

# ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Runner Analyst: Darrine Distefano Bill Number: AB 2463

Related Bills: See Legislative History Telephone: 845-6458 Amended Date: 04-27-2004

Attorney: Patrick Kusiak Sponsor: California Credits Group

**SUBJECT:** Enterprise Zones/Qualified Wages Credit & Sales & Use Tax Credit/Apportionment Procedures & Formula/Unitary Group

## SUMMARY

This bill would revise the method for computing credit limits for taxpayers that operate a business in an Enterprise Zone (EZ).

## SUMMARY OF AMENDMENTS

The April 27, 2004, amendments would allow a taxpayer or a unitary group of corporations to calculate all business income attributable to those EZs that received an audit determination of "pass" or "superior" from Department of Housing and Community Development (DHCD) for purposes of determining and applying the EZ income tax incentives.

This is the department's first analysis of this bill.

## PURPOSE OF THE BILL

It appears that the purpose of this bill is to allow taxpayers to more broadly apply their EZ tax benefits against income generated in any EZ.

## EFFECTIVE/OPERATIVE DATE

This bill would be effective and operative for taxable years beginning on or after January 1, 2004.

## POSITION

Pending.

## ANALYSIS

### FEDERAL/STATE LAW

Existing federal law provides special tax incentives for empowerment zones and enterprise communities to provide economic revitalization of distressed urban and rural areas.

Board Position:

S       NA       NP  
 SA       O       NAR  
 N       OUA       PENDING

Department Director

Date

Gerald H. Goldberg

5/12/04

Qualified zone businesses operating in federal empowerment zones and federal enterprise communities are eligible to receive two tax incentives: (1) tax-exempt private activity bonds to finance certain facilities; and (2) the "brownsfields" tax incentive, which allows taxpayers to expense (rather than capitalize) certain environmental remediation expenditures. Qualified empowerment zone businesses are allowed an additional \$20,000 depreciation expense deduction.

Under the Government Code, existing state law allows the governing body of a city or county to apply for designation as an EZ. Using specified criteria, DHCD designates EZs from the applications received from the governing bodies. Once designated, DHCD may audit EZ programs and determine a result of superior, pass, or fail, and may dedesignate failing programs. Any business located in a dedesignated zone that has elected to avail itself of any state tax incentive for any taxable year prior to dedesignation may continue to avail itself of those tax incentives for a period equal to the remaining life of the EZ, provided the business otherwise is still eligible for those incentives.

Under the Revenue and Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within an EZ. These incentives include a sales or use tax credit, hiring credit, business expense deduction, special net operating loss treatment, and net interest deduction. In addition, specified employees of businesses operating in an EZ may claim a wage credit.

For businesses operating inside and outside an economic development area, the amount of credit or net operating loss deduction that may be claimed is limited by the amount of tax on income attributable to the economic development area. Income is first apportioned to California using the same formula as that used by all businesses that operate inside and outside the state (property, payroll, a double-weighted sales factor). This income is further apportioned to the economic development area using a two-factor formula based on the property and payroll of the business.

Under state law, an individual taxpayer must file a return to report all income he or she received during the taxable year as a resident of California or, if not a resident, then the individual must report income that is sourced to California. A corporation must also file a return to report all income derived from, or attributable to, sources within California. In the case of corporations, to determine the portion of income attributable to California, the unitary business principle is applied. Under this principle, all members of a single trade or business are viewed as a unit or whole, and are engaged in a "unitary business." Members of a unitary business report all unitary business income on a combined report to determine California-source income. Generally, a taxpayer included in a combined report must file its own tax return. However, some unitary groups may elect to file a group return and report the total separate tax liabilities of the unitary members.

