means Committee and five members of the Senate Finance Committee.

Committee Duties:

- ◆ To determine the original purpose of existing tax credits.
- ◆ To establish a standard for evaluating and measuring the success or failure of the tax credits, which may include:
 - ◆ The history, rationale and estimated revenue impact of the credit;
 - ◆ Whether the credit has provided a benefit to this State including, for corporate tax credits, measurable economic development, new investments, creation of new jobs or retention of existing jobs in this state;
 - ◆ Whether the credit is unnecessarily complex in the application, administration and approval process.
- ◆ To review the individual and corporate income tax credits pursuant to the statutory schedule.
- ◆ After the review process, determine whether the credit should be amended or repealed.
- ◆ Submit a report to the President of the Senate, Speaker of the House of Representatives and the Governor by December 15 each year.

Committee Action:

The Committee met once on December 12, 2002 and reviewed information provided by the Joint Legislative Budget Committee. The information was provided for the following income tax credits:

- ARS 43-1076 Recycling Equipment
- ARS 43-1077 and ARS 43-1165 Employment by qualified defense contractor
- ARS 43-1078 and ARS 43-1166 Property taxes paid for qualified defense contractor
- ARS 43-1079 and ARS 43-1167 Employment in military reuse zone
- ARS 43-1080 and ARS 43-1169 Construction cost for qualified environmental technology facility

The Committee requested that additional information be provided in future reports. The information should include the following:

- ♦ Any public information that gives specifics about which companies are certified through the Department of Commerce for tax credits that require certification.
- ♦ Other incentives to the industries or businesses that are affected by a particular tax credits.
- ♦ The percentage of businesses taking a tax credit for a particular industry (for example, how many recycling businesses are located in this state and what percent is taking advantage of the credit)
- ♦ Fiscal information by year, in addition to total fiscal impacts.

The Committee discussed the elimination of the recycling equipment tax credit. A similar credit existed for corporate taxpayers, but was eliminated in 1999 when the corporate rate was reduced. The Committee discussed if there was a need to keep the individual tax credit in place in light of the fact that it is no longer available to corporate taxpayers, is used by few taxpayers and does not have a significant revenue impact. However, due to lack of a quorum, no formal recommendation was made.

The Committee also discussed the elimination of the military reuse zone credit. The discussion centered on the fact that this only affects Williams Gateway Airport (formerly Williams Air Force Base). The tax incentive has been in place since 1996. Only four taxpayers have used this credit and the transition from a military use to civilian use has taken place. However, due to lack of a quorum, no formal recommendation was made.

**Information and Statutes for the
Income Tax Credits Reviewed
In the 2002 review cycle**

Recycling Equipment Income Tax Credit

- Statute:** A.R.S. § 43-1076 (Individual)
- Description:** An individual income tax credit allowed for placing recycling equipment in service in Arizona. Recycling equipment is defined as new or used equipment purchased and used exclusively to process post-consumer solid waste materials or to produce materials composed of at least 25% post-consumer solid waste.
- Refundable:** No.
- Carry Forward:** Yes, 15 years.
- History:** Created in 1992 as part of a recycled materials market development program intended to create demand for recycled materials and increase overall recycling in the state.
- Revenue Impact:** Taxpayer claim information is largely confidential. In 1997, 5 taxpayers claimed a total of \$17,757 in credit. All other years are unknown.
- Economic Benefits:** It is difficult to quantify the economic benefits from this credit, due to taxpayer confidentiality concerns. In general terms, new businesses startups attributable to this credit would have a positive economic benefit. However, without knowing the number of new businesses and employees hired, the economic impact cannot be estimated.
- Complexity:** Certification process is not unduly complex based on information from the business community. The Department of Revenue did not cite undue complexities in the administration or approval processes.

43-1076. Recycling equipment tax credit; recapture; record keeping; definitions

A. A taxpayer who places recycling equipment in service in this state may elect to take a credit for taxable years beginning from and after December 31, 1992 against the taxes imposed by this title unless the taxpayer has previously deducted an amount for depreciation or amortization of costs of the recycling equipment in determining taxable income. A taxpayer who elects to take a credit pursuant to this section shall not deduct any amount for depreciation or amortization of costs of the recycling equipment in determining taxable income for any tax year.

B. The credit is equal to ten per cent of the installed cost of the recycling equipment. The amount of credit claimed in a tax year shall not exceed the lesser of twenty-five per cent of the tax liability determined for that tax year without applying the credit or five thousand dollars.

C. If recycling equipment for which a credit has been claimed ceases to be recycling equipment or is transferred to another person during any tax year, the tax imposed by this title for that tax year shall be increased by the amount of the credit claimed for the recycling equipment multiplied by the recapture percentage prescribed in subsection D of this section. A taxpayer shall not carry over any unused credit relating to recycling equipment which ceases to be recycling equipment or is transferred to another person.

D. The recapture percentage for recycling equipment which ceases to be recycling equipment or is transferred to another person is:

1. One hundred per cent if the recycling equipment has been in service less than one year.

2. Eighty per cent if the recycling equipment has been in service one or more years but less than two years.

3. Sixty per cent if the recycling equipment has been in service two or more years but less than three years.

4. Forty per cent if the recycling equipment has been in service three or more years but less than four years.

5. Twenty per cent if the recycling equipment has been in service four or more years but less than five years.

6. Zero per cent if the recycling equipment has been in service five years or more.

E. Recycling equipment is in service for determining the recapture percentage from the time it is placed in service until it ceases to be recycling equipment or is transferred to another person.

F. The entire amount of the unused credit shall be carried to the earliest of the tax years to which the unused credit may be carried. Credits for a tax year shall be applied in the following order:

1. Unused credit carryovers.

2. Current year credits.

G. An unused credit may be carried over to each of the fifteen years following the unused credit year except as provided in subsection B of this section.

