West Virginia Tax Credit Review and Accountability Report - Tax Year 2003

Economic Opportunity Tax Credit
Strategic Research and Development Tax Credit
Manufacturing Investment Tax Credit
High-Growth Business Investment Tax Credit

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Executive Summary

Sections 11-13Q-20, 11-13R-11, 11-13S-10 and 11-13U-8 of the West Virginia Code require a periodic tax credit review and accountability report evaluating the cost effectiveness of tax credits for Economic Opportunity, Strategic Research and Development, Manufacturing Investment, and High-Growth Business Investment, respectively. This report covers tax credit claims for the 2003 Tax Year. The 2003 Tax Year represents the first year of existence for all of these programs with the exception of the High Growth Business Investment Tax Credit, a program that first became effective in 2005.

By Law, a tax credit application filing, due on or before the extended due date of the annual income tax return, is required of each of these tax credit programs. The general extended due date for tax credit application filings related to the 2003 Tax Year was September 15, 2004 for most calendar year Taxpayers. However, some extended due dates occurred as late as March 15, 2005 for certain fiscal year Taxpayers. Tax credit application filings and required Tax Department responses for the 2004 Tax Year are still in process. The statistical information related to the 2004 Tax Year application filings is incomplete at this time. Therefore, this report only covers the 2003 Tax Year.

Major report findings include the following:

- Total tax credit expenditures for the initial year of these programs are relatively small because of carryover benefits from expiring tax credit programs, a learning curve for the new programs, lack of full compliance regarding the credit application requirement, the existence of a bonus depreciation deduction for new investment, and a slow growing economy in 2003.

- Statistical data retrieved from the sun-setting Business Investment and Jobs Expansion Tax Credit Program indicate an expected annual credit expenditure cost of no more than $7-$10 million for a mature Economic Opportunity Tax Credit. First year activity generated less than 5 applications.

- Annual expenditure credit costs for a mature Strategic Research and Development Tax Credit will likely exceed the $3 million level of the old Research and Development Tax Credit Program.

- Statistical data retrieved from the old 10% Industrial Expansion and Revitalization Tax Credit Program indicate an expected annual credit expenditure cost of no more than $10-$15 million for a mature Manufacturing Investment Tax Credit. First year activity generated only $290,000 in tax credits.

- The amount of tax credit claimed on tax returns will generally be less than the amount of available tax credit due to the tax liability limits of the Taxpayer.

- Companies participating in one or more of these tax credit programs generally outperformed their peers in the area of net job creation in 2003.

- The Tax Department’s ability to analyze tax credit programs will be greatly enhanced when various manual business tax return processes are automated via information captured in the new Integrated Tax System. Services provided to business Taxpayers will be greatly enhanced in the process. Manual processing of more than 50,000 annual corporate tax returns greatly hinders the ability to capture statistical information in a timely fashion.

- Some Taxpayers, particularly those with Manufacturing Investment Tax Credit, are still not complying with the tax credit application requirements. There was no application requirement for the old Industrial Expansion and Revitalization Tax Credit Program. The 50% penalty provision for lack of timely compliance will stimulate future compliance with the annual credit application requirement.

- The credit programs may help some individual business Taxpayers, but their overall impact upon economic growth is suspect.

- The West Virginia State tax burden for the manufacturing sector is generally competitive with surrounding states because of the 50% tax break offered by the Manufacturing Investment Tax Credit. Local taxes are not part of this equation.

- The cost of the new business tax credit incentive programs is relatively small in comparison to both the overall state budget and other state and local tax expenditures.

- Business tax credits complicate the Tax Code, and result in additional compliance costs for Taxpayers and additional administrative costs for the Tax Department.

