It’s Time to Cap the Research Activities Tax Credit

Iowa offers an extremely generous tax credit to the largest and most profitable corporations in the state – the Research Activities Tax Credit. The Research Activities Tax Credit creates refunds when the tax credit exceeds a company’s or an individual’s state tax liability and no state income tax in owed. Individuals can receive the Research Activities Tax Credit, as can limited liability corporations, S corporations, and partnerships. Additionally the Iowa Economic Development Authority can grant Supplemental Research Activities Tax Credit, which increases the amount of tax credits a company can claim. The Iowa Code does not place a cap on the total amount of Research Activities Tax Credit that can be refunded. This tax credit can be claimed year-after-year, becoming an annual subsidy.

Current Iowa Code lays out which companies can claim the Research Activities Tax Credit. According to the Iowa Department of Revenue, “During the 2018 Legislative session, the Iowa Research Activities Tax Credit was limited, retroactively for tax years beginning on or after January 1, 2017, to businesses conducting qualified research that are engaged in manufacturing, life sciences, software engineering, or the aviation and aerospace industry. Ineligible businesses include but are not limited to those engaged in agricultural production, those that are an agricultural cooperative, finance or investment company, retailer, wholesaler, transportation company, publisher, real estate company, collection agency, accountant, or architect, or those that are a contractor, subcontractor, builder, or contractor-retailer engaging in commercial and residential repair and installation including but not limited to heating or cooling installation and repair, plumbing and pipe fitting, security system installation, and electrical installation and repair. In addition, to be eligible to claim the Iowa credit, Iowa law requires that the researching entity must claim and be eligible for the Federal Credit for Increasing Research Activities under IRC section 41 for the same taxable year.”

Then in 2019, the Iowa legislature passed some clarifying language that would include agriscience in the list of businesses that would qualify for the Research Activities Tax Credit, making the change retroactive to January 1, 2017. Previously the Department of Revenue included agriscience in the life sciences industry.

In 2018, the Research Activities Tax Credit refund checks for companies and individuals totaled $46 million, the Department of Revenue reports. Many of the tax credits in 2018 went to big corporations, including these companies who received the largest refunds:

- Rockwell Collins, which claimed $13.7 million
- Deere & Co., which claimed $4.8 million
- E I DuPont De Nemours, owner of Pioneer, Hi-Bred which claimed $4.8 million
- John Deere Construction & Forestry, $2.4 million
- Green Plains Inc., which claimed $1.7 million
- The list continues with Poet, Monsanto, Cargill, Dow Chemical, Syngenta, and others.

Is the Research Activities Tax Credit Too Generous?

The significant size of the Research Activities Tax Credit refunds leads to some questions. Do the largest corporations in the state need subsidies this large? What in government is not being funded because of these large subsidies? What is happening to the funding for our public universities and their research initiatives?

1 “Research Activities Tax Credit Annual Report For the Period January 1 – December 31, 2018”, Iowa Department of Revenue
2 To see the Research Activities Tax Credit Annual Reports for current and prior years, see https://tax.iowa.gov/report/Reports?combine=Research%20Activities
Supporters claim that the research performed in private companies creates good-paying jobs, which circulates money in the local community and allows the employees to pay taxes. But the big question is does this incentive need to be so generous when other areas of government are starved and needed programs are barely funded, such as clean water initiatives.

**Research confirms tax breaks hurt a state’s finances: research and development tax credits have the largest negative impact**

Perhaps you have wondered why the state of Iowa does not spend money on water quality improvements, why funding for state universities has been decreasing, why the Iowa Department of Natural Resources faces tight budgets year-after-year, and the list goes on and on and on. City governments face tough budget choices, such as funding libraries or other public services. Bruce McDonald, John Decker, Brad Johnson, and Michelle Allen, from North Carolina State University, looked into those questions in a study “You Don't Always Get What You Want: The Effect of Financial Incentives on State Fiscal Health”, published in SSRN on April 23, 2019. And the conclusion was “Ultimately, the results show that financial incentives negatively affect the overall fiscal health of a state.”