H. Co-owners of a business, including partners in a partnership and shareholders of an S corporation, as defined in section 1361 of the internal revenue code, may each claim only the pro rata share of the credit allowed under this section based on the ownership interest. The total of the credits allowed all such owners may not exceed the amount that would have been allowed for a sole owner of the business.

I. The department shall prescribe by rule record keeping requirements for taxpayers who claim a credit pursuant to this section.

J. A taxpayer who claims a credit for recycling equipment under this section may not claim a credit under section 43-1081 for the same equipment.

K. In this section:

1. "Recycling equipment" means new or used equipment purchased during the tax year and used exclusively to process post-consumer select solid waste materials and manufacturing machinery used exclusively to produce finished products, the composition of which is at least twenty-five per cent post-consumer select solid waste materials.

2. "Select solid waste" means paper, plastic, scrap metal and iron, glass and rubber.

3. "Unused credit" means the excess of the sum of credit carryovers and current year credit for a tax year over the limit prescribed in subsection B of this section.

4. "Unused credit year" means a year in which an unused credit exists.

Defense Contracting Credit

- Statute:** A.R.S. § 43-1165 & 1166 (Corp.) and A.R.S. §43-1077 & 1078 (Ind.)
- Description:** A corporate income tax credit limited to companies that have been certified by the Arizona Department of Commerce as qualified defense contractors. The tax credit is for a net increase in employment of qualified employees under a United States Department of Defense contract. The credit may also be claimed for a net increase in private commercial employment by a qualified defense contractor due to full-time positions transferred from exclusively defense related activities to exclusively private commercial activities. A credit is also allowed for a portion of property taxes paid on class 1 (commercial or industrial) property.
- The credit for a net increase in employment is \$2,500 for the first year, \$2,000 for the second year, \$1,500 for the third year, \$1,000 for the fourth year, and \$500 for the fifth year of full-time employment.
- The credit for property tax paid is 40% of the property tax if more than 900 new full-time equivalent positions are created, 30% for 601 to 900 positions, 20% for 301 to 600 positions, and 10% for up to 300 positions.
- Refundable:** No.
- Carry Forward:** Yes, until taxable years beginning from and after December 31, 2011.
- History:** Created in 1993 to keep Arizona's defense-related companies competitive and closed military bases operational. The legislation addressed 3 issues: (1) the decline in federal defense spending, (2) the need for defense contractors to make the transition from military to commercial markets, and (3) the closing of military bases.
- Revenue Impact:** Corporate:
Since 1993, \$53.3 million of the employment credit and \$7.2 million of the property tax credit have been created. Of the total credit amount of \$60.5 million, at least \$8.8 million in credit has been used. Actual amount used may exceed \$8.8 million; however, the amount is unknown due to taxpayer confidentiality concerns.
- Individual:
No revenue impacts since no claims for this credit have been submitted by taxpayers.
- Economic Benefits:** Corporate:
Since 1993, corporations have reported 9,714 positions eligible for the credit, which corresponds to \$6,225 in credit per job. (Since the creation of this credit, 7 taxpayers have claimed it.)
- Individual:
No economic benefits since no claims for this credit have been submitted by taxpayers.

Complexity:

Certification process is not complex based on information from the business community. Since 3 different state agencies (Department of Commerce, Department of Economic Security, and Department of Revenue) are involved in monitoring and administrating the credit, some additional complexity may result. The Department of Revenue reports that the tracking of employees by name is a little burdensome for both the taxpayer and auditing oversight. The Department also reports that the apportionment issues of defense contracts associated with the property tax credit create some difficulties.

43-1077. Credit for employment by qualified defense contractor

A. A credit is allowed against the taxes imposed by this title for:

1. Net increases in employment under United States department of defense contracts during the taxable year, as computed under subsection D of this section, by a qualified defense contractor who is certified by the department of commerce under section 41-1508.

2. Net increases in private commercial employment during the taxable year, as computed under subsection E of this section, by a qualified defense contractor who is certified by the department of commerce under section 41-1508 due to full-time equivalent employee positions transferred during the taxable year by the taxpayer from exclusively defense related activities to employment by the taxpayer in exclusively private commercial activities.

B. The amount of the credit is a dollar amount allowed for each full-time equivalent employee position created, determined as follows:

1st year	\$2,500
2nd year	\$2,000
3rd year	\$1,500
4th year	\$1,000
5th year	\$ 500

C. If the allowable tax credit exceeds the taxes otherwise due under this title on the claimant's income, or if there are no taxes due under this title, the taxpayer may carry the amount of the claim not used to offset the taxes under this title forward until taxable years beginning from and after December 31, 2011 as a credit against subsequent years' income tax liability, regardless of continuing certification as a qualified defense contractor.

D. The net increase in employment under defense related contracts shall be determined as follows:

1. Establish an employment baseline for the taxpayer based on a multiyear forecast of employment on United States department of defense contracts that was submitted to the department of defense before June 1, 1992. The annual average employment forecast for the first year the taxpayer qualified is the baseline. If the taxpayer did not make such a forecast before June 1, 1992, the baseline is the average annual employment as reported to the department of economic security during the preceding taxable year. If a taxpayer qualifies in the same year it relocates into this state, the taxpayer's baseline is zero.

2. For the first year of the credit, the taxpayer's net increase in average employment is the increase in employment reported to the department of economic security for the taxable year over the employment baseline.

3. For each succeeding year of the credit, the taxpayer's net increase in average employment is the increase in employment reported to the department of economic security for the taxable year over the preceding taxable year's average employment.

E. In computing the amount of credit allowed under subsection A, paragraph 2 of this section, the taxpayer shall:

1. Prorate employment during the taxable year according to the date of transfer from defense to private commercial activities or the date of transfer from private commercial activities to defense.