Introduction

Following a comprehensive review of West Virginia's tax credit incentives, Legislation was enacted in 2002 to terminate a number of credit programs. A Taxpayer who gained entitlement to multiple-year credit allocations prior to January 1, 2003 retained that entitlement, and may apply the credit in due course pursuant to the requirements of the particular credit until the original multiple-year entitlement has been exhausted or otherwise terminated. The tax credit programs terminated include the following:

Business Investment and Jobs Expansion Tax Credit
Research and Development Projects Credit
Industrial Expansion and Revitalization Credit[1]
Housing Development Projects Credit
Management Information Services Facilities Credit
Aerospace Industrial Facilities Credit
New Steel Manufacturing Operations Credit

Additionally, the 2002 Legislature created three new tax credit programs applicable to investment placed in service or use on or after January 1, 2003. The three new credits were the Economic Opportunity Tax Credit, the Strategic Research and Development Tax Credit and the Manufacturing Investment Tax Credit. In 2004, an additional new credit, the High-Growth Business Investment Tax Credit, was enacted.

The intent of the Economic Opportunity Tax Credit as stated in West Virginia Code §11-13Q-2 was as follows: "The Legislature finds that the encouragement of economic opportunity in this state is in the public interest and promotes the general welfare of the people of this state. In order to encourage greater capital investment in businesses in this state and thereby increase economic opportunity in this state, there is hereby enacted the economic opportunity tax credit." In order to claim the Economic Opportunity Tax Credit, eligible Taxpayers must create a minimum number of new jobs. With the termination of the Business Investment and Jobs Expansion Tax Credit (Super Credit), the Economic Opportunity Tax Credit is West Virginia's primary job creation tax incentive. The major enhancement of the Economic Opportunity Tax Credit, compared to the Super Credit, was a reduction in the number of new jobs required to qualify for the credit. Also, the complexity of the Business Investment and Jobs Expansion Tax Credit required a fourteen-page form to claim the credit. The Economic Opportunity Tax Credit is much simpler and the form for claiming the credit is only two pages.

The second new credit was the Strategic Research and Development Tax Credit. The Legislative intent stated at West Virginia Code §11-13R-2 indicates that the Strategic Research and Development Tax Credit was enacted "to encourage research and development in this state and thereby increase employment and economic development." The Strategic Research and Development Tax Credit essentially replaced the Research and Development Project Credit. The previous credit was primarily for manufacturers and producers of natural resources. For purposes of the Strategic Research and Development Tax Credit, research and development "means systematic scientific, engineering or technological study and investigation in a field of

[1] The Industrial Expansion and Revitalization Credit was retained for electric power producers.

knowledge in the physical, computer or software sciences, often involving the formulation of hypotheses and experimentation, for the purpose of revealing new facts, theories or principles, or increasing scientific knowledge, which may reveal the basis for new or enhanced products, equipment or manufacturing processes."

The Manufacturing Investment Tax Credit was the third new credit enacted in 2002 applicable to investment placed in use or service on or after January 1, 2003. As stated in West Virginia Code §11-13S-2, the intent and purpose of the Manufacturing Investment Tax Credit was "The Legislature finds that the encouragement of the location of new industry in this state, and the expansion, growth and revitalization of existing industrial facilities in this state is in the public interest and promotes the general welfare of the people of this state." The new credit essentially replaced the Industrial Expansion and Revitalization Credit for manufacturers. The Industrial Expansion and Revitalization Credit was retained only for electric power producers. Although the percentage used in determining the amount of credit available from qualifying investment was reduced for the Manufacturing Investment Tax Credit, the credit can now be used to offset Corporation Net Income Tax liability. Additionally, the definition of "manufacturers" was narrowed in comparison to the definition used for the Industrial Expansion and Revitalization Credit.

The last of the four credits that are subject of this report is the High-Growth Business Investment Tax Credit. As enacted in 2004, the Legislative intent stated at West Virginia Code §11-13U-2 was as follows: "The Legislature finds the encouragement of investment in potentially high-growth research and development businesses in this state is in the public interest and promotes economic growth and development for the people of this state. In order to encourage investment in start-up, growth-oriented, research and development businesses in this state and thereby increase employment and economic development, there is hereby provided a high-growth business investment tax credit."

