

SPOTLIGHT ON SECRET CHECKS

Revenue Report Notes Size, Growth of Research Credit

A new report today from Iowa Department of Revenue provides important new information about the size and growth of the state's Research Activities Credit (RAC). The Iowa Fiscal Partnership has indicated this business-oriented tax credit needs legislative scrutiny and reform. The RAC, which has cost the state over \$263 million since its inception in 1985, provides a credit to corporate and individual income taxpayers tied to increases in expenditures for research carried out in Iowa. The new report shows most of this money has gone to a small number of large, multistate corporations. For the top 10 corporations claiming the credit, the "refund" checks have averaged \$3 million. They were among 134 corporations that paid no state income tax in FY2005 but instead received RAC checks from the state.

REFUNDABILITY: SECRET CHECKS WITH NO OVERSIGHT

According to the report, 38 states have an RAC, but Iowa is one of only five states that allow the credit to be refundable. What does this mean? Suppose a corporation expands its spending on research activities in Iowa and by so doing qualifies for a credit of \$500,000. The corporation owes just \$100,000 in corporate income taxes. In most states, the credit would simply eliminate the tax; the corporation would receive a \$100,000 credit offsetting the \$100,000 tax liability. In Iowa, however, the company would get a check for \$400,000 — the amount of the credit over and above its tax due. This is called, rather misleadingly, a refund, which implies that the state is returning money the company paid.

It would be more accurate to simply call these "refunds" secret checks to companies that receive no oversight and that are made through the tax system instead of through the appropriations process.

Refundability turns out to account for most of the cost of the Iowa research credit. The Revenue report found that, of all the money claimed by corporations for the RAC from 2000 to 2005, 92 percent consisted of secret checks, or "refunds" to undisclosed companies. Refundability also makes the Iowa credit substantially more costly than RACs in most other states, including Iowa's neighbors. For fiscal year 2006, research activities credits reduced corporate income tax receipts by \$17.5 million in Minnesota, \$18.5 million in Wisconsin, and just \$0.6 million in Illinois, compared to \$29.5 million in Iowa, despite all three of those border states having much larger economies than Iowa.

RAC CLAIMS ARE HIGHLY CONCENTRATED IN A FEW LARGE FIRMS

From 2000 to 2005, total corporate RAC claims averaged \$29.7 million per year, and on average \$24.3 million of those credits, 82 percent of all credits, went to just the top 10 firms making the claims each year. There were, on average, 152 claims each year. From 2000 to 2005, 86 percent of the dollars paid went to firms with over 500 employees, while 6 percent went to smaller firms (under 100 employees).

The "refunds" or undisclosed appropriations are even more concentrated. From 2000 to 2005, the top 10 firms accounted for 86 percent of the state checks issued for the RAC. The average RAC check written

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to the top 10 firms in 2005 was nearly \$3 million. Furthermore, these were multistate companies doing only a small share of their business in Iowa; the average top-10 firm getting one of these \$3 million checks in 2005 did over 97 percent of its business outside the state.

While the state spent \$39 million on this one tax credit program in 2005, taxpayers are not allowed to know which firms receive RAC credits or checks. Only with supplementary credits awarded by the Iowa Department of Economic Development is the identity of the recipient company disclosed. A number of states require disclosure of tax credits received by business, known as “tax transparency,” but Iowa does not (See IFP report, *Looking Behind the Curtain: Unveiling the Problem of Tax Expenditures in Iowa*).

DOES THE RAC WORK?

In an attempt to measure the extent to which larger credits produced larger expenditures on research, more patents, or more employment of scientists and engineers, Revenue’s study performed a statistical analysis looking at Iowa and its neighboring states and other leading manufacturing states. According to the report: “In a comparison with other top manufacturing states, and in a comparison that pooled both sets of states, the size of the credit did not appear to affect any of the three indicators of research activity.” Overall, although the study indicated there may be some effect on research spending and patents compared with neighboring states, the study results were inconclusive, and could not confirm that Iowa’s annual expenditure of \$30-plus million is actually having a significant effect on the level of research activity in the state. The credits may for the most part be paying firms for conducting research that would have been undertaken anyway.

The Revenue report explored several options for changing the RAC, based on features of research credits in other states. Because the Iowa claims are so highly concentrated in a small number of large multistate corporations, putting a cap on the total credit or on the refundability of the credit would substantially reduce overall spending without reducing the credit received by the majority of RAC claimants. The fiscal effect of some of these options, estimated for tax year 2004, is shown below.

- Capping refundability of the credit at \$100,000 per firm would have reduced RAC claims by about 75 percent, saving the state \$26 million.
- Allowing refundability only for firms with \$20 million or less in total receipts would have saved the state \$30 million, or 86 percent.

Capping refundability would be a first step in getting some control over state tax credits and their unintended impacts. It would further enable Iowa to make more strategic and transparent investments in Iowa’s economy, particularly around workforce development and workforce shortages (see IFP backgrounder, *No More Secret Checks?*).

Corporate Research Activities Credit Claims Have Grown, 2000-05

Tax Year	Number of Claims	Total claims (\$ millions)	Claims paid as refunds (\$ millions)	Percent of claims with refunds	Claims by top 10 firms (\$ millions)	Refunds to top 10 firms (\$ millions)	Percent of claims paid as refunds	Percent of claims by top 10	Percent of refunds by top 10
2000	139	25.3	22.6	73.4	20.7	19.4	89.1	81.5	86.0
2001	143	25.4	23.9	80.4	20.5	20.0	94.0	80.7	83.5
2002	142	27.5	25.7	85.2	22.2	21.7	93.7	80.8	84.3
2003	160	29.8	28.1	81.3	23.4	23.1	94.1	78.3	82.4
2004	158	33.1	30.2	79.2	27.5	26.3	91.4	83.0	86.9
2005	172	37.2	32.8	77.9	31.6	29.7	88.4	85.1	90.5
Average	152	29.7	27.2	79.6	24.3	23.4	91.8	81.6	85.6

Source: Iowa Department of Revenue, *Iowa’s Research Activities Tax Credit: Tax Credits Program Evaluation Study*, January 2008