2. Compute and subtract an amount pursuant to subsection B of this section for full-time equivalent employee positions that were transferred during the taxable year by the taxpayer from exclusively private commercial activities to exclusively defense related activities.

F. The taxpayer shall account for qualifying full-time equivalent employee positions on a first-in first-out basis. If a decrease in qualifying employment occurs, the taxpayer shall subtract the decrease from the earliest qualifying positions.

G. A credit is not allowed under both subsection A, paragraphs 1 and 2 of this section with respect to the same employee position. A full-time equivalent employee position may be considered for purposes of computing the credit under either subsection A, paragraph 1 or 2 of this section, but not both.

H. A credit is not allowed under this section with respect to employment that was transferred from an outside contractor in this state to in-house employment by the taxpayer solely for purposes of qualifying for the credit.

I. A taxpayer who claims a credit under section 43-1074 or 43-1079 may not claim a credit under this section with respect to the same employees.

J. Co-owners of a business, including partners in a partnership and shareholders of an S corporation, as defined in section 1361 of the internal revenue code, may each claim only the pro rata share of the credit allowed under this section based on the ownership interest. The total of the credits allowed all such owners may not exceed the amount that would have been allowed for a sole owner of the business.

43-1078. Credit for property taxes paid by qualified defense contractor

A. A credit is allowed against the taxes imposed by this title equal to a portion of the amount paid as taxes during the taxable year by a qualified defense contractor that is certified by the department of commerce under section 41-1508, on property in this state that is classified as class one, paragraphs 12 and 13 pursuant to section 42-12001.

B. The amount of the credit is determined as follows:

1. Multiply the amount paid as taxes on property classified as class one, paragraphs 12 and 13 pursuant to section 42-12001 in this state during the taxable year by a percentage based on net new defense related employment, determined by subtracting the employment baseline determined pursuant to section 43-1077, subsection D, paragraph 1, from average annual employment as reported to the department of economic security for the taxable year, as follows:

<u>New employment</u>	<u>Credit percentage</u>
More than 900	40%
601 - 900	30%
301 - 600	20%
1 - 300	10%

2. Multiply the amount determined under paragraph 1 of this subsection by a percentage determined by dividing the taxpayer's total gross income from United States department of defense contracts apportioned to this state by the taxpayer's total gross income from all sources apportioned to this state.

C. If the allowable tax credit exceeds the taxes otherwise due under this title on the claimant's income, or if there are no taxes due under this title, the taxpayer may carry the amount of the claim not used to offset the taxes under this title forward until taxable years beginning from and after December 31, 2011 as a credit against subsequent years' income tax liability, regardless of continuing certification as a qualified defense contractor.

D. The credit allowed by this section is in lieu of a deduction for property taxes under section 43-1042 with respect to the same taxes paid.

E. Co-owners of a business, including partners in a partnership and shareholders of an S corporation, as defined in section 1361 of the internal revenue code, may each claim only the pro rata

share of the credit allowed under this section based on the ownership interest. The total of the credits allowed all such owners may not exceed the amount that would have been allowed for a sole owner of the business.

43-1165. Credit for employment by qualified defense contractor

A. A credit is allowed against the taxes imposed by this title for:

1. Net increases in employment under United States department of defense contracts during the taxable year, as computed under subsection D of this section, by a qualified defense contractor that is certified by the department of commerce under section 41-1508.

2. Net increases in private commercial employment during the taxable year, as computed under subsection E of this section, by a qualified defense contractor that is certified by the department of commerce under section 41-1508 due to full-time equivalent employee positions transferred during the taxable year by the taxpayer from exclusively defense related activities to employment by the taxpayer in exclusively private commercial activities.

B. The amount of the credit is a dollar amount allowed for each full-time equivalent employee position created, determined as follows:

1st year	\$2,500
2nd year	\$2,000
3rd year	\$1,500
4th year	\$1,000
5th year	\$ 500

C. If the allowable tax credit exceeds the taxes otherwise due under this title on the claimant's income, or if there are no taxes due under this title, the taxpayer may carry the amount of the claim not used to offset the taxes under this title forward until taxable years beginning from and after December 31, 2011 as a credit against subsequent years' income tax liability, regardless of continuing certification as a qualified defense contractor.

D. The net increase in employment under defense related contracts shall be determined as follows:

1. Establish an employment baseline for the taxpayer based on a multiyear forecast of employment on United States department of defense contracts that was submitted to the department of defense before June 1, 1992. The annual average employment forecast for the first year the taxpayer qualified is the baseline. If the taxpayer did not make such a forecast before June 1, 1992, the baseline is the average annual employment as reported to the department of economic security during the preceding taxable year. If a taxpayer qualifies in the same year it relocates into this state, the taxpayer's baseline is zero.

2. For the first year of the credit, the taxpayer's net increase in average employment is the increase in employment reported to the department of economic security for the taxable year over the employment baseline.

3. For each succeeding year of the credit, the taxpayer's net increase in average employment is the increase in employment reported to the department of economic security for the taxable year over the preceding taxable year's average employment.

E. In computing the amount of credit allowed under subsection A, paragraph 2 of this section, the taxpayer shall:

1. Prorate employment during the taxable year according to the date of transfer from defense to private commercial activities or the date of transfer from private commercial activities to defense.

2. Compute and subtract an amount pursuant to subsection B of this section for full-time equivalent employee positions that were transferred during the taxable year by the taxpayer from exclusively private commercial activities to exclusively defense related activities.

F. The taxpayer shall account for qualifying full-time equivalent employee positions on a first-in first-out basis. If a decrease in qualifying employment occurs, the taxpayer shall subtract the decrease from the earliest qualifying positions.