Tax Credit Review and Accountability Report Criteria

The enacting legislation for each of the aforementioned new credits includes provisions for the Tax Commissioner to submit to the Governor, the President of the Senate and the Speaker of the House of Delegates, a tax credit review and accountability report evaluating the cost effectiveness of the indicated credit. The report requirements as set forth in West Virginia Code §§11-13Q-20, 11-13R-11, 11-13S-10 and 11-13U-8 for the Economic Opportunity Tax Credit, Strategic Research and Development Tax Credit, Manufacturing Investment Tax Credit and High-Growth Business Investment Tax Credit, respectively, are similar. The general criteria for the Tax Credit Review and Accountability Reports are as follows:

- The number of taxpayers claiming the credit.[2]
- The net number, type and duration of new jobs created by all taxpayers claiming the credit and wages and benefits paid.[3,4]
- The cost of the tax credit.
- The cost of the tax credit per new job created.
- Comparison of employment trends for the industry and for taxpayers within the industry that claim the tax credit.

Additionally, the Legislation specified that the first report was due February 1, 2006 and every third year thereafter covering the most recent three-year period for which information is available. This report will only cover credit claims on tax year 2003 returns. Although all tax year 2004 tax returns should have been filed by the fall of 2005, not all returns were available for electronic or manual review as of mid-January 2006. Also, most tax year 2005 returns are not due until after the due date of this report.

Taxpayers Claiming the Credit

The table below shows the number of Taxpayers filing an approved[5] credit application and the number actually claiming the credit on a tax year 2003 return.

Table 1 - Tax Year 2003 Credit Applications and Credit Claimants[6]

Credit	Approved Applications	Credit Claims
Economic Opportunity Tax Credit	(D)	(D)
Strategic Research and Development Tax Credit	7	(D)
Manufacturing Investment Tax Credit	55	14
High-Growth Business Investment Tax Credit	(N)	(N)

(D) – To maintain confidentiality, the West Virginia State Tax Department suppresses data when the number of observations is five or less.
(N) – The provisions of the High-Growth Business Investment Tax Credit were effective on July 1, 2005 and apply only to qualified investment made after on or after July 1, 2005.

In many cases, new programs start slowly due to the learning process for both participants and administrators. Previously, only Taxpayers desiring to claim the Business Investment and Jobs Expansion Tax Credit and a few minor tax credits had to file an application and obtain approval before claiming the credit. All four of the credits that are the subject of this report require an application before the Taxpayer may claim the credit. Additionally, the

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[2] For the High-Growth Business Investment Tax credit, the criteria was stated as "The number of eligible taxpayers claiming the tax credit."
[3] For the Economic Opportunity Tax credit, the criteria was stated as "The net number of new jobs created by all taxpayers claiming the credit."
[4] For the High-Growth Business Investment Tax credit, the criteria was stated as "The net number, type, and duration of new jobs created by all qualified research and development companies in which taxpayers claiming the credit made investment in and the wages and benefits paid by such companies."
[5] Applications not meeting the Statutory requirements were denied.
[6] Amended returns and applications filed by Taxpayers previously unaware of the application / approval process for the new credits will likely increase the above values.

Economic Opportunity Tax Credit, the Strategic Research and Development Tax Credit and the High-Growth Business Investment Tax Credit require approval before the credit may be claimed. The Tax Commissioner receives and approves applications for the Economic Opportunity Tax Credit and the Strategic Research and Development Tax Credit, while the Economic Development Authority receives and approves applications for the High-Growth Business Investment Tax Credit. The Tax Commissioner also receives applications for the Manufacturing Investment Tax Credit.

Due to the similarities between the new credits and a terminated credit, many Taxpayers submitted credit claims without the required prior application. This is particularly true for the Manufacturing Investment Tax Credit. As previously noted, the Manufacturing Investment Tax Credit replaced the Industrial Expansion and Revitalization Credit, a credit first enacted in 1969 to promote industrial expansion. Many Taxpayers continued to use the Industrial Expansion and Revitalization Tax Credit schedule to report investment made after the December 31, 2002 termination date and also did not file the required Manufacturing Investment Tax Credit Application.

