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Individual and Corporate Income and Franchise Tax -- Development Zone Tax Credit Modification (General Fund Taxes -- Individual and Corporate Income Taxes)

[LFB 2005-07 Budget Summary: Page 179, #9]

CURRENT LAW

Currently, a consolidated development zones tax credit can be claimed by businesses in development, enterprise development and development opportunity zones, and by businesses in the agricultural development zone. The credit is based on amounts spent on environmental remediation and the number of full-time jobs created or retained. The development zones capital investment tax credit can be claimed by businesses in certain development opportunity zones, and in the agricultural development zone. The credit is based on eligible expenses for tangible personal and real property. In general, the credits can only be used to offset income from the claimant's business activities in the zones and income from directly related business operations. Unused credits may be carried forward for 15 years to offset future tax liabilities.

GOVERNOR

Permit claimants of the consolidated development zones environmental remediation and jobs tax credit, the development zones capital investment tax credit, and the development zones investment tax credit, to use the credits to offset the entire amount of their income or franchise tax liability, rather than only the amount of tax attributable to income from business operations in the zone or from directly-related business operations. In addition, this provision would apply to carry-forwards of the former development zones tax credits for sales taxes, location expenses, environmental remediation, and day care expenses.

DISCUSSION POINTS

1. Prior to 1997 Wisconsin Act 27, businesses in development zones, development opportunity zones, and enterprise development zones were eligible for any of seven development zones tax credits under the state individual and corporate income and franchise taxes including: the jobs credit; investment credit; location credit; sales tax credit; research credit; day care credit; and environmental remediation credit. Act 27 created the current consolidated development zones environmental remediation and jobs tax credit to replace those credits. The 2001-03 biennial budget act (2001 Wisconsin Act 16) created the development zone capital investment tax credit. In addition, under current law, the former development zones investment tax credit can still be claimed by businesses in development opportunity zones (Kenosha, Milwaukee, and Beloit). The former development zones investment tax credit and the current consolidated development zones credit and capital investment tax credit are described in the Appendix.

2. As noted, the bill would allow taxpayers to use the consolidated development zones environmental remediation and jobs tax credit, the development zones capital investment tax credit, and the development zones investment tax credit to offset the entire tax liability of the business, not just the taxes on income generated by business operations in development, development opportunity, or enterprise development zones, or in the agricultural development zone. In addition, unused carry-forwards of previous development zone tax credits could also be used in this manner. The provision would first apply to credits claimed for tax years beginning on or after January 1, 2005, including the unused credits carried forward from prior years. However, if the bill takes effect after July 31, the provisions would first apply to tax years beginning on January 1, of the year following the year in which the bill takes effect.

3. The proposed change is supported, in part, because it would increase the incentive value of the tax credits to businesses that have operations both inside and outside the zones. Frequently, business operations in the zones, particularly in development zones, are start-ups or expansions that generate little initial net income and tax liability. As a result, a nonrefundable tax credit does not provide much financial incentive to a business to invest or create or retain jobs in a zone. However, a firm would have more incentive to locate a branch facility in a zone if it could use the tax credits to offset all of the business' income or franchise taxes. Also, certain types of business operations would not benefit from involving branch plants or offices credits. As an example, a distribution center, by itself, is likely to have substantial costs compared to the income that could be attributed to it. As a result, the tax credits would have minimal financial effect on the center's operations. On the other hand, the center would increase the overall profitability of the business and the credits could offset some of the taxes on the increased income. Commerce staff has indicated that there have been cases where a business project was not undertaken because the credits provided relatively few tax benefits to the business. Economic research indicates that tax incentives are more effective if the benefits are relatively large and targeted to distressed areas such as development zones.

