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Joint Committee on Finance

Paper #331

Administration of WEDC-Certified Business Tax Credits (General Fund Taxes -- Income and Franchise Taxes)

[LFB 2019-21 Budget Summary: Page 137, #5; Page 145, #22;
Page 146, #25; Page 147, #26; and Page 149, #34]

CURRENT LAW

In general, businesses may be eligible to claim a tax credit when preparing and filing the required individual income and corporate income/franchise tax forms with Department of Revenue (DOR). A tax credit is an amount that is subtracted from the gross income tax liability of a taxpayer in a given tax year.

If a nonrefundable credit exceeds tax liability, any amounts claimed that cannot be used to offset tax liability are identified so that the taxpayer can carry the unused amount forward for use in a future tax year. Taxpayers claim a refundable credit to reduce taxes otherwise due and/or to receive a check for the amount of the credit in excess of the claimant's tax liability in that year. Alternatively, a business may choose to apply any excess refundable tax credit as a payment towards its tax liability in the next year.

Nonrefundable credits are counted as revenue reductions in the state's accounting system. Refundable credits are paid from appropriations and counted as state expenditures from the general fund.

Pass-through entities (partnerships, limited liability companies (LLCs), and tax-option (S) corporations) may not claim the credits directly, but the eligibility for, and the amount of, the credit are based on their eligible activities. Pass-through entities must compute the amount of credit that each of their owners may claim and provide that information to each of them. Partners of a partnership, members of LLCs, and shareholders of S corporations may claim the credit in proportion to their ownership interest.

Some business tax credits are jointly administered by DOR and the Wisconsin Economic Development Corporation (WEDC). WEDC is responsible for certifying and verifying eligible claimants under the following tax credit programs: (a) business development; (b) enterprise zones; (c) electronics and information technology manufacturing (EITM) zone; (d) development opportunity zone; (e) historic preservation; and (f) early stage seed and angel investment. Claimants are required to include, with their tax returns, a copy of the certification for tax benefits and verification of expenses from WEDC.

Business development credits may be awarded throughout the state. EITM zone credits may be awarded only to businesses that conduct operations in one specific geographical zone designated by WEDC. Similar to the EITM zone program, WEDC may award enterprise zone credits for businesses that conduct operations in specific geographic zone areas designated by WEDC.

In practice, WEDC has designated enterprise zone credits on the basis of specific economic development projects performed by individual companies, rather than to multiple companies located in a geographic area. Pursuant to 2017 Act 369, there is no specific limit on the number of enterprise zones which WEDC may designate. Instead, each designation is subject to approval by the Committee under a 14-day passive review process. When designating an enterprise zone, WEDC must consider the economic need of the area and the effect on other initiatives and programs to promote economic and community development in the surrounding area. WEDC is required to certify at least three enterprise zones in a political subdivision with populations of fewer than 5,000, and two enterprise zones in political subdivisions with populations between 5,000 and 30,000.

For all tax credits administered by WEDC, DOR must track the amount of credits that have been claimed or used to offset tax liability and the amount of all available unused credits. WEDC is required to provide certain information to DOR by the last day of the first month of each calendar quarter for each of the credits that the two agencies jointly administer, including any credits transferred to another claimant.

In general, when certifying a recipient for a tax credit, WEDC must require the recipient to sign a contract which sets out a compliance schedule of anticipated actions and reporting requirements. WEDC must independently verify, from a sample of tax credits, the accuracy of the information required to be reported. WEDC must revoke a certification for tax benefits if the recipient submits false or misleading information. Further, specific requirements regarding revocation apply for certain tax credit programs.

WEDC may require tax credit repayment clauses in its contracts for not meeting contract obligations or when revoking a certification. For example, WEDC must require recipients to repay tax benefits for failing to maintain contracted levels of employment or capital expenditures under its tax credit programs. WEDC may recover EITM zone credits that are revoked or otherwise invalid from a partnership, limited liability company, or tax-option corporation or from the individual partner, member, or shareholder. However, current law does not specify to which state agency recovered credits must be repaid for other tax credits.

Pursuant to Wis. Stat. § 20.906, agencies generally must deposit funds received on behalf of the state within one week into the state treasury, which is administrated by the Department of Administration (DOA). However, WEDC is created as an "authority" under state law, rather than an "agency."