As mentioned previously, the Economic Opportunity Tax Credit essentially replaced the Business Investment and Jobs Expansion Tax Credit. The low number of applications for the Economic Opportunity Tax Credit is likely attributable to a number of factors. The primary reason for the low number of applications was due to the economic recession that began in 2001. Total employment for the State fell by 0.8 percent from 2002 to 2003; thus, very few businesses were actually creating jobs. Also, Taxpayer recognition of the complexity of the credit it replaced may have dampened participation. In the last three years before the Business Investment and Jobs Expansion Tax Credit was terminated for new entitlements, the number of credit applications acknowledged / approved by the State Department had steadily declined. Additional applications for the Economic Opportunity Tax credit are expected as the economy improves.

In some cases, Taxpayers filing an application and making the necessary investment or expenditure to gain entitlement to one of the new credits did not use any of the credit due to outstanding credit allowances for other credits, including the terminated credits. Some Taxpayers with Business Franchise Tax liability and / or Corporation Net Income Tax liability and available Strategic Research and Development Tax Credit were able to use credit entitlement from terminated credits, including the Research and Development Projects Credit, to reach their maximum allowable tax offset. Similarly, some Taxpayers with Business Franchise Tax liability or Severance Tax liability and available Manufacturing Investment Tax Credit used accumulated Industrial Expansion and Revitalization Tax Credit to offset the maximum of 50 percent of liability and did not have to use the Manufacturing Investment Tax Credit attributable to investment in 2003.

New Jobs Created By Taxpayers Claiming Credits

Based upon information from the credit applications, the number of new jobs created by Taxpayers claiming the credits was calculated as the difference between jobs reported prior to the required credit investment or expenditure and the numbers of jobs for the tax year of the credit claim. The following table shows the number of new jobs created for each of the new credits.

Table 2 – New Jobs Created Tax Year 2003

Credit	Applicants Reporting Job Levels at or Below Pre-Investment Level	Applicants Reporting Job Increases	Net New Jobs[7]
Economic Opportunity Tax Credit	(D)	(D)	(D)
Strategic Research and Development Tax Credit	(D)	(D)	214
Manufacturing Investment Tax Credit	36	22	-103
High-Growth Business Investment Tax Credit	(N)	(N)	(N)

(D) – To maintain confidentiality, the West Virginia State Tax Department suppresses data when the number of observations is five or less.
(N) – The provisions of the High-Growth Business Investment Tax Credit were effective on July 1, 2005 and apply only to qualified investment made after on or after July 1, 2005.

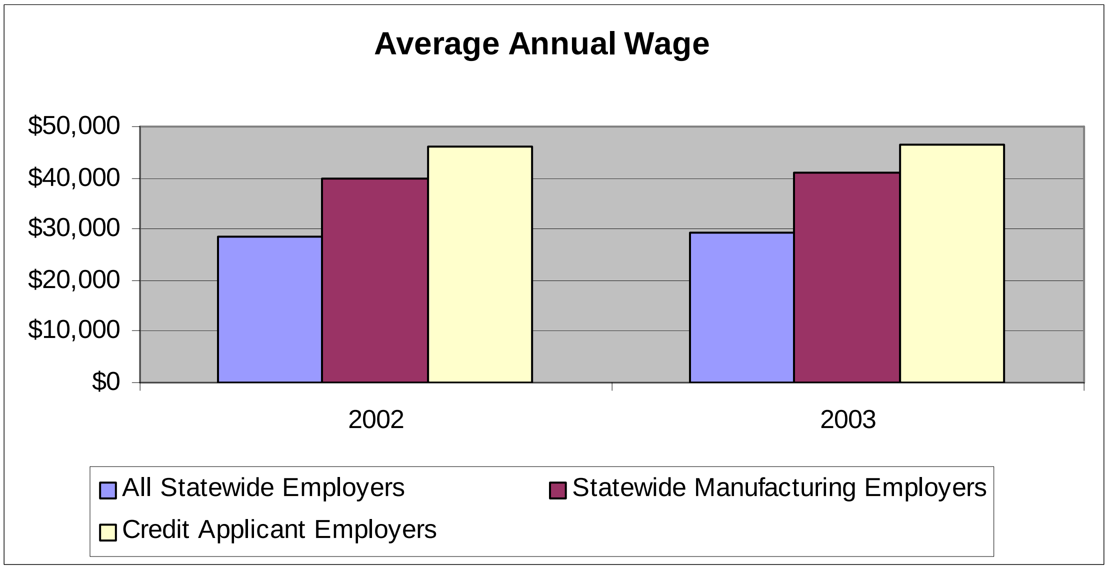
All of the above listed credits require investment.[8] However, only the Economic Opportunity Tax credit requires new jobs to be created.