4. The provision is also supported because it would simplify administration of the tax credits for the Department of Revenue (DOR). Currently, there is no specified form or method for

determining the income from a business operation in a zone for multi-location businesses. Consequently, it is difficult to determine what portion of the total net income of a multi-location business would be generated by the operations in the zone. The issue is similar to apportionment of the income of multi-state corporations. For example, the business is required to attribute overhead and management expenses to a particular branch and while identifying the specific revenue flow from that facility. In addition, limits on the use of tax credits to offset tax liability vary depending on the tax year in which the tax credit was claimed. When applied to credit carry-forwards, this can create confusion for taxpayers and administrative problems for DOR. Specifically, the limits on the offset of tax liability under current law are: (a) development zone tax credits that were claimed for tax years prior to 1998 can offset the income and franchise tax on income from business operations in the zone and income from other business operations that are directly related to operations in the zone; (b) development zone tax credits that were claimed in tax years 1998 and 1999 can offset any income or franchise tax due; and (c) development zone tax credits for tax years beginning on or after January 1, 2000, may only offset the income and franchise tax on income that is directly attributable to income from business activities in a zone. The AB 100 provision would provide for consistent treatment of tax credit carry forwards.

5. According to Department of Revenue, aggregate individual income tax statistics for the 2003 processing year, a total of $1.2 million in development zone tax credits were claimed, and almost the entire amount claimed was used to offset income tax liability. Generally, entities claiming these credits under the state individual income tax use the credits to offset income tax liabilities in the year in which they are claimed. However, this is not the case for corporations. The aggregate corporate statistics for 2002 indicate that a total of $12.8 million in development zones tax credits was claimed, while $8.6 million was used to offset tax liability. Consequently, $4.2 million in credits were carried forward to future years. Both the total amount of credits available and the amount used include carry-forwards from previous years as well as current year amounts. Simulations using the 2001 corporate income and franchise tax sample indicate that between $1.0 and $2.0 million in tax credits annually are not used to offset current year tax liabilities. Under the bill, multi-location firms with development zone tax credit carry-forwards could apply those amounts to the business' entire tax liability. These data indicate that, depending on the number of multi-location firms with development zone tax credit carry-forwards and the firms' gross tax liabilities, state corporate income and franchise tax revenues could be reduced by a significant amount, under the provisions in the bill. However, information is not available to determine the number of multi-location firms and the total tax liabilities of those firms. As a result, the fiscal effect of the provision is unknown.

6. Some economic analyses indicate that tax incentives are not always cost-effective. Business investment decisions that are influenced by the tax benefits are more than offset by investment actions that would have occurred without any incentives. Studies have found that nine out of each one hundred jobs created, and three out of 10 business start-ups or expansions were influenced by tax incentives. One national study of enterprise zones found cases where tax incentives resulted in negative tax rates on new plant investment. From this view, allowing development zone tax credits to offset the total tax liability of some companies could effectively subsidize business activities outside of development zones.

ALTERNATIVES

1. Adopt the Governor's recommendation to permit claimants of the consolidated development zones environmental remediation and jobs tax credit, the development zones capital investment tax credit, and the development zones investment tax credit to use the credits to offset the entire amount of their income or franchise tax liability rather than only the amount of tax attributable to income from business operations in the zone or from directly-related business operations. In addition, apply the provision to carry-forwards of the former development zones tax credits for sales taxes expenses, location expenses, environmental remediation, location expenses, and day care expenses.

2. Maintain current law.

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APPENDIX

Former Development Zones Investment Tax Credit and Current Consolidated Development Zones Credit and Capital Investment Credit

Former Development Zones Investment Tax Credit

The former development zones investment tax credit can still be claimed under the state individual and corporate income and franchise taxes by businesses in development opportunity zones (Kenosha, Milwaukee, and Beloit) under current law. The development zones investment tax credit provides a credit against income and franchise taxes due equal to 2.5% of the purchase price of depreciable tangible personal property not expensed under section 179 of the Internal Revenue Code, or 1.75% of the purchase price of depreciable tangible personal property that is expensed under section 179. The property must be purchased after the business is certified for tax benefits by the Department of Commerce. Only taxes due on income generated by or directly related to business activities in the development zone can be offset by the credit. The credit is not refundable, but unused credit amounts can be carried forward fifteen years to offset future tax liabilities.

