

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Dutton Analyst: Norman Catelli Bill Number: AB 2076

Related Bills: See Legislative History Telephone: 845-5117 Introduced Date: February 17, 2004

Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Manufacturers' Investment Credit/6% of Amount Paid or Incurred On or After 1/1/04/Qualified Property Includes Electric Services

### SUMMARY

This bill would reinstate the previous Manufacturers' Investment Credit (MIC) only for electric services.

### PURPOSE OF THE BILL

According to the author's staff, the purpose of the bill is to increase the incentive for the production of electricity in California.

### EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2004.

### POSITION

Pending.

### 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 and allow a depreciation deduction for the obsolescence or wear and tear of property used in a trade or business or for the production of income.

Existing federal law does not have a credit comparable to the previous MIC.

Previous state law allowed qualified taxpayers a credit equal to 6% of the amount paid or incurred after January 1, 1994, and before January 1, 2004, for qualified property that was placed in service in California.

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

Board Position:	Department Director	Date
_____ S		
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_____ NA		
_____ O		
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_____ NP		
_____ NAR		
_____ X PENDING	Roger Lackey	03/24/04

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

- Manufacturing, processing, refining, fabricating, or recycling of property;
- Research and development;
- The maintenance, repair, measurement, or testing of otherwise qualified property; or
- 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) Special purpose buildings and foundations that are an integral part of specified activities.

For taxpayers engaged in computer programming and computer software related activities, qualified property included 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 excluded certain types of property from the definition of qualified property, such as furniture, inventory, and equipment used in an extraction process.

The MIC has been repealed by its own terms and ceased to be operative as of January 1, 2004, due to a reduction in manufacturing sector jobs.

### THIS BILL

This bill would reinstate indefinitely the previous MIC, which sunset by its own terms on January 1, 2004, for taxable years beginning on or after January 1, 2004, but only for taxpayers in lines of business described as electric services, e.g., power generation, transmission, or distribution (SIC Code 4911). This bill also allows taxpayers engaged in activities related to electric services to claim the MIC for special purpose buildings and foundations.

### IMPLEMENTATION CONSIDERATIONS

A recent Board of Equalization decision concluded that electricity is an "intangible" and the generation and transmission of electricity is the sale of a service (*Appeal of PacifiCorp, 2002-SBE-005, 9/12/2002*). Qualified property for the MIC is limited to property used to alter tangible personal property to its completed form. Under the Board of Equalization decision, property used to generate and transmit electricity may not be eligible for the MIC. It may be necessary to provide a specific statutory reference to the process of generating and transmitting electricity to allow property used in this activity to qualify for the MIC. This reference would avoid disputes between taxpayers and the department.

## LEGISLATIVE HISTORY

AB 1998 (Dutton, 2003-2004) would reinstate the previous MIC for taxable years beginning on or after January 1, 2005, and extend the MIC to activities related to electric service (power generation, transmission, or distribution). AB 1998 is waiting for a hearing date in the Assembly Revenue and Taxation Committee.

AB 2070 (Houston, 2003-2004) would reinstate the previous MIC for taxable years beginning on or after January 1, 2005. AB 2070 is waiting for a hearing date in the Assembly Revenue and Taxation Committee.

SB 1295 (Morrow, 2003-2004) would reinstate the previous MIC for taxable years beginning on or after January 1, 2004, and increase the rate of credit from 6% to 8%. SB 1295 is waiting for a hearing date in the Senate Revenue and Taxation Committee.

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 676 specifically limited the MIC to the lessee.

## OTHER STATES' INFORMATION

The states surveyed include *Illinois, Massachusetts, Michigan, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. None of these states offer income or franchise tax benefits just for electric services.

## FISCAL IMPACT

This bill would not significantly impact the department's costs.

## ECONOMIC IMPACT

### Revenue Estimate

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

Estimated Revenue Impact Operative for Taxable Years Beginning on or After January 1, 2004 Assumed Enactment After June 30, 2004 (In Millions)		
2004-05	2005-06	2006-07
-\$60	-\$115	-\$145

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

### Revenue Discussion

The revenue effect of this credit is determined by the following formula:

“Qualified costs” incurred in “qualifying activities” by a “qualified taxpayer” multiplied by 6% equals the gross amount of the credit earned.

The amount of credit allowed to reduce tax liability is limited by the amount of alternative minimum tax, if any, for the year. Other tax rules require a carryover credit to be applied to the limitation amount until exhausted. The newly earned credit may be applied to any remaining tax liability balance. The amount of the newly earned credit actually applied to tax liability is the revenue impact. Any credit not applied to the current year tax liability is a carryover to the next year.

This bill would provide a credit to taxpayers engaged in activities described in SIC Code 4911 (Electric Services). The revenue effect of this bill was determined by applying the above methodology to a forecast of qualifying costs, qualifying activities, and qualified taxpayers. This forecast was based on available U.S. Census information identifying capital expenditures by qualifying businesses and actual departmental data regarding the previous MIC.

This estimate is based on a micro simulation model of California tax returns for taxable year 2001. These numbers were grown to approximate 2002 and beyond. The above estimate represents only that portion of applied credits with respect to newly generated credits pursuant to this bill.

The fiscal year cash flow patterns are based on the department’s analysis of how manufacturers adjusted their tax payments to reflect the reduction in liability resulting from the previous MIC.

### **POLICY CONCERNS**

This bill does not contain a sunset date. Sunset dates generally are provided in tax incentive bills (credits, special deductions) to allow periodic review by the Legislature.

### **LEGISLATIVE STAFF CONTACT**

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