Although there was a net job loss by Taxpayers claiming the Manufacturing Investment Tax Credit, the job loss experienced by these Taxpayers was not as great as the job loss of all West Virginia manufacturers combined. Based on data from WorkForce West Virginia, manufacturing jobs of all employers fell from 68,648 in 2002 to 64,587 in 2003. The job loss rate for all manufacturers was roughly 2.6 jobs per employer, while the job loss rate for Taxpayers claiming the Manufacturing Investment Tax Credit was roughly 1.78 per applicant.

The average annual wage for all West Virginia workers was $28,615 in 2002 and $29,284 in 2003. As shown in the chart below, the average annual wage for all manufacturing employees was roughly 40 percent higher than the wage for all employees. Similarly, the applicants for the Strategic Research and Development Tax Credit and Manufacturing Investment Tax Credit paid wages that were approximately 60 percent higher than the statewide average annual wage.

[7] The values reflect the total increase in jobs as reported by Taxpayers claiming the indicated credit. Since some Taxpayers have applied for more than one of the indicated credits, the new jobs may not be solely the result of the activity associated with the indicated credit.
[8] Entitlement to the Strategic Research and Development Credit may also be earned by an increase in research and development expenditures compared to a base period.

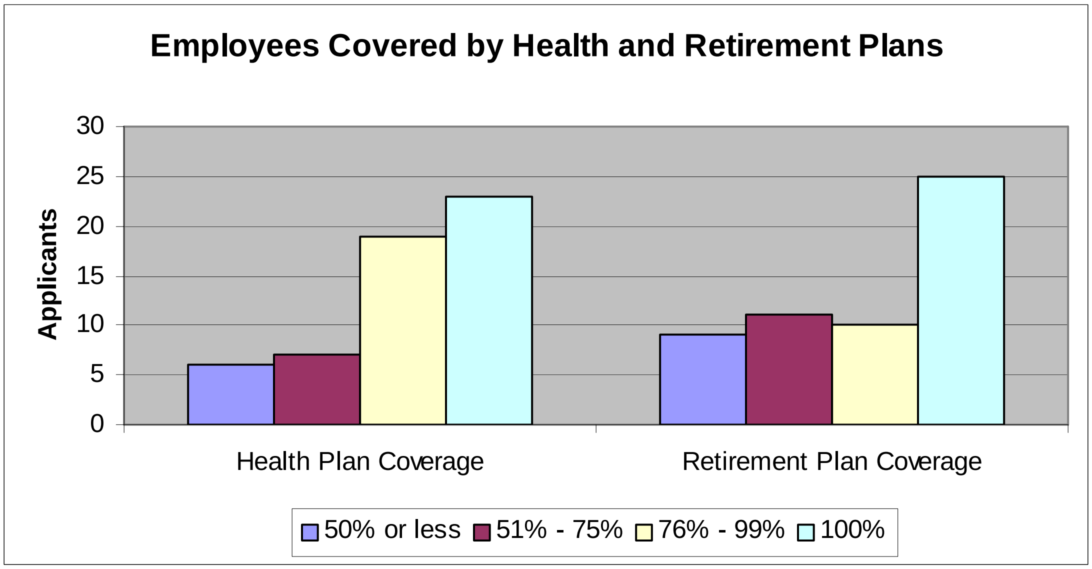
Figure 1 – Average Annual Wage



Although the Strategic Research and Development Tax Credit and Manufacturing Investment Tax Credit applicants paid higher wages compared to all manufacturers and all statewide employers for 2002 and 2003, the rate of increase was below the other groups. The average annual wages paid by the credit applicants increased by 1.7 percent, while wages paid by all employers increased by 2.3 percent and wages paid by all manufacturers increased by 2.9 percent.