GOVERNOR

The bill would require that, no later than seven days after WEDC receives a repayment of tax credits, WEDC must remit the full amount of that payment to the Secretary of DOA for deposit in the general fund. According to the administration, the provision is intended to conform to an issue highlighted by the Legislative Audit Bureau (LAB) as part of its May, 2017, report (Report 17-9) for legislative consideration.

Further, the bill would provide estimated funding of \$18,100,000 GPR in 2019-20 and \$18,400,000 GPR in 2020-21 for the business development credit, \$211,954,900 GPR in 2020-21 for the EITM zone credit, and \$64,300,000 GPR in 2019-20 and \$50,700,000 GPR in 2020-21 for the enterprise zone tax credit.

LFB Papers #327 and #329 address budget related issues regarding the business development tax credit and enterprise zone tax credit, respectively. The estimated funding level for the enterprise zone tax credit is revised higher in 2020-21 to \$81,700,000 GPR under LFB Paper #327 and the estimated funding level for the business development tax credit is revised higher in 2019-20 to \$18,700,000 and in 2020-21 to \$20,100,000 under LFB Paper #328.

DISCUSSION POINTS

1. As noted, WEDC has extensive administrative responsibilities over certain business tax credits. This paper presents alternatives to clarify the administrative responsibilities for paying tax credits to, and recovering revoked credits from, businesses certified under economic development programs by WEDC. This paper also presents an alternative to codify WEDC's current practice of designating enterprise zones based on individual businesses rather than geographic location.

Recovery of WEDC-Administered Refundable Tax Credits

2. If tax credit recipients do not perform the terms of their contracts with WEDC, they may be required to repay the amount of tax credits previously claimed. Typically, in an event of default, the contract would allow for either WEDC or DOR (but not both) to recover 100% of the tax credits verified by WEDC and claimed by the recipient from DOR plus certain penalties, interests, and fees.

3. LAB Report 17-9 found that tax credit recipients repaid \$5.3 million to WEDC from July, 2016, through November, 2016. However, WEDC indicated to LAB on March 16, 2017, that it had not yet deposited the \$5.3 million with DOA. Instead, WEDC indicated that it had a verbal agreement with DOA, under which it could retain the funds unless, and until, DOA requested their return. Seven days later, WEDC deposited \$5.3 million with DOA.

4. As stated in Report 17-9, state law generally requires agencies to deposit at DOA within

one week any funds received on behalf of the State. However, Report 17-9 indicated that because WEDC is not a state agency, current law does not specify how frequently WEDC is required to deposit tax credits with DOA. Report 17-9 recommended that current law be modified to require WEDC to deposit all tax credits repaid to it with DOA within one week.

5. The Committee could adopt the Governor's recommendation in order to clarify that WEDC may not retain repayments of tax credits recovered pursuant to its contracts with certified businesses (Alternative A1). This alternative would require WEDC to return all recovered state funds to DOA, rather than potentially allowing WEDC to retain and expend those monies as part of its economic development programs.

6. Alternatively, the Committee could take no action on the Governor's recommendation and instead modify the bill to require that all repayment of tax credits be directed to DOR rather than to WEDC (Alternative A2). Under this alternative, WEDC could not actually obtain the repayment of tax credits under its contracts, and would instead remit to DOR the amounts that must be repaid. DOR would ultimately receive the payment and remit the funds to DOA.

7. Although WEDC may know the amount of tax credits it verifies a recipient to claim and the amount that are revoked, nonrefundable and refundable tax credits are actually claimed at DOR. Thus, it is DOR, and not WEDC, which has direct knowledge of the amounts each year that have been actually paid to claimants or used to offset tax. Current law provides DOR authority to recover tax amounts due and owing.

8. Any nonrefundable credit claimed at DOR that is used to offset tax reduces state general fund tax revenues. If a claimant did not have sufficient tax liability to use the full amount of a revoked credit, DOR would know the used credit amount that must be repaid, whereas WEDC would not have such information. Any refundable credit claimed in excess of tax owed that is disbursed to a claimant is a state expenditure paid out of the general fund. In either case, expenditures or reduced revenues related to a tax credit claim are not attributed to WEDC's appropriations or revenues and are authorized by DOR. As such, the Committee could conclude that DOR is better suited to recover such funds.

9. Finally, the Committee could elect both Alternatives A1 and A2 (Alternative A3). This would clarify current law so that DOR is the proper party for repayment, but in the event that WEDC does receive a repayment of a tax credit, WEDC would be required to remit it to DOA within a week.