Consolidated Development Zones Tax Credit

The consolidated development zones tax credit can be claimed under the state individual and corporate income and franchise taxes and is based on environmental remediation expenses and the creation and retention of jobs.

a. *Environmental Remediation Component.* A credit against income taxes due can be claimed for 50% of the amount expended for environmental remediation in a development enterprise development or agricultural development zone. "Environmental remediation" is defined as removal or containment of environmental pollution, and restoration of soil or groundwater that is affected by environmental pollution in a brownfield if removal, containment, or restoration began after the area that contains the site where the work was done was designated a development or enterprise development zone. Investigation costs are eligible unless the investigation determines that remediation is required and remediation is not undertaken. "Environmental pollution" means the contaminating or rendering unclean or impure the air, land or waters of the state, or making the same injurious to public health, harmful for commercial or recreational use, or deleterious to fish, bird, animal or plant life. "Brownfield" is defined as an industrial or commercial facility the expansion or redevelopment of which is complicated by environmental contamination.

b. *Full-Time Jobs Component.* A credit of up to $8,000 against income and franchise taxes can be claimed for: (1) each full-time job created in a development enterprise development, or agricultural development zone and filled by a member of a targeted group; and (2) retaining a full-time job in an enterprise development zone if Commerce determines that a significant capital investment was made to retain the full-time job. In addition, a credit of up to $6,000 can be claimed for each full-time job created or retained in a development or enterprise development zone that is filled by a Wisconsin resident who is not a member of a targeted group. At least one-third of jobs credits claimed must be based on jobs created and filled by targeted group members. In addition, except for businesses that only claim credits for environmental remediation, 25% of all tax credits claimed must be based on creating or retaining full-time jobs.

The development zone tax credit can only be used to offset the amount of tax that is attributable to the income from business operations in the zone. Credits that are not entirely used to offset income or franchise taxes in the current year can be carried forward up to fifteen years to offset future tax liabilities.

Members of a targeted group include food stamp recipients, dislocated workers, economically disadvantaged youths, economically disadvantaged ex-convicts, vocational rehabilitation referrals, economically disadvantaged veterans, general assistance recipients, supplemental security income (SSI) recipients, qualified summer youth employees, Wisconsin Works (W-2) participants, and residents of a federally designated enterprise community.

Development Zones Capital Investment Tax Credit

The development zones capital investment tax credit is provided under the state individual and corporate income and franchise taxes and can be claimed by businesses in the Milwaukee and Beloit development opportunity zones, and by eligible claimants in the agricultural development zone. The development zone capital investment tax credit equals 3% of the following:

a. The purchase price of depreciable, tangible personal property. The property must have been purchased after the claimant was certified as eligible for tax benefits, and the personal property has to have at least 50% of its use in the claimant's business location in the zone. If the property is mobile, the base of operations for at least 50% of its use must be in the zone.

b. The amount expended to acquire, construct, rehabilitate, remodel, or repair real property in the zone. Such expenses are eligible for the credit if the claimant began the physical work of construction, rehabilitation, remodeling or repair, or any demolition or destruction in preparation for the physical work, after the place where the property is located was designated a zone, or if the completed project is placed in service after the claimant is certified for tax benefits. A credit cannot be claimed for expenses for preliminary activities such as planning, designing, securing financing, research, developing specifications, or stabilizing the property to prevent deterioration.

A claimant can also claim a tax credit for amounts expended to acquire real property, if the property was not previously owned and the claimant acquired the property after the place where the property was located was designated a development opportunity, technology, or agricultural development zone or if the completed project was placed in service after the clamant was certified as eligible for tax benefits.

Credits can be used to offset income generated by or directly related to business activities in the zone. Credits that are not entirely used to offset income or franchise taxes in the current year can be carried forward up to 15 years to offset future tax liabilities.