Of the fifty-five Strategic Research and Development Tax Credit and Manufacturing Investment Tax Credit applicants for which information on the employee coverage by health plans was reported, twenty-three reported that 100 percent of their employees were covered. Similarly, twenty-five applicants reported that 100 percent of their employees were covered by retirement plans. The chart below shows the percentage of applicant employees covered by health and retirement plans.

Figure 2 – Health and Retirement Plan Coverage



The median cost per employee of health plan coverage provided by the Strategic Research and Development Tax Credit and Manufacturing Investment Tax Credit applicants was $6,282 and the median cost per employee of retirement plan coverage was $1,715. For both cost per employee series, there was a wide range from the lowest amounts to the highest amounts.

Cost of the Credit and Cost of the Credit Per New Job Created

The total dollar amount of the new credits utilized on tax year 2003 returns available as of January 2006 is shown in the following table.

Table 3 – Cost of Credits Tax Year 2003

Credit	Cost of Credit	Cost of Credit Per New Job Created
Economic Opportunity Tax Credit	(D)	(D)
Strategic Research and Development Tax Credit	$619,443	*
Manufacturing Investment Tax Credit	$84,539	*
High-Growth Business Investment Tax Credit	(N)	(N)

(D) – To maintain confidentiality, the West Virginia State Tax Department suppresses data when the number of observations is five or less.
(N) – The provisions of the High-Growth Business Investment Tax Credit were effective on July 1, 2005 and apply only to qualified investment made after on or after July 1, 2005.
*– Not meaningful.

Some Taxpayers claiming the Strategic Research and Development Tax Credit also claimed other investment credits attributable to investment made in tax year 2003 (e.g., Transition Status Business Investment and Jobs Expansion Credit or Manufacturing Investment Tax Credit). Thus, the cost of the Strategic Research and Development Tax Credit per reported new job would not be meaningful. Similarly, the net job loss for Taxpayers claiming the

Manufacturing Investment Tax Credit makes the cost of the credit per new job created meaningless.

The cost of credit shown above does not include amounts that Taxpayers claimed erroneously. The erroneous claims include claims made by Taxpayers ineligible for the credits and claims made without filing the approved application. Resolution of these errors, particularly claims for Industrial Expansion and Revitalization credit attributable to investment made on or after January 1, 2003, through filing the required applications and amended returns will likely increase the above amounts. Also, a number of tax year 2003 returns of Taxpayers applying for the credits were not available for ready retrieval and analysis.

Comparison of Employment Trends

The table below shows the percentage change in employment from 2002 to 2003 for all employers and for Taxpayers claiming either the Strategic Research and Development Credit or the Manufacturing Investment Tax Credit. The industry classifications for the credit claimants were aggregated to avoid disclosing information for classifications with fewer than five claimants.

Table 4 – Percent Change in Employment 2002 to 2003

Industry	Statewide Employment	Credit Claimant
Wood product manufacturing	-0.6	4.4
Chemical manufacturing	-5.4	-1.1
Nonmetallic mineral product manufacturing	-15.9	8.6
Fabricated metal product manufacturing	-7.7	-3.8
All other manufacturing	-5.5	-3.0
All manufacturing	-5.9	0.1
Non-manufacturing	-0.2	(D)
All employment	-0.8	(D)

(D) – To maintain confidentiality, the West Virginia State Tax Department suppresses data when the number of observations is five or less. In some cases, additional observations or totals are suppressed to preclude the derivation of values where the count is five or less.

All of the industry classifications shown above experienced job reductions from 2002 to 2003 on a Statewide basis. While some of the credit claimants also experienced job reductions from 2002 to 2003, the reductions were not as large as the Statewide rate. And some credit claimants actually added jobs.

