ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Chesbro	Analyst:	Marion Mann DeJong	Bill Number:	SB 595
Related Bills:	See Legislative History	Telephone:	845-6979	Introduced Date:	02/22/2001
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Manufacturers' Investment Credit/Extend to Certain Types of Property Used in Winemaking Activities

SUMMARY

This bill would allow the Manufacturers' Investment Credit (MIC) for certain buildings and tanks used in winemaking businesses.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to clarify that tanks and foundations used in winemaking businesses have always qualified for the MIC.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2001. However, the bill specifies that certain property (tanks and buildings) placed in service on or after January 1, 1996, that is used in SIC Code 2084 winemaking activities, would qualify for the MIC.

POSITION

Pending.

Summary of Suggested Amendments

Amendments are needed to clarify the author's intent regarding the years to which the bill applies and whether the expansion of the definition of special purpose buildings in the case of SIC Code 2084 winemaking activities will be operative retroactively or January 1, 2001. See "Implementation Considerations" below. Department staff is available to assist the author with amendments.

Technical amendments are provided. See "Technical Considerations" below.

ANALYSIS

FEDERAL/STATE LAW

Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's trade or business. Also, these laws allow a depreciation deduction for the obsolescence or wear and tear of property used in a trade business or held for the production of income.

Board Position:			Department Director	Date
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Existing federal law does not have a credit comparable to the MIC.

Existing state law allows qualified taxpayers a credit, known as the MIC, equal to 6% of the amount paid or incurred after January 1, 1994, for qualified property that is placed in service in California.

For purposes of the MIC, a qualified taxpayer is any taxpayer engaged in manufacturing activities described in specified codes listed in the Standard Industrial Classification (SIC) Manual, 1987 edition. Qualified property is any of the following:

1) Tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code (IRC) and used primarily:

- for manufacturing, processing, refining, fabricating, or recycling of property;
- for research and development;
- for the maintenance, repair, measurement, or testing of otherwise qualified property; or
- for pollution control that meets or exceeds state or local standards.

2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.

3) For certain taxpayers engaged in specified SIC Code activities, special purpose buildings and foundations.

For taxpayers engaged in computer programming and computer software related activities, qualified property includes computers and computer peripheral equipment used primarily for the development and manufacture of prepackaged software, and the value of any capitalized labor costs directly allocable to such property.

The MIC explicitly excludes certain types of property from the definition of qualified property, such as furniture, inventory, and equipment used in an extraction process.

Department staff has interpreted “qualified property” to exclude "other tangible property" (as defined under Section 1245(a)(3)(B) of the Internal Revenue Code) that is permanently affixed to real property. This interpretation is based on the MIC definition of "qualified property" as generally being limited to "tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code." Thus, other tangible property that is permanently affixed to a foundation would not qualify for the MIC, while similar property that is movable would qualify since it is treated as tangible personal property under Section 1245(a)(3)(A) of the Internal Revenue Code.

<u>THIS BILL</u>

This bill would modify the definition of “qualified property” to allow taxpayers engaged in activities related to winemaking (as described in SIC Code 2084) to claim the MIC for special purpose buildings and foundations or tanks and foundations. Only tanks and foundations that were placed in service on or after January 1, 1996, would qualify under this expanded definition.

“Special purpose tank and foundation” would mean a tank and the foundation immediately underlying the tank that is specifically designed and constructed or reconstructed for use in activities related to winemaking as described in SIC Code 2084.

SIC Code 2084 describes establishments primarily engaged in manufacturing of wines, brandy, and brandy spirits. This industry also includes bonded wine cellars that are engaged in blending wines.

This bill also would make minor technical changes to delete obsolete language referencing the repealed low-emission vehicle credit and change “which” to “that” in various places.

IMPLEMENTATION CONSIDERATIONS

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

- The dates added by the bill are inconsistent and thus may not properly reflect the author’s intent. According to the author’s staff, the bill is intended to clarify that the costs of any affixed tanks and foundations used in winemaking activities were always intended to be allowed under the MIC as originally enacted. However, the bill specifically provides that the amendments are operative for taxable years beginning on or after January 1, 2001. The bill also specifies that tanks placed in service on or after January 1, 1996, would qualify for the credit.

- According to the author’s staff, the MIC was always intended to apply to the costs of any affixed tanks and foundations used in winemaking activities. However, department staff has consistently interpreted the MIC to exclude such costs since "affixed tanks and foundations" are not "tangible personal property described in Section 1245(a) of the Internal Revenue Code," which is the operative definition contained in the MIC for qualified property. Moreover, affixed tanks and foundations used in SIC Code 2084 winemaking activities are not within the enumerated statutory definition of those taxpayers whose special purpose buildings and foundations can qualify for the MIC under specified circumstances. As a result, staff has been disallowing credits claimed for such costs. If such costs should have been allowed, the bill should be amended to be “declaratory of existing law.”