Tax incentives limit revenue. They also require additional expenditures to support the services needed for the new businesses and the people that are brought into the community along with the business. It is a cycle that ultimately results in draining revenue, reducing overall fiscal health, and reducing core public services. The problem is exacerbated when efforts are made to cut tax rates.

The McDonald study reported that the “research and development tax credits were shown to have the largest negative effect, followed by investment tax credits and property tax abatements. Job training grants were shown to increase a state’s dependence on the federal government for additional funding, whereas job-creation credits were found to have no significant effect on the fiscal health of a state.”

Further, the McDonald study pointed out “Politicians and economic developers alike tout the incentives as good economic policy (Buss, 1999; Jensen & Malesky, 2018; Noto, 1991). With new business comes an expectation of new employment opportunities and an improved quality of life for residents within the community; however, the incentives used to bring the new business also place limitations on the offering government. Tax incentives, for example, limit the revenue available for a government to collect, while also requiring additional expenditures to meet the increased demand for public services that come with economic expansion (Buss, 2001). When an incentive is offered, governments become bound to the liability they have created. This opens the possibility of a dueling effect. That is, financial incentives may produce an economic boom for an area by inducing businesses to locate or expand, but they may also hinder the ability of the government to address financial hardships.”

**Policy Discussion**

One of the basic principles regarding taxation is that everyone should pay their fair share. One of the most unfair tax incentives in Iowa is the Research Activities Tax Credit. Our legislators are giving away millions of dollars in tax refunds each year to the largest corporations operating in this state by allowing the Research Activities Tax Credit to continue uncapped. There are no caps for the amount of Research Activities Tax Credits that can by claimed by an individual or corporation. Nor is there an overall cap of the total amount of Research Activities Tax Credits that can be claimed by all parties in any given year. When tax credits are given, all other tax payers must make up the difference. Corporate tax incentives such as the refunds for the Research Activities Tax Credit should be eliminated or capped.

In 2019, State Senator Joe Bolkcom introduced a bill (SF23) that would place a cap of $1 million on the Research Activities Tax Credit, including the Supplemental Research Activities Tax Credit, which is refundable in aggregate to a corporation or individual. A fiscal note for the bill noted that the cap would result in an increase to the state net revenue of 3.6 percent ($25.2 million per year).

Even placing a cap on the refund an individual or corporation can claim is still a problem. The cap would only serve to reduce the refund. The Research Activities Tax Credit itself significantly reduces the taxes that a corporation or individual must pay to the state treasury. Not all entities taking advantage of the tax credit would be entitled to a refund, so significant amounts of money can be claimed short of a refund.
In 2009, Governor Chet Culver created a Tax Credit Review Panel, comprised of seven agency leaders that would study Iowa’s tax credits. The group’s report recommended “elimination of refundability for large companies defined as those with gross receipts in excess of $20.0 million yearly and that these companies receive a five-year carry-forward for their research investment. Recommend moving the tax credit under the global $185 million cap because of the impact on the General Fund.” That recommendation has never been implemented. That same panel recommended placing a 5-year sunset on all tax credits, including the Research Activities Tax Credit. Likewise, that provision was never implemented.

A better use of the Research Activities Tax Credit funds – funding public universities

When tax credits are extended, the government is doling out tax payer money to reduce the tax liability of the recipient of the tax credit. In essence, a tax credit is an expenditure. The very generous nature of the Research Activities Tax Credit has turned it into a subsidy.

Instead of giving these large subsidies, the Sierra Club recommends:

- Sun-setting the Research Activities Tax Credit.
- Then re-allocating the revenue for that subsidy to fund Iowa’s public universities and the public universities’ research mission.

By sun-setting the Research Activities Tax Credit, Iowa would join other states that currently do not have the equivalent tax credit – Alabama, Alaska, Illinois, Michigan, Missouri, Mississippi, Montana, Nevada, New Mexico, Oklahoma, South Dakota, Tennessee, Washington, Wyoming, and Washington DC.3

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