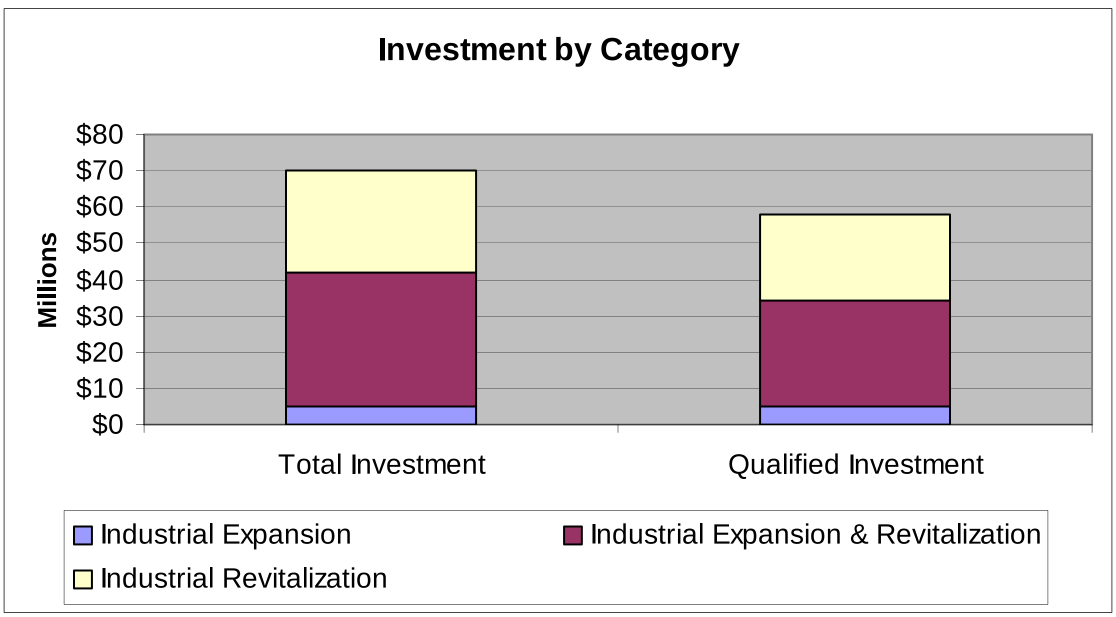
Other Information

As indicated on the available tax year 2003 Manufacturing Investment Tax Credit applications, Taxpayers reported $70.4 million of total investment and $58.3 million of qualified investment. Where qualified investment is determined as a percentage of the total investment based upon the useful life property placed in service. The applicable percentages for determining qualified investment for purposes of the Manufacturing Investment Tax Credit are as follows:

Useful Life	Percentage
Less than 4 years	0
4 years or more but less than 6 years	33 1/3
6 years or more but less than 8 years	66 2/3
8 years or more	100

Taxpayers classified the investment reported on the applications as industrial expansion, industrial revitalization or both industrial expansion and revitalization. For purposes of the Application for Manufacturing Investment Tax Credit, industrial expansion is defined as "capital investment in a new or expanded industrial facility in this State." And, industrial revitalization is defined as "capital investment in an industrial facility in this State to replace or modernize buildings, equipment, machinery and other tangible personal property used in connection with the operation of the facility in an industrial business …" The chart below shows the reported investment by category.

