Fiscal Note

BILL # HB 2815

TITLE: employment; incentives; regulatory tax credit

SPONSOR: Mesnard

STATUS: Senate Engrossed

PREPARED BY: Hans Olofsson

Description

HB 2815 includes the following provisions: (1) reduces the income taxation of long-term capital gains accrued on assets acquired after 2011, (2) increases the net operating loss carry forward for businesses from 5 to 20 years, (3) increases the exemption amount for business personal property (4) provides a one-time income tax deduction equal to 10% of federal bonus depreciation on assets placed in service in 2012, (5) creates a new income tax credit for capital investments in certain facilities, and (6) repeals the individual employer cap for the $3,000 new job tax credit enacted in 2011. Please see attached detail for more information.

Estimated Impact

HB 2815 is estimated to cost $28.4 million in FY 2014 and $53.0 million in FY 2015. By the time all provisions in the bill are implemented in FY 2019, the total cost will be an estimated $107.8 million.

The bill may generate increased economic activity that would not occur absent the legislation. Any additional economic growth spurred by the bill's tax provisions may have a "dynamic impact" in the sense of producing additional tax dollars for the state. Dynamic models typically place the offsetting impact of tax reductions at a range of 2% to 20%. The estimates in the table above do not reflect such dynamic effects.

5/23/12

General Fund Impact of Senate Engrossed Version of HB 2815 ($ in Millions) [1/]

Description (Effective Date)	Tax	FY 14	FY 15	FY 16	FY 17	FY 18	FY 19
Phases in (over 3 years) a 25% reduction of long-term capital gains on assets purchased after CY 2011 (TY 2013) [2/]	Individual Income	(17.5)	(40.5)	(56.5)	(61.4)	(65.6)	(69.3)
Extends the net operating loss (NOL) carry forward from 5 years to 20 years (TY 2012) [3/]	Corporate Income	0.0	0.0	0.0	0.0	0.0	(12.2)
Amends calculation of the index used to determine the annual business personal property exemption amount (TY 2013) [4/]	Property	(0.9)	(0.9)	(0.9)	(0.9)	(0.9)	(0.9)
Provides income tax deduction equal to 10% of federal bonus depreciation for assets placed in service in CY 2012 (TY 2013) [5/ 6/]	Individual Income	(4.2)					
Creates a new income tax credit for capital investments in new or expanded manufacturing facilities, commercial headquarters, or research facilities (TY 2013) [7/]	Individual & Corporate Income	(4.0)	(8.0)	(12.0)	(16.0)	(20.0)	(20.0)
Eliminates individual company cap of 400 credit-eligible new employees for purposes of claiming the $3,000 job tax credit (TY 2013) [8/]	Individual & Corporate Income	(1.8)	(3.6)	(5.4)	(5.4)	(5.4)	(5.4)
Total General Fund Impact [9/]		**$ (28.4)**	**$ (53.0)**	**$ (74.8)**	**$ (83.7)**	**$ (91.9)**	**$(107.8)**

Notes:

1/ Estimates prepared by JLBC Staff on May 3, 2012.

2/ Reduction, which is 10% in FY14, 20% in FY15, and 25% in FY16 and thereafter, applies to long-term capital gains.

3/ This provision is the same as in SB 1084. For more detail, see fiscal note for SB 1084.

4/ This provision is the same as in SB 1367. For more detail, see fiscal note for SB 1367.

5/ Estimate provided by the Department of Revenue (DOR) on April 30, 2012.

6/ Revenue impact after FY14 will depend on whether federal bonus depreciation is extended.

7/ Estimate assumes new capital investments totaling $200 million each year. Credit must be claimed in equal installments over 5 years.

8/ Estimate assumes that 600 additional employees will qualify for the $3,000 new job tax credit each year as a result of the bill's elimination of the individual company credit cap of 400 new employees.

9/ Does not include an estimate of "dynamic" revenue impacts.

Description of Fiscal Impact Provisions in HB 2815

Reduction of Long-Term Capital Gains
The bill reduces the individual income taxation of long-term capital gains on assets acquired after Tax Year (TY) 2011. Long-term capital gains are realized on assets held longer than 12 months. The capital gains reduction is 10% in TY 2013, 20% in TY 2014, and 25% in TY 2015 and thereafter. Capital gains on assets purchased in TY 2011 or earlier are not affected by the bill.

This provision is estimated to reduce individual income taxes by $(17.5) million in FY 2014, $(40.5) million in FY 2015, $(56.5) million in FY 2016, $(61.4) million in FY 2017, $(65.6) million in FY 2018, and $(69.3) million in FY 2019. The direct revenue loss associated with the bill is expected to increase over time as increasingly more assets acquired after 2011 are sold. (Note that this analysis assumes that the revenue impact of a tax year change will occur in the following fiscal year.)