G. A credit is not allowed under both subsection A, paragraphs 1 and 2 of this section with respect to the same employee position. A full-time equivalent employee position may be considered for purposes of computing the credit under either subsection A, paragraph 1 or 2 of this section, but not both.

H. A credit is not allowed under this section with respect to employment that was transferred from an outside contractor in this state to in-house employment by the taxpayer solely for purposes of qualifying for the credit.

I. A taxpayer that claims a credit under section 43-1161 or 43-1167 may not claim a credit under this section with respect to the same employees.

J. Co-owners of a business, including corporate partners in a partnership, may each claim only the pro rata share of the credit allowed under this section based on the ownership interest. The total of the credits allowed all such owners may not exceed the amount that would have been allowed for a sole owner of the business.

43-1166. Credit for property taxes paid by qualified defense contractor

A. A credit is allowed against the taxes imposed by this title equal to a portion of the amount paid as taxes during the taxable year by a qualified defense contractor that is certified by the department of commerce under section 41-1508 on property in this state that is classified as class one, paragraphs 12 and 13 pursuant to section 42-12001.

B. The amount of the credit is determined as follows:

1. Multiply the amount paid as taxes on property classified as class one, paragraphs 12 and 13 pursuant to section 42-12001 in this state during the taxable year by a percentage based on net new defense related employment, determined by subtracting the employment baseline determined pursuant to section 43-1165, subsection D, paragraph 1 from average annual employment as reported to the department of economic security for the taxable year, as follows:

<u>New employment</u>	<u>Credit percentage</u>
More than 900	40%
601 - 900	30%
301 - 600	20%
1 - 300	10%

2. Multiply the amount determined under paragraph 1 of this subsection by a percentage determined by dividing the taxpayer's total gross income from United States department of defense contracts apportioned to this state by the taxpayer's total gross income from all sources apportioned to this state.

C. If the allowable tax credit exceeds the taxes otherwise due under this title on the claimant's income, or if there are no taxes due under this title, the taxpayer may carry the amount of the claim not used to offset the taxes under this title forward until taxable years beginning from and after December 31, 2011 as a credit against subsequent years' income tax liability, regardless of continuing certification as a qualified defense contractor.

D. Co-owners of a business, including corporate partners in a partnership, may each claim only the pro rata share of the credit allowed under this section based on the ownership interest. The total of the credits allowed all such owners may not exceed the amount that would have been allowed for a sole owner of the business.

Military Reuse Zone Credit

- Statute:** A.R.S. § 43-1167 (Corporate) & A.R.S. § 43-1079 (Individual)
- Description:** A corporate income tax credit allowed for net increases in employment of full-time employees working in a military reuse zone, and who are primarily engaged in providing aviation or aerospace services or products. A credit is also allowed for dislocated military base employees that are civilians who previously had permanent full-time civilian employment on the military facility at the date of the closure of the facility.
- For dislocated military base employees, the credit amount starts at \$1,000 in the first year of employment and increases in \$500 increments each year until it reaches \$3,000 in the fifth year of employment. For each employee that is not a dislocated military base employee, the credit is \$500 in the first year of employment and increases in \$500 increments until it reaches \$2,500 in the fifth year of employment.
- Refundable:** No.
- Carry Forward:** Yes, 5 years.
- History:** The military reuse zone program was established in 1992 to lessen the impact of military base closures. The legislation included targeted economic incentives for aviation and aerospace businesses that create new jobs and capital investments within military reuse zones. The state's first military reuse zone was established in 1996 at the Williams Gateway Airport.
- Revenue Impact:** Corporate:
Since the creation of the first military reuse zone, approximately \$200,000 of the credit has been created. Of this amount, at least \$38,200 has been used. Actual amount used may exceed \$38,200; however, the amount is unknown due to taxpayer confidentiality concerns.
- Individual:
No revenue impacts since no claims for this credit have been submitted by taxpayers.
- Economic Benefits:** Corporate:
Since the creation of this credit, slightly more than 80 jobs have been claimed under this credit, which corresponds to \$2,500 in credit per employee. (Since the creation of this credit, 4 taxpayers have claimed it.)
- Individual:
No economic benefits since no claims for this credit have been submitted by taxpayers.
- Complexity:** Based on information from the business community, the Department of Commerce reports that this credit is not deemed unnecessarily complex in its

application, administration, and approval process. The Department of Revenue reports that the record keeping associated with this credit is not difficult.

43-1079. Credit for increased employment in military reuse zones; definition

A. A credit is allowed against the taxes imposed by this title for net increases in employment by the taxpayer of full-time employees working in a military reuse zone, established under title 41, chapter 10, article 3, and who are primarily engaged in providing aviation or aerospace services or in manufacturing, assembling or fabricating aviation or aerospace products. The amount of the credit is a dollar amount allowed for each new employee, determined as follows:

1. With respect to each employee other than a dislocated military base employee:

1st year of employment	\$ 500
2nd year of employment	\$1,000
3rd year of employment	\$1,500
4th year of employment	\$2,000
5th year of employment	\$2,500

2. With respect to each dislocated military base employee:

1st year of employment	\$1,000
2nd year of employment	\$1,500
3rd year of employment	\$2,000
4th year of employment	\$2,500
5th year of employment	\$3,000

B. If the allowable tax credit exceeds the taxes otherwise due under this title on the claimant's income, or if there are no taxes due under this title, the amount of the claim not used to offset the taxes under this title may be carried forward as a credit against subsequent years' income tax liability for the period, not to exceed five taxable years, if the business remains in the military reuse zone.

C. The net increase in the number of employees for purposes of this section shall be determined by comparing the taxpayer's average employment in the military reuse zone during the taxable year with the taxpayer's previous year's fourth quarter employment in the zone, based on the taxpayer's report to the department of economic security for unemployment insurance purposes but considering only employment in the zone.