- Although this bill would allow taxpayers engaged in activities related to winemaking to claim the MIC for special purpose buildings and foundations, it is unlikely that buildings used by such taxpayers would otherwise meet the tests for special purpose buildings. Special purpose buildings must be specifically designed for a specific purpose, be used exclusively for that purpose, and be uneconomical to convert to a general-purpose building. According to the author’s staff, the intent is to allow the credit only for tanks and foundations, not special purpose buildings.

TECHNICAL CONSIDERATIONS

Amendments 1 through 4 would reference the specific laws that amended the MIC.

LEGISLATIVE HISTORY

SB 671, Alquist (Ch. 881, Stats 1993) added the MIC to the Revenue and Taxation Code. *SB 676, Alquist (Ch. 751, Stats. 1994)* made clarifying changes to the MIC, and added provisions allowing the credit for leased property. *SB 38, Lockyer (Ch. 954, Stats. 1996)* expanded the MIC by: (1) adding semiconductor equipment manufacturing and certain aerospace manufacturing to the definition of "qualified taxpayer" for the special purpose building provision; and (2) adding taxpayers engaged in certain biopharmaceutical and biotech activities to the definition of "small business." *AB 2798, Machado (Ch. 323, Stats 1998)* extended the MIC to manufacturers of custom or prepackaged computer software.

OTHER STATES' INFORMATION

New York provides an investment tax credit (ITC) to manufacturers for depreciable equipment or buildings. The credit is 5% of up to $350 million of qualified expenditures and 4% for qualified expenditures in excess of $350 million. Research and development (R&D) property may qualify for an optional rate of 9%.

Illinois provides a replacement tax investment credit equal to 0.5% of the basis of qualified property used in Illinois by a taxpayer primarily engaged in manufacturing, retailing, coal mining, or fluorite mining.

Massachusetts provides a 3% credit based on the cost of qualified property used for manufacturing, farming, fishing, or research and development.

Michigan provides a graduated investment tax credit based on adjusted gross receipts of a firm. The credit is a percentage (0.85% to 2.3%) of the net costs of qualifying tangible, depreciable assets located in Michigan.

The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

If the implementation considerations addressed in this analysis are resolved, the department's costs are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate

Based on the discussion below, the revenue loss from this bill is as follows:

Revenue Impact of SB 595 For Property Placed in Service On or After January 1, 1996 Assumed Enactment After 6/30/2001 Fiscal Impact (In Millions)		
2001-02	2002-03	2003-04
-$3	-$3	-$2

The reduction in revenue loss for fiscal year 2003-04 is due to additional credits allowed from prior year investments that are reflected in fiscal years 2001-02 and 2002-03.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this proposal.

Tax Revenue Discussion

The revenue impact of this credit would depend on the amount of qualified costs incurred and the tax liability of qualified taxpayers.

Qualified costs were estimated based on an U.S. Census Bureau survey of capital expenditures for the wine industry for 1996 through 1998 and information from the Wine Institute Communications regarding the full economic impact of wine in California based on 1998 data. The 1998 numbers were grown to approximate year 1998 and beyond. The credit use rates taken from the microsimulation model of California tax returns were then applied to derive the aggregate credit use. The fiscal year cash flow patterns are based on FTB analysis of how manufacturers adjusted their tax payments to reflect the reduction in liability resulting from the current law MIC.

ARGUMENTS/POLICY CONCERNS

This bill would benefit transactions for which binding contracts already exist and would not be limited to benefit only future business decisions. Under this bill, any costs paid under the terms of a contract for winemaking tanks placed in service on or after January 1, 1996, but prior to taxable years beginning on or after January 1, 2001, would qualify for the credit.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 595
As Introduced February 22, 2001

AMENDMENT 1

On page 13, modify line 17 as follows:

(j) The amendments made by ~~the act adding this subdivision~~ Chapter 954 of the Statutes of 1996

AMENDMENT 2

On page 13, modify line 20 as follows:

(k) The amendments made by ~~the act adding this subdivision~~ Chapter 323 of the Statutes of 1998

AMENDMENT 3

On page 25, modify line 15 as follows:

(j) The amendments made by ~~the act adding this subdivision~~ Chapter 954 of the Statutes of 1996

AMENDMENT 4

On page 25, modify line 18 as follows:

(k) The amendments made by ~~the act adding this subdivision~~ Chapter 323 of the Statutes of 1998