The estimates above were based on a report issued by the Statistics of Income Division of the Internal Revenue Service (IRS) in 2010. This report, which is based on federal individual income tax returns filed for TY 2007, shows that 37.6% of net capital gains included in federal adjusted gross income (FAGI) in TY 2007 were for assets held between 1 and 2 years, 5.9% for assets held between 2 and 3 years, 5.1% for assets held between 3 and 4 years, 4.2% for assets held between 4 and 5 years, and 13.0% for assets held between 5 and 10 years. An earlier report by the IRS that included capital gains data for tax years 1999 through 2003 showed similar percentages with respect to the asset holding periods as those contained in the 2010 report.

Based on the University of Arizona's (UA) Capital Gains Model, the state is projected to collect individual income taxes from capital gains averaging $465 million annually between TY 2013 and TY 2018. It should be noted, however, that capital gains can vary considerably over time. To provide some perspective, capital gains contributed between $150 million and $750 million annually to individual income tax collections in the period between FY 2000 and FY 2010. This analysis assumes that the asset holding times for annual net capital gains in each year through TY 2018 will be the same as those reported in the 2010 IRS study.

Based on the 2010 IRS report and UA's capital gains forecast, this provision is estimated to reduce individual income taxes from capital gains by $(17.5) million in FY 2014, the first year of the 3-year phase-in period. This estimate was derived by applying the 10% exemption to the amount of net capital gains attributable to assets held between 1 and 2 years [37.5% of $465 million, or $175 million]. In the third and final year of the phase-in period (FY 2016), the revenue loss is estimated to be $(56.5) million [25% exemption applied to the amount of net capital gains derived from assets held between 1 and 4 years, or 48.6% of $465 million]. The revenue loss is estimated to grow to $(69.3) million in FY 2019 by which time all the bill's provisions have been implemented.

The analysis does not attempt to adjust for any potential change in the level of capital gains realizations that could result from the bill's 3-year exemption schedule of 10%, 20%, and 25%. The exemption phase-in could result in fewer asset sales (and hence capital gains) in TY 2013 and TY 2014 than under current law since individuals may defer taking their capital gains until TY 2015 when the maximum exemption of 25% has been phased in.

The method used to produce the estimates above is essentially the same as that used in the fiscal note for the original version of HB 2815. For more detail on the methodology, see the prior fiscal note for HB 2850 (As Introduced).

Local Government Impact
Each year, incorporated cities and towns receive 15% of income tax collections from 2 years prior. This provision would reduce local government distributions by $(2.6) million in FY 2016 and $(6.1) million in FY 2017.

Extension of Net Operating Loss Carry Forward
Under Arizona law, a corporation that incurs a net operating loss (NOL) is allowed to carry forward that amount in each of the 5 succeeding years for purposes of offsetting its taxable income in those future years. HB 2815 increases the NOL carry forward period from 5 years to 20 years, beginning in TY 2012. According to DOR, this provision, which is the same as in SB 1084, is expected to reduce corporate income taxes by an estimated $(5.6) million to $(18.9) million annually. This analysis assumes that the cost will be the mid-point of that range, or $(12.2) million, beginning in FY 2019. DOR's estimate cannot be independently verified, as JLBC Staff does not have access to tax-filing data. For more detail on the estimate, see the fiscal note for SB 1084 (As Introduced).

Local Government Impact
Each year, incorporated cities and towns receive 15% of income tax collections from 2 years prior. This provision would reduce local government distributions by $(1.8) million, beginning in FY 2021.

<u>Change in Calculation of Index Used to Determine Personal Property Exemption Amount</u>
In 1996, the Legislature referred to the ballot, and voters approved, a constitutional $50,000 exemption for business personal property. This exemption amount is adjusted for inflation each year and is currently $68,079. Laws 2011, 2nd Special Session, Chapter 1 replaced the Gross Domestic Product (GDP) Implicit Price Deflator with the Employment Cost Index for purposes of calculating the inflation-adjusted exemption amount each year, beginning in Tax Year (TY) 2012.

Beginning in TY 2013, HB 2815 calculates the exemption amount based on the percentage increase in the Employment Cost Index in the 2 most recent complete fiscal years rather than only the most recent fiscal year. Additionally, the exemption amount is recalculated as if this provision had been continuously in effect since 1997. According to DOR, the exempt amount under HB 2815 is expected to be about $125,700.

Based on data provided by the Maricopa County Assessor's Office, this provision is estimated to reduce net assessed valuation (NAV) in the state by $(86.6) million, which results in a direct General Fund cost of $3.8 million, beginning in FY 2014. The bill's NAV reduction increases the direct cost for K-12 funding under the Basic State Aid formula. However, depending on the decision of the Legislature, this cost increase could be mitigated as a result of the automatic tax rate adjustments allowed under the state's Truth-In-Taxation (TNT) provisions. If the Legislature decides to allow the TNT adjustment to automatically take effect, the net General Fund cost would be reduced to an estimated $900,000, beginning in FY 2014.

This provision is the same as in SB 1367. For more detail on the estimate, see the fiscal note for SB 1367 (As amended by Senate Finance).

Local Government Impact
This bill would shift the tax burden to property owners not affected by this legislation and/or result in property tax losses for local governments.