D. Co-owners of a business, including partners in a partnership and shareholders of an S corporation, as defined in section 1361 of the internal revenue code, may each claim only the pro rata share of the credit allowed under this section based on the ownership interest. The total of the credits allowed all such owners may not exceed the amount that would have been allowed for a sole owner of the business.

E. A credit is not allowed under this section with respect to an employee whose place of employment is relocated by the taxpayer from a location in this state to the military reuse zone, unless the employee is engaged in aviation or aerospace services or in manufacturing, assembling or fabricating aviation or aerospace products and the taxpayer maintains at least the same number of employees in this state but outside the zone.

F. A taxpayer who claims a credit under section 43-1074 or 43-1077 may not claim a credit under this section with respect to the same employees.

G. For the purposes of this section, "dislocated military base employee" means a civilian who previously had permanent full-time civilian employment on the military facility as of the date the closure of the facility was finally determined under federal law, as certified by the department of commerce.

43-1167. Credit for increased employment in military reuse zones; definition

A. A credit is allowed against the taxes imposed by this title for net increases in employment by the taxpayer of full-time employees working in a military reuse zone, established under title 41, chapter 10, article 3, and who are primarily engaged in providing aviation or aerospace services or in

manufacturing, assembling or fabricating aviation or aerospace products. The amount of the credit is a dollar amount allowed for each new employee, determined as follows:

1. With respect to each employee other than a dislocated military base employee:

1st year of employment	\$ 500
2nd year of employment	\$1,000
3rd year of employment	\$1,500
4th year of employment	\$2,000
5th year of employment	\$2,500

2. With respect to each dislocated military base employee:

1st year of employment	\$1,000
2nd year of employment	\$1,500
3rd year of employment	\$2,000
4th year of employment	\$2,500
5th year of employment	\$3,000

B. If the allowable tax credit exceeds the taxes otherwise due under this title on the claimant's income, or if there are no taxes due under this title, the amount of the claim not used to offset the taxes under this title may be carried forward as a credit against subsequent years' income tax liability for the period, not to exceed five taxable years, if the business remains in the military reuse zone.

C. The net increase in the number of employees for purposes of this section shall be determined by comparing the taxpayer's average employment in the military reuse zone during the taxable year with the taxpayer's previous year's fourth quarter employment in the zone, based on the taxpayer's report to the department of economic security for unemployment insurance purposes but considering only employment in the zone.

D. Co-owners of a business, including corporate partners in a partnership, may each claim only the pro rata share of the credit allowed under this section based on the ownership interest. The total of the credits allowed all such owners may not exceed the amount that would have been allowed for a sole owner of the business.

E. A credit is not allowed under this section with respect to an employee whose place of employment is relocated by the taxpayer from a location in this state to the military reuse zone unless the employee is engaged in aviation or aerospace services or in manufacturing, assembling or fabricating aviation or aerospace products and the taxpayer maintains at least the same number of employees in this state but outside the zone.

F. A taxpayer who claims a credit under section 43-1161 or 43-1165 may not claim a credit under this section with respect to the same employees.

G. For the purposes of this section, "dislocated military base employee" means a civilian who previously had permanent full-time civilian employment on the military facility as of the date the closure of the facility was finally determined under federal law, as certified by the department of commerce.

Environmental Technology Facility Income Tax Credit

- Statute:** A.R.S. § 43-1169 (Corporate) & A.R.S. § 43-1080 (Individual)
- Description:** An income tax credit allowed for construction expenses of a qualified environmental technology manufacturing, producing, or processing facility. The facility construction must cost at least \$20 million within 5 years after construction begins. The facility must be either owned by the manufacturer, producer or processor or leased for at least 5 years. Credit is equal to 10% of plant construction costs in a tax year, but cannot exceed 75% of total tax liability for the year. Eligibility determined through Department of Commerce certification process.
- Refundable:** No.
- Carry Forward:** Yes, 15 years.
- History:** Created in 1993 to induce out-of-state businesses to locate in Arizona. Specific companies targeted at the time include Fort Howard Inc., Fletcher Challenge recycling, and North Star Steel manufacturing. This credit was part of a package of property, sales, and income tax incentives targeting this industry. Fort Howard, the largest of the companies targeted for the credit, did not build a plant in the state. Department of Commerce certification process ended in 1996, after which time no new projects could qualify for the credit.
- Revenue Impact:**
- Corporate:
Since 1993, nearly \$53 million in credit has been created. Of that amount, at least \$21 million in credit has been used. Actual amount used may exceed \$21 million; however, the amount is unknown due to taxpayer confidentiality concerns.
- Individual:
No revenue impacts since no claims for this credit have been submitted by taxpayers.
- Economic Benefits:**
- Corporate:
More than \$522 million in qualified plant construction has occurred in the state. A total of 1,407 jobs have been created or retained due to the new construction. A larger number of businesses have qualified for the credit yet have not begun construction. This potential construction could generate an additional \$2.3 billion in investment and \$227 million in credit.
- Individual:
No economic benefits since no claims for this credit have been submitted by taxpayers.
- Complexity:** Certification process is not complex based on information from the business community. The Department of Revenue reports that tracking asset values after applying the credit creates some complexity.

43-1080. Credit for construction costs of qualified environmental technology facility

A. A credit is allowed against the taxes imposed by this title for expenses incurred in constructing a qualified environmental technology manufacturing, producing or processing facility as described in section 41-1514.02. The amount of the credit is equal to ten per cent of the amount spent during the taxable year to construct the facility, including land acquisition, improvements, building improvements, machinery and equipment, but not exceeding seventy-five per cent of the tax liability under this title for the taxable year determined without applying the credit.

B. Amounts qualifying for the credit under this section must be includible in the taxpayer's adjusted basis for the facility. The adjusted basis of any asset with respect to which the taxpayer has claimed a credit shall be reduced by the amount of credit claimed with respect to that asset. This credit does not affect the deductibility for depreciation or amortization of the remaining adjusted basis of the asset.