Payment of WEDC-Administered Refundable Business Tax Credits

10. Most state tax deductions and credits do not require prior approval from a state agency; all eligible persons may claim the tax benefits. In contrast, the credits discussed in this paper are awarded at WEDC's discretion, subject to statutory requirements, and are very similar to grants paid directly by the certifying agency.

11. The business development credit, enterprise zone credit, and EITM zone credit are refundable. Similar to grants awarded by state agencies, refundable tax credits are not affected by a claimant's tax liability and are recorded as state expenditures. According to DOR, in tax year 2016, claims for WEDC-certified refundable credits totaled \$45.0 million. Of this amount, \$8.2 million

(18%) was used to offset the claimants' tax liability and \$36.8 million (82%) was refunded to the claimants.

12. The business development credit, enterprise zone credit, and EITM zone tax credits may be claimed if pass-through entities conduct eligible economic activities in the state. However, unlike grants awarded by state agencies, the credits are not directly claimed by the business entity that conducted the eligible activities. Instead, the credits are passed through to the individual owners of the entity and claimed on their individual income tax returns. This is also the case for S corporations, LLCs, and partnerships electing to be taxed at the entity level under the provisions of 2017 Act 368.

13. Often, owners of pass-through entities are other pass-through entities, which, in turn, may be owned by still other pass-through entities. This makes it difficult to ascertain whether individual credit claims are valid without further review of multiple pass-through entities' tax returns. Also, with this arrangement, the tax benefits only indirectly assist the business entity that received certification from WEDC and conducted the eligible activities.

14. Furthermore, after a business is certified for tax benefits by WEDC, several years may pass before WEDC verifies that the business has completed the required activities, and additional time may elapse before the credit is actually claimed on a tax return. When claimed, DOR will not be directly aware of that claimant's performance under its contract with WEDC.

15. In fiscal year 2017-18, WEDC entered into contracts to award refundable tax credits totaling \$2,970.1 million, which can be earned and claimed over the next several years, including: (a) \$2,850.0 million in EITM zone credits; (b) \$104.5 million in enterprise zone credits; and (c) \$15.6 million in business development credits.

16. Under current law, funding for these tax credits does not appear in WEDC's appropriation schedule even though WEDC is responsible for nearly all aspects of awarding the credits. Instead, the costs of the EITM zone credit, enterprise zone credit, and the business development credit appear in separate GPR appropriations under "Shared Revenue and Tax Relief" in the schedule of appropriations. The value of these credits exceeds \$96 million in 2018-19. Further, as amended by the sum sufficient reestimates described above, the bill would provide funding of \$396.8 million during the 2019-21 biennium for these credits. This is far larger than WEDC's base funding level for its operations and other economic development programs (\$41,550,700 all funds annually). Appropriations under "Shared Revenue and Tax Relief" are primarily aids to counties and municipalities and are not related to tax credits for businesses. It would be more appropriate to place these credits under WEDC.

17. The budgetary impact of WEDC's activities would be more transparent if the existing tax credit appropriations were transferred to, and paid to businesses by, WEDC (Alternative B1). Under this alternative, the Committee could retain the current business development, EITM zone, and enterprise zone tax credits, but require WEDC to pay credit claims directly to the business entity that is eligible for the credit rather than requiring that claims be filed with DOR. Payments would be made to eligible C corporations, pass-through entities, and sole proprietors from GPR appropriations for these tax credits using policies and procedures developed by the WEDC Board. The main advantage of this approach is that WEDC would make a single payment to eligible pass-through entities rather than having multiple individual owners file relatively small credit claims with DOR. This would

reduce the potential for fraudulent claims and significantly decrease paperwork and processing requirements for these credits. It would also enhance transparency and accountability for these programs and provide the applicable financial benefits directly to the business entity that conducted the eligible activities.

18. Under the Governor's proposal discussed above, any tax credits recovered by WEDC would be required to be paid to DOA within seven days. WEDC would not be permitted to retain any funds for use in its programs or operations. Likewise, alternatives A2 and A3 would also prohibit WEDC from retaining recovered tax credits, as they would be recovered by DOR.

19. Alternatively, the Committee could choose to only eliminate the current provisions regarding pass-through entities and, instead, require eligible pass-through entities to file credit claims with DOR and require credit payments to be made directly to the pass-through entity (Alternative B2). As with the preceding option, this alternative would reduce the potential for fraudulent claims and reduce paperwork and processing requirements for these credits. It would also provide the financial benefits directly to the business entity that conducted the eligible activities.