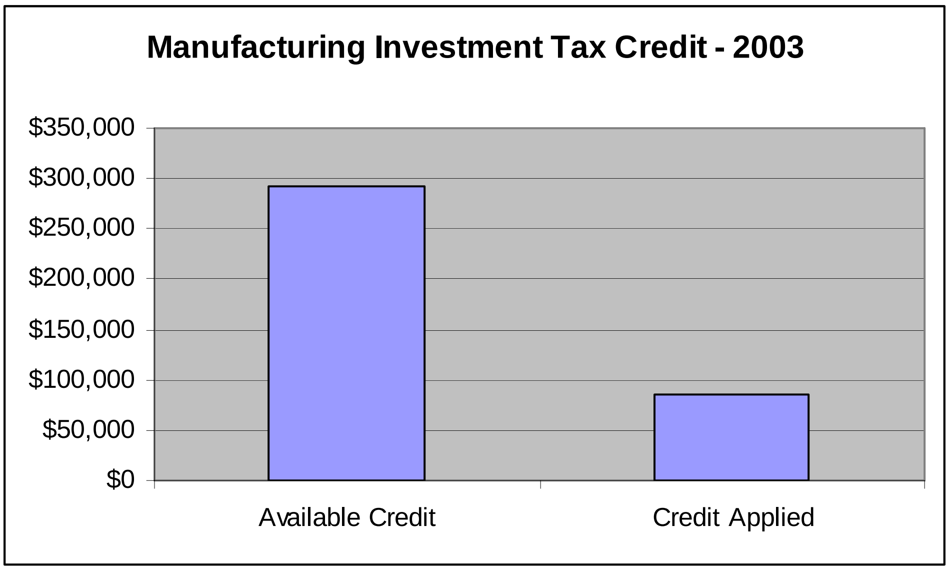
Figure 3 – Manufacturing Investment Tax Credit Investment by Category



The amount of total Manufacturing Investment Tax Credit available to eligible Taxpayers is five percent of the qualified investment. The $58.3 million of reported tax year 2003 qualified investment entitles Taxpayers to a total of $2.9 million of credit. Since the Manufacturing Investment Tax Credit entitlement must be claimed over a ten-year period, roughly $290,000 of credit was available to offset tax year 2003 taxes. The tax year 2003 investment also entitles Taxpayers to $290,000 of credit each year for tax years 2004 through 2012. Additional investment in subsequent years will also generate a ten-year credit stream. Thus, the available Manufacturing Investment Tax Credit will grow rapidly through 2012 as additional annual credit entitlements are earned. In tax years 2013 and beyond, the total credit available will likely continue to increase, but the growth will be dampened as entitlements from prior years expire (i.e., the available credit in tax year 2013 will be the sum of credit earned in tax years 2004 through 2013 as the entitlement attributable to 2003 investment will expire in 2012).

As stated previously, many of the Taxpayers earning entitlement to either the Strategic Research and Development Tax Credit or the Manufacturing Investment Tax Credit did not use the credit to offset tax liability due to the use of other credits. The chart below shows a comparison of the potential Manufacturing Investment Tax Credit and the credit actually applied to offset tax year 2003 liability.

Figure 4 – Potential and Applied Manufacturing Investment Tax Credit



Conclusion

Along with the enactment of new investment credits in 2002 and 2004, a requirement to periodically report on the cost effectiveness of the credits was included. The Economic Opportunity Tax Credit, the Strategic Research and Development Tax Credit and the Manufacturing Investment Tax Credit apply to investment placed in use or service on or after January 1, 2003. The High-Growth Business Investment Tax Credit applies to investment made on or after July 1, 2005.

Due to the timing of tax return filing and processing, this first Tax Credit Review and Accountability Report could only be based upon tax year 2003 applications and returns. However, due to the learning process for both participants and administrators associated with new programs, it is unlikely that the tax year 2003 data is complete. Since most manufacturers make periodic investments to replace equipment they generally earn entitlement to additional credit each year. For the most recent years available, approximately 230 Taxpayers claimed Industrial Expansion and Revitalization Credit on Severance Tax and/or Business Franchise Tax returns (predominantly Business Franchise Tax returns). However, for tax year 2003 the State Tax Department is aware of only 55 approved applications for the Manufacturing Investment

Tax Credit, the credit that essentially replaced the Industrial Expansion and Revitalization Credit. Many Taxpayers may not have realized that the investment credit had changed and requires an application to be filed before the credit can be applied to offset tax liability. A review of the claims for terminated credits and notification to Taxpayers concerning the new credit requirements will likely increase the number of applications for the Manufacturing Investment Tax Credit and the other new credits.

Although observations about the effectiveness of the aforementioned credits may be premature, the limited available data suggests that Taxpayers claiming the new credits fared better in terms of job creation/retention then all businesses.