C. A credit allowed under this section is in lieu of a credit under section 43-1076 with respect to the same recycling equipment.

D. A taxpayer may claim a credit under this section with respect to new qualifying construction within ten years after the start of the facility's initial construction, but a credit is not allowed under this section for any amount spent more than ten years after the start of the facility's initial construction.

E. A taxpayer qualifies for the credit under this section if the taxpayer owns the facility or leases the facility or any component of the facility for a term of five or more years.

F. If the allowable tax credit exceeds seventy-five per cent of the taxes otherwise due under this title on the claimant's income, or if there are no taxes due under this title, the amount of the claim not used to offset taxes under this title may be carried forward for not more than fifteen taxable years as a credit against subsequent years' income tax liability.

G. Co-owners of a business, including partners in a partnership and shareholders of an S corporation, as defined in section 1361 of the internal revenue code, may each claim only the pro rata share of the credit allowed under this section based on the ownership interest. The total of the credits allowed all such owners may not exceed the amount that would have been allowed for a sole owner of the business.

H. If either of the following circumstances occurs with respect to a qualified environmental technology manufacturing, producing or processing facility, the tax imposed by this title for the taxable year in which the circumstance occurs shall be increased by the full amount of all credits previously allowed under this section with respect to that facility:

1. The taxpayer abandons construction before the facility is placed in service.
2. Before the facility is placed in service, the taxpayer changes plans in such a manner as to no longer qualify as an environmental technology manufacturing, producing or processing facility under section 41-1514.02.

I. If, within five years after being placed in service, an operating environmental technology manufacturing, producing or processing facility with respect to which a credit has been allowed under this section ceases for any reason to operate as an environmental technology manufacturing, producing or processing facility as described in section 41-1514.02, the tax imposed by this title for the taxable year shall be increased by an amount determined by multiplying the full amount of all credits previously allowed under this section with respect to that facility by a percentage determined as follows:

1. If the facility was placed in service less than one year before ceasing to operate as an environmental technology manufacturing, producing or processing facility, one hundred per cent.
2. If the facility was placed in service at least one year but not more than two years before ceasing to operate as an environmental technology manufacturing, producing or processing facility, eighty per cent.

3. If the facility was placed in service at least two years but less than three years before ceasing to operate as an environmental technology manufacturing, producing or processing facility, sixty per cent.
4. If the facility was placed in service at least three years but less than four years before ceasing to operate as an environmental technology manufacturing, producing or processing facility, forty per cent.
5. If the facility was placed in service at least four years but less than five years before ceasing to operate as an environmental technology manufacturing, producing or processing facility, twenty per cent.
- J. The department by rule shall prescribe record keeping requirements for taxpayers who claim a credit under this section.

43-1169. Credit for construction costs of qualified environmental technology facility

A. A credit is allowed against the taxes imposed by this title for expenses incurred in constructing a qualified environmental technology manufacturing, producing or processing facility as described in section 41-1514.02. The amount of the credit is equal to ten per cent of the amount spent during the taxable year to construct the facility, including land acquisition, improvements, building improvements, machinery and equipment, but not exceeding seventy-five per cent of the tax liability under this title for the taxable year determined without applying the credit.

B. Amounts qualifying for the credit under this section must be includible in the taxpayer's adjusted basis for the facility. The adjusted basis of any asset with respect to which the taxpayer has claimed a credit shall be reduced by the amount of credit claimed with respect to that asset. This credit does not affect the deductibility for depreciation or amortization of the remaining adjusted basis of the asset.

C. A taxpayer may claim a credit under this section with respect to new qualifying construction within ten years after the start of the facility's initial construction, but a credit is not allowed under this section for any amount spent more than ten years after the start of the facility's initial construction.

D. A taxpayer qualifies for the credit under this section if the taxpayer owns the facility or leases the facility or any component of the facility for a term of five or more years.

E. If the allowable tax credit exceeds seventy-five per cent of the taxes otherwise due under this title on the claimant's income, or if there are no taxes due under this title, the amount of the claim not used to offset taxes under this title may be carried forward for not more than fifteen taxable years as a credit against subsequent years' income tax liability.

F. Co-owners of a business, including partners in a partnership, may each claim only the pro rata share of the credit allowed under this section based on the ownership interest. The total of the credits allowed all such owners may not exceed the amount that would have been allowed for a sole owner of the business.

G. If either of the following circumstances occurs with respect to a qualified environmental technology manufacturing, producing or processing facility, the tax imposed by this title for the taxable year in which the circumstance occurs shall be increased by the full amount of all credits previously allowed under this section with respect to that facility:

1. The taxpayer abandons construction before the facility is placed in service.
2. Before the facility is placed in service, the taxpayer changes plans in such a manner as to no longer qualify as an environmental technology manufacturing, producing or processing facility under section 41-1514.02.

H. If, within five years after being placed in service, an operating environmental technology manufacturing, producing or processing facility with respect to which a credit has been allowed under this section ceases for any reason to operate as an environmental technology manufacturing, producing or processing facility as described in section 41-1514.02, the tax imposed by this title for the taxable year shall be increased by an amount determined by multiplying the full amount of all credits previously allowed under this section with respect to that facility by a percentage determined as follows:

1. If the facility was placed in service less than one year before ceasing to operate as an environmental technology manufacturing, producing or processing facility, one hundred per cent.

2. If the facility was placed in service at least one year but not more than two years before ceasing to operate as an environmental technology manufacturing, producing or processing facility, eighty per cent.

3. If the facility was placed in service at least two years but less than three years before ceasing to operate as an environmental technology manufacturing, producing or processing facility, sixty per cent.

