Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Wyman	Analyst:	Marion Mann DeJong	Bill Number:	AB 2304
Related Bills:	See Legislative History	Telephone:	845-6979	Introduced Date:	02/21/2002
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Employer Credit for Wages Paid to Employees for Aviation Property

SUMMARY

This bill would create a credit for wages paid by an employer for work performed on items used in aircraft.

PURPOSE OF THE BILL

The purpose of this bill appears to be to stimulate California's aircraft manufacturing and related industries.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment. However, the bill specifies that it would apply to taxable years beginning on or after January 1, 2003, and before January 1, 2013.

POSITION

Pending.

Summary of Suggested Amendments

Department staff is available to assist with amendments to resolve the implementation concerns discussed in this analysis. See "Implementation Considerations" below.

ANALYSIS

FEDERAL/STATE LAW

Current state and federal laws generally allow taxpayers engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business (e.g. wages paid to employees).

Board Position:			Department Director	Date
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Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Current state law allows a business located in an economic development area (i.e., Enterprise Zones, Local Agency Military Base Recovery Areas (LAMBRA's), and Targeted Tax Areas) to reduce tax by a percentage of wages paid to certain employees. The credit is based on the lesser of the actual hourly wage paid or 150% of the current minimum hourly wage (202% of the minimum wage for taxpayers engaged in certain aircraft manufacturing activities within the Long Beach Enterprise Zone). The amount of the credit must be reduced by any other federal or state jobs tax credits, and the taxpayer's deduction for ordinary and necessary trade or business expenses must be reduced by the amount of the hiring credit. Certain criteria regarding which employees qualify for the credit and certain limitations differ between the various economic development areas.

Current state law also provides a wage credit for taxpayers under an initial contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter (JSF). The credit is generally equal to a specified percentage (50% for 2001, 40% for 2002, 30% for 2003, 20% for 2004, and 10% for 2005) of employee wages that are direct costs allocable to property manufactured in California for ultimate use in a JSF, with certain limitations. The credit is allowed only if the bid that the JSF contract or subcontract is based upon is reduced by the credit amount.

THIS BILL

This bill would create a wage credit, similar to the JSF wage credit, for taxpayers located in California that are under an initial contract or subcontract with the U.S. Department of Defense (DOD), any branch of the U.S. military, the National Aeronautics and Space Administration (NASA), or a private commercial or general aviation company to research, develop, manufacture, test, distribute, or refurbish property for use in aircraft. The credit would be equal to a percentage of wages paid to employees as follows:

Taxable Years	**% of wages**
Beginning on or after January 1, 2003, and before January 1, 2005	50%
Beginning on or after January 1, 2005, and before January 1, 2007	40%
Beginning on or after January 1, 2007, and before January 1, 2009	30%
Beginning on or after January 1, 2009, and before January 1, 2011	20%
Beginning on or after January 1, 2011, and before January 1, 2013	10%

Only the portion of wages that are direct costs, as defined in Section 263A of the Internal Revenue Code, and are allocable to property that is researched, developed, manufactured, tested, distributed, or refurbished for use in aircraft pursuant to a contract or subcontract with one of the entities listed above would qualify for the credit.

The wages could be paid to new or existing employees whose services for the taxpayer are performed in California and are at least 90% directly related to the contract or subcontract for aircraft property. The credit would be limited to $10,000 per year, per employee, and be prorated for partial years.

Any credit in excess of tax liability could be carried forward for up to eight years. No credit would be allowed unless the bid upon which the contract or subcontract is based is reduced by the credit amount. The taxpayer would be required to provide, at the request of the Franchise Tax Board, all references to the credit and ultimate cost reductions incorporated into any successful bid that was awarded a contract or subcontract.

IMPLEMENTATION CONSIDERATIONS

This bill would raise the following implementation concerns. Department staff is available to assist the author with any amendments.

- In the definition of “qualified taxpayer” the terms “initial contract or subcontract” are used. Other parts of the bill use the terms “contract or subcontract.” Consistency in the language should be used throughout the statute for clarity. It should be noted that the terms “initial contract or subcontract” have been problematic for the JSF credit. Department staff has proposed that the terms “initial contract or subcontract” limit the JSF credit to the original contract only and do not necessarily allow for subsequent changes to the contract to be considered for the JSF credit. Further, since the credit proposed by this bill is not targeted to contracts for one specific project like the JSF, the author might consider removing the phrase “initial” and simply use “contract or subcontract.” This would allow any contractor or subcontractor to claim the credit and remove the potential for disputes over the issue.

- The term “private commercial or general aviation company” is unclear. Does this mean a “private commercial company” (i.e., any business) or, does it mean a “private commercial aviation company and a general aviation company?” The bill should specify whether the contractor must be an “aviation” contractor to qualify. Also, the terminology is very broad and may bring in unexpected taxpayers such as flight schools or charter flight companies that “refurbish” their aircrafts. Contracts entered into with these companies can be substantially different that those entered into with the remainder of the referenced group such as the DOD, military, and NASA.

- The terms “research,” “develop,” “manufacture,” “test,” “distribute,” or “refurbish” are not defined. Undefined terms can lead to disputes between taxpayers and the department.