<u>Income Tax Deduction for Federal Bonus Depreciation</u>
Federal law provides 50% bonus depreciation for qualified property placed in service in 2012. This provision serves to reduce federal income taxes. Since Arizona does not conform to federal bonus depreciation, however, such a deduction is not allowed on state income tax returns. HB 2815 amends current statute by partially conforming to the federal bonus depreciation provision. The bill provides a one-time state individual income tax deduction equal to 10% of the bonus depreciation claimed on federal returns for assets placed in service in 2012.

According to an estimate provided by DOR on April 30, 2012, the provision is expected to reduce income taxes by $(4.2) million in FY 2014. This estimate cannot be independently verified since JLBC Staff does not have access to tax return data.

The fiscal impact of this provision after FY 2014 will depend on whether the federal government extends bonus depreciation. The 50% bonus depreciation currently provided to businesses will expire at the end of calendar year 2012.

Local Government Impact
Each year, incorporated cities and towns receive 15% of income tax collections from 2 years prior. This provision would reduce local government distributions by $(0.6) million in FY 2016.

<u>Qualified Facility Income Tax Credit</u>
Beginning in TY 2013, the bill creates a new individual and corporate income tax credit for businesses that expand or locate qualified facilities in the state. The credit is 10% of the lesser of: (1) the capital investment in the facility or (2) $200,000 for each net new employee at the facility. To be eligible for the credit, a business is required to devote at least 80% of its property and payroll at the facility to manufacturing, research, or a national or regional headquarters. There are also certain minimum requirements with respect to wage and health insurance coverage for new employees at the facilities.

The credit is refundable but no single taxpayer can claim more than $30 million in credits per calendar year. The credit must be taken in equal installments over 5 taxable years. The qualified facility credit program is subject to an aggregate annual cap of $70 million, which it shares with the renewable energy credit program enacted in 2009.

The direct revenue loss of the credit program depends on the extent to which businesses would expand or locate qualified facilities in the state in the absence of this incentive. If such investments would not occur without the credit program, then the bill's cost would be at least partially offset by the additional tax collections related to new facilities. This analysis assumes that there will be a total of $20 million in new credits claimed each year, taken in equal installments over 5 years. This level of credit use would be the equivalent of $200 million in qualifying capital investments <u>or</u> 1,000 qualified new employees each year, or some combination thereof. Under this scenario, the cumulative revenue loss would grow from $(4.0) million in FY 2014 to $(20.0) million in FY 2019 with the 5-year equal installment provision.

To provide some perspective on the $200 million in investments without HB 2815, the Greater Phoenix Economic Council (GPEC) listed in its 2011 Annual Report a total of 31 companies that the organization had helped to locate to the Metro Phoenix area. These companies will reportedly create more than 7,000 new jobs and make capital investments of almost $800 million in the state. Not all of these businesses would necessarily qualify for the facility credit (if had been available in 2011). Additionally, some of the businesses may use other incentives, such as the renewable energy credit or new job tax credit.

This analysis is based on a scenario with qualifying capital investments of $200 million each year, or approximately one-fourth of the level reported by GPEC, which translates into $20 million in new credits claimed each year. Alternatively, the same amount of credit use could come also from the hiring of 1,000 new employees at qualified facilities [10% of $200,000 multiplied by 1,000 net new employees] each year.

As noted above, the facility credit will share the annual credit cap of $70 million with the existing renewable energy credit. This cap-sharing provision does not, however, eliminate the cost of the new facility credit. The fiscal impact is calculated based on the current revenue base, and therefore, the current use of the renewable energy credit. The current revenue base does not assume $70 million in renewable energy credit use. According to the Arizona Commerce Authority, the actual use of the credit was $2.5 million in 2011. Credit use in the first quarter of 2012 was $3.9 million. Since the new facility credit will expand usage beyond these levels, it will have a General Fund cost.

Local Government Impact
Each year, incorporated cities and towns receive 15% of income tax collections from 2 years prior. This provision would reduce local government distributions by $(0.6) million in FY 2016 and $(1.2) million in FY 2017.

<u>Elimination of the Individual Employer Cap for the $3,000 New Job Tax Credit</u>
Laws 2011, 2^{nd} Special Session, Chapter 1 established a 3-year $3,000 annual tax credit for each net new qualifying job added by an employer in the state. The act provided an annual aggregate credit cap of 10,000 net new jobs. However, no employer is allowed to claim more than 400 net new employees per year. Beginning in TY 2013, HB 2815 eliminates the individual company credit cap of 400 new employees.

The removal of the company-specific cap is likely to increase to cost of the existing job tax credit program. Data on current credit usage is not available. Absent such data, this analysis assumes that the elimination of the cap will result in 600 new credit claims each year over and above the level currently assumed in the baseline. Under this scenario, the revenue loss would be $(1.8) million in FY 2014, $(3.6) million in FY 2015, and $(5.4) million in FY 2017 through FY 2019.

Local Government Impact
Each year, incorporated cities and towns receive 15% of income tax collections from 2 years prior. This provision would reduce local government distributions by $(0.3) million in FY 2016 and $(0.5) million in FY 2017.