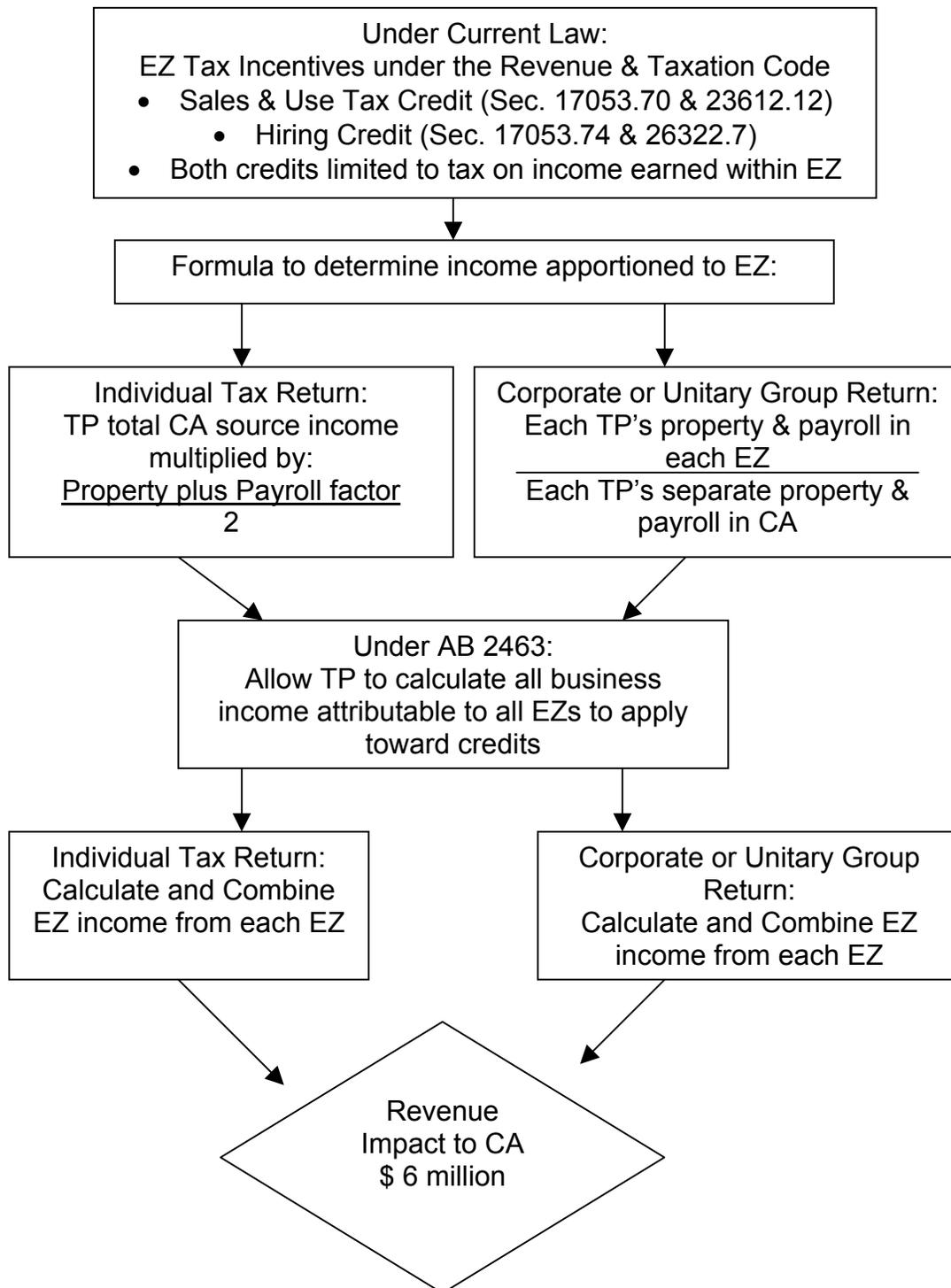
### THIS BILL

Under the Personal Income Tax Law (PITL), this bill would allow a taxpayer that has businesses located in various EZs to combine all business income attributable to those EZs. The taxpayer would use the total income from all EZs to calculate the EZ income tax incentives. The taxpayer would only be able to use income from EZs that have received an audit determination of "pass" or "superior" from DHCD.