4. If the facility was placed in service at least three years but less than four years before ceasing to operate as an environmental technology manufacturing, producing or processing facility, forty per cent.

5. If the facility was placed in service at least four years but less than five years before ceasing to operate as an environmental technology manufacturing, producing or processing facility, twenty per cent.

I. The department by rule shall prescribe record keeping requirements for taxpayers who claim a credit under this section.

ARIZONA STATE LEGISLATURE
Forty-fifth Legislature -- Second Regular Session

JOINT LEGISLATIVE INCOME TAX CREDIT
REVIEW COMMITTEE

Minutes of Meeting
Thursday, December 12, 2002
House Hearing Room 3 -- 2:30 p.m.

(Tape 1, Side A)

Cochairman May called the meeting to order at 2:39 p.m. and attendance was noted by the secretary.

Members Present

Senator Brown
Senator Valadez
Representative Camarot

Representative Chevront
Senator Cirillo,
Cochairman

Representative May,
Cochairman

Members Absent

Senator Bundgaard
Senator Daniels

Representative Knaperek
Representative Leff

Speakers Present

Kitty Decker, Majority Analyst, House Ways and Means Committee
Tom Miksell, Senior Fiscal Analyst/Economist, Joint Legislative Budget Committee (JLBC)
Georganna Meyer, Chief Economist, Arizona Department of Revenue
Kevin McCarthy, President, Arizona Tax Research Association (ATRA)
Craig Sullivan, Assistant Deputy Director/Policy, Research & Planning, Arizona Department of
Commerce
David Kimball, Environment Committee Chairman, Arizona Chamber of Commerce
Hans Olofsson, Senior Economist, Joint Legislative Budget Committee (JLBC)
Richard Stavneak, Director, Joint Legislative Budget Committee (JLBC)
Jim Apperson, President, Arizona Chamber of Commerce

Opening Remarks

Kitty Decker, Majority Analyst, House Ways and Means Committee, reviewed the charge of the committee (Attachment 1).

Cochairman May commented he has been working on having a review of tax credits done for two years. He would prefer to hear information on all the credits that are up for review prior to making decisions on retaining, amending or repealing the credits.

Mr. Chevront said that over the past eight years that he has been in office, he has heard that this type of review was needed. It is difficult to determine the point where more information is needed or that hard decisions need to be made.

Cochairman Cirillo stated he feels the entire tax code needs to be simplified. The current code is very difficult to understand. He would recommend eliminating all business and personal tax credits and replacing them with reduced tax tables that would allow for revenue neutral change. Some of the current tax credits support great programs. These credits should be handled as grants, not as tax credits.

Presentation by Joint Legislative Budget Committee (JLBC) on income tax credits for the 2002 review schedule

Tom Miksell, Senior Fiscal Analyst/Economist, Joint Legislative Budget Committee (JLBC), said he would review each credit individually in terms of history, revenue impact, economic benefits and complexity.

- Arizona Revised Statute (A.R.S.) 43-1076 - Recycling Equipment:

Mr. Miksell reviewed the recycling equipment tax credit (Attachment 2). He said it is difficult to determine the economic benefits of many of the tax credits due to confidentiality concerns.

Mr. Camarot said future legislators may want to look at changing some of the confidentiality requirements as it is very difficult to affect change when information is limited.

Mr. Cirillo commented if tax credits were separated from the tax system and put into a more open system, confidentiality concerns would be addressed.

In response to inquiry by Cochairman May, Mr. Miksell replied the corporate credit was repealed in 1999. There is a small amount that will be carried forward.

Mr. Cirillo inquired if it could be surmised that, based on the information presented, there are very few people in the recycling equipment business. Mr. Miksell attested there are a number of unknowns that could lead to the reason why there are not a lot of businesses taking advantage of the credit.

Cochairman May said it is important to know if the credit is working or not. Deeper analysis may be needed by JLBC in the future. It would be interesting to know why the corporate portion of this credit was repealed.

Georganna Meyer, Chief Economist, Arizona Department of Revenue, said she believes several corporate tax credits were repealed in an effort to lower the corporate tax rate. This effort began in the Senate.

Cochairman May inquired if tax credit benefits are transferable to an acquiring company. Mr. Miksell responded in the affirmative.

Kevin McCarthy, President, Arizona Tax Research Association (ATRA), stated when the bill was passed to eliminate some corporate tax credits, the corporate tax rate reduction was minimal.

- A.R.S. 43-1169 (Corporate) and A.R.S. 43-1080 (Individual) - Construction cost for qualified environmental technology facility:

Mr. Miksell reviewed the summary of the tax credit (Attachment 3).

Cochairman May suggested that in the future, current costs be included in the tax credit summary.

Mr. Chevront said it appears to him that a number of the credits that have been issued in this category are for projects that have not been constructed. This could have a significant impact on the budget.

In response to inquiry by Mr. Camarot, Mr. Miksell replied an environmental technology facility could be a facility that manufactures something that runs on a renewable fuel source. It could also be a recycling plant.

Mr. Camarot commented this credit seems to cover a very broad spectrum. Future Legislatures may want to re-examine this credit and narrow the scope of what it covers.

Mr. Chevront asked if confidentiality concerns prohibit the identification of companies that utilize the credit. Mr. Miksell responded in the affirmative.

Mr. Chevront continued by stating there were also sales tax and property tax incentives given to these companies to lure them to Arizona. He asked if there was a way to determine which companies received which credit. Ms. Meyer said if less than three corporations are in the group asking for the credit, the Department of Revenue will not report.

Mr. Chevront said he is concerned that there are a significant amount of tax credits being issued under this category that are being used by only a few corporations. The Department of Commerce would know who these corporations are as they need to be certified in order to qualify for the credit.

Cochairman May asked if there was a list of these corporations that could be made available to the public.