- “Aircraft” as used in this bill appears to be broad in nature, covering simple aircraft such as twin-engine craft to aircraft such as commercial passenger airliners, military aircraft, and spacecraft. The author may want to specifically define the group of aircraft intended for the credit. Also, it is unclear what is intended by the phrase “property for use in aircraft.” Does this mean that the property must be physically attached to the aircraft? Or, is property such as ground radar and related equipment, food preparation equipment, televisions, and food consumed on an aircraft included? Department staff does not possess the expertise to determine the relevance of a particular part to an aircraft. Thus, for purposes of the JSF credit, physical installation is used for determining if property qualifies.

- The 90% requirement in the definition of "qualified employee" is subject to interpretation. It could be interpreted as 90% of the services performed in California, or 90% of all services performed by the employee must be in California and directly related. Many of the aerospace companies have employees that work inside and outside of California, or work part-year here and part-year somewhere else. The 90% requirement should be clarified to avoid disputes over the issue.

- The requirement that the credit be reflected in the bid will likely lead to disputes between taxpayers and the department because if a bid is reduced and the credit cannot be used (expires during the carryover period), then taxpayers cannot recoup the money. Further, this requirement may be a compliance issue given the large number of potential contracts and subcontracts. The bid reduction was placed in the JSF credits as a way to ensure that the tax incentive benefited the portion of a company located in California. Since this bill is not limited to the JSF or another large project, the reason for the limitation in this bill is unclear.

LEGISLATIVE HISTORY

AB 2797 (Machado, Stats. 1998, Chapter 322) enacted the JSF credits.

SB 85 (Knight, 1999/2000) would have created a credit equal to 10% of wages paid by an employer to employees for performing services related to the engineering, design and manufacture of a Reusable Launch Vehicle (RLV) or any launch site for a RLV. SB 85 failed passage in the Senate Revenue and Taxation Committee.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and *New York* laws do not provide a credit comparable to the credit proposed by this bill. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

If the bill is amended to resolve the implementation considerations addressed in this analysis, the department's costs are expected to be minor.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Potential revenue losses from the credit proposed by this bill would be very substantial. Beginning in 2003, this bill could generate as much as $800 million per year in credits. Since the credit is not refundable, and other existing tax credits could also be claimed by the same taxpayers, it is projected that between $50 million and $75 million of these credits would actually be applied each year, resulting in carryovers of at least $700 million. It is assumed that the intent is not to limit the credit by the existing tentative minimum tax.

This analysis does not take into account any change in employment, personal income, or gross state product that may result from this bill becoming law.

Revenue Discussion

According to the California Statistical Abstract, there are about 150,000 employees in the California aerospace industry. The definitions of qualified taxpayer, qualified wages and qualified employee in this bill are quite broad. They are limited, however, by the restriction that the credit must be explicitly incorporated into the bid for any qualifying contract. This analysis assumes that two-thirds of the employees in this industry (100,000) will be employed on contracts that could qualify for this credit. Based on the limitations on qualified wages, this estimate assumes that the average potential tax credit per employee will be $8,000 for the first several years of the credit. Thus, the potential pool of credits is approximately $800 million per year.

Many firms in this industry may not have sufficient tax liability to use all of the credits for which they qualify. The likelihood that firms will not have sufficient tax liability to use all of their credits is enhanced by the fact that many of the activities covered by this credit will also qualify for other credits, such as the JSF wage credit, the research and development credit, and the enterprise zone credit. Overall, this estimate assumes that less than 10% of potential credits will actually be used. The actual revenue loss in the first year of this credit will likely be between $50 million and $75 million, with unapplied carryovers of around $700 million.

LEGAL IMPACT

This bill would define “qualified taxpayer” as a taxpayer “in this state” under an initial contract or subcontract for aircraft property. A requirement that a taxpayer be located in California may be subject to constitutional challenge under the Commerce Clause of the United States Constitution. Simply removing the requirement from the definition of “qualified taxpayer” and letting the “qualified wages” definition provide the rule that the work must be performed in California would likely avoid this challenge.

ARGUMENTS/POLICY CONCERNS

This bill would allow taxpayers to claim multiple credits for the same expenditure since it does not contain a provision restricting the taxpayer to one credit based upon wages paid to a single employee. Currently, the JSF wage credit, the enterprise zone hiring credit, and the research credit are available for wage expenditures covered under this bill for some or all taxpayers.

Statistically, at least eight years is needed for a taxpayer to exhaust a credit, thereby receiving maximum benefit from the credit. However, unlike most other credits, a taxpayer claiming the credit proposed by this bill must first reduce its contract bid by the amount of the credit it expects to claim under the contract. Eight years may not be sufficient time to fully utilize the credit and allow the taxpayer to recover the required bid reduction. Therefore, taxpayers may be hesitant to claim the credit. The author may want to consider making the carryover period longer if the requirement that the credit be reflected in the bid is retained.

In order to ensure that certain credits act as an incentive to encourage certain desired behavior, generally a property type credit (e.g., manufacturer's investment credit, JSF property credit) includes specific rules that prevent certain costs of property from qualifying for the credit if the property was purchased pursuant to a contract entered into prior to the operative date of the credit. Although the credit proposed by this bill is not based specifically on property, it does contain a "contract" requirement. The contract requirement is not limited to contracts entered into on or after the operative date of the credit, and thus the credit may not operate as an incentive for taxpayers to engage in the desired behavior.

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