20. A potential drawback of having pass-through entities claim the credit is that individual owners of such entities would no longer be able to reduce their estimated tax payments in anticipation of receiving the credit. Thus, the Committee could choose to maintain current law (Alternative B3).

Enterprise Zone Designations by WEDC

21. State law provides little guidance as to what geographic area should comprise an enterprise zone. WEDC states that certain businesses have been awarded enterprise zone credits for economic development projects in non-contiguous geographic areas throughout the state. Further, under the current statutory construction, as long as so approved by the Committee, state law does not prohibit an enterprise zone that could encompass the entire state for an unlimited number of businesses to receive enterprise zone credits.

22. As discussed above, in practice, enterprise zone credits have been awarded on the basis of specific economic development projects performed by individual companies, rather than to multiple companies located in a geographic area.

23. The Committee could choose to statutorily codify WEDC's current practice of certifying businesses as eligible to receive the credits, rather than certifying businesses in a geographically designated zone for the credits by eliminating the term "zones" under the enterprise zone program and replacing it with "projects" (Alternative C1). Under this alternative, WEDC could certify, with the Committee's approval, businesses as eligible to receive enterprise zone tax credits for economic development projects performed by certified businesses in the state. The criteria for whether a business could be certified by WEDC to receive the credits would be the same as under current law.

ALTERNATIVES

A. Recovery of WEDC-Administered Tax Credits

1. Approve the Governor's recommendation and require WEDC to remit the full amount

of any repayment of tax credits it receives to the Secretary of DOA for deposit in the state general fund within seven days of their receipt.

2. Take no action on the Governor's recommendation. Instead, clarify current law to require that all repayments of tax credits administrated by WEDC be paid directly to DOR.

3. Adopt Alternative 1, but with the modification to require in WEDC's tax credit contracts that all repayments of tax credits administrated by WEDC be paid directly to DOR.

4. Take no action.

B. Payment of WEDC-Administered Tax Credits

1. Maintain the current EITM zone, enterprise zone, and business development tax credits, but transfer the existing GPR appropriations for these programs to WEDC and require that credit claims be filed with, and paid by, WEDC using policies and procedures developed by the WEDC Board. Provide under WEDC's appropriations, rather than under the title "Shared Revenue and Tax Relief," \$83,000,000 GPR in 2019-20 and \$313,754,900 GPR in 2020-21 for the transferred sum sufficient tax credit appropriations. Specify that this provision would first apply to credit claims filed on September 1, 2019. In addition, require credits earned by pass-through entities to be claimed by, and paid to, the business entity instead of the individual owners of the business, effective with credits earned by pass-through entities on January 1, 2020. This would include pass-through entities electing to pay tax at the entity level pursuant to 2017 Act 368. For credits earned on or after that date, prohibit partners of a partnership, members of LLCs, and shareholders of S corporations from claiming the credits individually. Specify that credits have been revoked or that are otherwise invalid may be recovered from either the pass-through entity or the individual owners of the entity. [The funding amounts identified above are equal to the sum of the appropriations under the bill for the business development, enterprise zones, and EITM zone tax credits with revised amounts described under LFB Papers #327 and #328.]

2. Effective with credits earned by pass-through entities in taxable years beginning on January 1, 2020, eliminate the current provisions of the refundable business development tax credit, EITM zone tax credit, and enterprise zone tax credit regarding pass-through entities. Instead, require eligible pass-through entities to file claims for these credits with DOR and require that credit payments be made directly to the pass-through entity. This would include pass-through entities electing to pay tax at the entity level pursuant to 2017 Act 368. Prohibit partners of a partnership, members of LLCs, and shareholders of S corporations from claiming the credits individually. Specify that credits have been revoked or that are otherwise invalid may be recovered from either the pass-through entity or the individual owners of the entity.

3. Maintain current law.

C. Enterprise Zone Designation by Project

1. Amend the enterprise zone tax credit statutes so that rather than designating specific

geographic zones, WEDC could certify, with the Committee's approval, businesses as eligible to receive enterprise zone tax credits for economic development projects undertaken by those businesses in Wisconsin. The criteria for whether a business could be certified by WEDC to receive the credits would be the same as under current law.

2. Maintain current law.

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