Under the Corporation Tax Law (CTL), this bill would allow a corporation or unitary group of corporations that have businesses located in various EZs to combine all business income attributable to those EZs. The corporation or unitary group would use the total income from all EZs to calculate the amount of EZ income tax incentives that can be utilized by the corporation that earned the credit. The corporation or unitary group would only be able to use income from EZs that received an audit determination of "pass" or "superior" from DHCD.

This bill also would make various technical changes.

The following chart displays *State law*, *This Bill*, and resulting revenue impact:



## IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

## **LEGISLATIVE HISTORY**

AB 850 (Morrissey, Ch. 506, Stat. 1996) and AB 1670 (Takasugi, 1995/1996) would have modified the two-factor apportionment formula used for purposes of determining income attributable to business activities within EZs, program areas, and Local Agency Military Base Revitalization Areas to apply the method used for the Los Angeles Revitalization Zone. AB 850 was amended to remove this provision and later chaptered to exclude from gross income of a nonresident "qualified retirement income" received on or after January 1, 1996. AB 1670 remained in the Senate Revenue & Taxation Committee.

## **FISCAL IMPACT**

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

## **ECONOMIC IMPACT**

### Revenue Estimate

Revenue Impact of AB 2463 Assumed Effective 1/1/04 and Enactment after 7/1/04 (\$ In Millions)			
Fiscal Year	2004/05	2005/06	2006/07
Revenue Losses	-\$6	-\$6	-\$6

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

### Revenue Discussion

The revenue impact associated with this bill would depend on the extent available credits are currently limited from treating EZ activities on a stand-alone apportionment basis. Taxpayers operating in multiple zones are required to look at each activity as an exclusive entity, meaning any hiring credits or sales and use credits generated cannot be shifted to another entity for tax purposes. Likewise, tax on income attributed to a primary zone activity cannot be offset by credits generated in a secondary activity, even if the same taxpayer owns both activities. Based on several discussions with DHCD, an evaluation of zone performance has produced mixed results. Therefore the impact of requiring EZ to be ranked in accordance with the eligibility criteria specified in the EZ Act is unknown.

Data indicates the number of taxpayers operating in multiple EZs is small (about 7%), while the amount of credits claimed account for almost half (about 40%) of total credits allowed. In 2004, the amount of revenue loss from applied credits from multiple zone taxpayers is estimated at \$64 million.

Although this bill affects a small number of taxpayers, the corresponding revenue impact is rather significant. During the 2001 tax year, roughly 75% of multiple zone taxpayers reported credit carryovers. In fact, the amount of carryovers was larger within this population than the amount of credits actually applied against tax. As such, it is anticipated that some acceleration of credit usage would result with respect to the amount of unused credits that would otherwise be carried over for any given year. This amount of additional credits claimed is projected to increase applied credit usage by 10%, or roughly \$6 million (\$64 million X 10%) per year over current law.

## **ARGUMENTS/POLICY CONCERNS**

This bill would allow all income generated from the taxpayer's or unitary group's business in an EZ to be applied to the hiring credit and the sales and use credit, but it does not put a limitation on the amount of income used to calculate the credit. Therefore, members of a unitary group operating in multiple EZs that earn high income in some, but not others, would be able to take a larger credit amount because that group is no longer limited by the amount of net business income generated within the particular EZ in which the actual credit was generated. For example, Corporation A has \$10 of business income apportioned to the EZ, Corporation B has \$20, and Corporation C has \$30. Each corporation would be able to apply credits up to \$60 (\$10+\$20+\$30) of business income, whereas under existing law each corporation would only be able to apply credit up to the amount of income apportioned to the zone.

Under existing state law, credits are only available to the taxpayer that incurred the expense that provided the basis for the credit. Only the low-income housing credit permits a corporation to assign all or a portion of its low-income housing credit to one or more affiliated corporations and only under extremely narrow circumstances (100% common ownership).

This bill would provide a tax benefit for businesses that operate in an EZ that would not be provided to other business entities that are not within an EZ. Thus, this bill would provide differing treatment based solely on location.

## **LEGISLATIVE STAFF CONTACT**

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