Craig Sullivan, Assistant Deputy Director/Policy, Research & Planning, Arizona Department of Commerce, said such a list exists and he will check on if it could be made available for review.

Ms. Meyer mentioned there was legislation passed that said the Department of Revenue could reveal confidential information if the taxpayer was notified and the taxpayer said there would be no competitive disadvantage created by releasing the information. This only relates to credits enacted after 1994.

In response to inquiry by Cochairman May, Mr. Miksell stated the Department of Commerce has indicated that they will review the certification on companies that have not begun construction

on the facility that qualified them for the tax credit. Mr. Sullivan added the Department is currently working on getting some clarity as to when construction will begin.

David Kimball, Environment Committee Chairman, Arizona Chamber of Commerce, said that although this credit was developed to entice facilities to Arizona, it was also created to encourage existing companies to expand.

Cochairman May commented that when this credit was first discussed, some members of the Chamber were opposed to it. By the end of the legislative process, the bill was rewritten to include existing companies looking to change their existing technologies to ones that were more environmentally sound. One of the major benefactors of this credit would be Phelps Dodge.

Mr. Camarot asked if there was any measurement to determine how beneficial this credit has been. Cochairman May responded there is no scientific way to determine benefits. All the committee can do is take the word of a company that has benefited from the credit.

Cochairman Cirillo said in this case, Phelps Dodge could provide information as to costs prior to implementation of the environmental measures and costs after the implementation.

Mr. Kimball responded that information can be gathered by the Chamber. This information speaks well of the benefit of the credit.

Mr. Chevront stated some of the retrofitting Phelps Dodge did at their mines was required by the federal government. In essence, the State of Arizona paid for improvements that Phelps Dodge would have had to make anyway.

Mr. Brown said that while Phelps Dodge does get some tax credits for various items, they do pay a great deal of taxes to the state.

- A.R.S. 43-1165 & 1166 (Corporate) and A.R.S. 43-1077 & 1078 (Individual) - Employment by and property taxes paid for by qualified defense contractor

Hans Olofsson, Senior Economist, Joint Legislative Budget Committee (JLBC), reviewed the defense contracting credit (Attachment 4).

In response to inquiry by Cochairman May, Mr. Olofsson said it is unknown whether or not this credit created new jobs.

Mr. Chevront said this credit was primarily created for manufacturers that were trying to restructure after losing military contracts. It is his understanding that none of these manufacturers pay corporate income taxes during the period the tax credits are in place.

Mr. Camarot asked how the provisions of this credit are monitored. Mr. Olofsson stated three different agencies are involved in the monitoring of this credit.

- A.R.S. 43-1167 (Corporate) and A.R.S. 43-1079 (Individual) - Employment in military reuse zone

Mr. Olofsson reviewed the military reuse zone credit (Attachment 5). The only military reuse zone in Arizona is at Williams Gateway Airport.

Cochairman May said this credit may have been well intentioned at its inception but certainly has not achieved anything to this point. He asked if a fiscal note was done on the bill that created this credit. Mr. Olofsson replied there was no fiscal note.

Richard Stavneak, Director, Joint Legislative Budget Committee (JLBC), said fiscal notes are kept in perpetuity. Requests for fiscal notes at the time of this measure were light at best.

Public Testimony

Mr. McCarthy stated he has opposed the environmental technology tax credit since its inception. A criterion of a good tax system is stability.

(Tape 1, Side B)

Mr. McCarthy continued by stating that taking a wide sweep at repealing tax credits will not help the current budget crisis. He would encourage making tax credit changes in concert with other changes that do not damage the chance to improve economic growth in Arizona.

Mr. Chevront remarked that a recent article in the newspaper stated Intel will not be expanding in Arizona due to a lack of a well educated workforce, which has nothing to do with tax credits. When there is a \$1 billion deficit in the budget, changes have to be made. He is concerned when cuts are made to programs that have an impact on revenues and no consideration is given to cutting credits.

Mr. McCarthy stated improving the tax system and encouraging economic growth will not be done by eliminating tax credits.

Further discussion ensued on tax credits and their use.

Jim Apperson, President, Arizona Chamber of Commerce, said his primary purpose is to encourage the committee to support a tax policy for the state that encourages economic development and the creation of high quality jobs for the citizens of Arizona. Decisions made by companies to relocate to Arizona often hinge on good tax policy. New companies can generate a great deal of tax revenue.

In response to inquiry by Cochairman May, Mr. Apperson replied it has been his experience that it is bad policy to make cuts here and there. It is important to create a positive tax environment in the state.

Mr. Camarot stated the Chamber says they want the tax code looked at as a whole, but they opposed a tax study that was performed in 1989. He feels the Chamber's action at that time

contradicts their request today. It seems that all the Chamber wants is to keep whatever economic incentives they can at the expense of other programs.

Mr. Apperson responded by saying the Chamber has supported actions that would cause a tax increase, like a proposition that would raise taxes to support education.

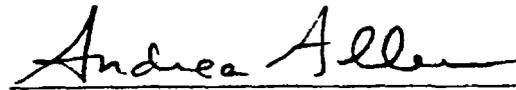
Cochairman May opined he is skeptical that changes are going to happen any time soon when it took him almost two years to get this committee into existence.

Cochairman Cirillo said he received a letter from the Chamber during the past Session related to the budget crisis that stated taxes could not be increased and credits should not be reduced.

Cochairman May stated he agrees that the tax code should be looked at over time, but remains skeptical that it will work. If the code was added to in small pieces, it can be changed in small pieces.

Cochairman May announced that due to a lack of a quorum, no action will take place.

Without objection, the meeting adjourned at 4:08 p.m.



Andrea Allen, Committee Secretary
December 17, 2002

(Original minutes, attachments and tape on file in the Office of the Chief Clerk.)