ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Villines | Analyst: Raul Guzman | Bill Number: AB 2395

Related Bills: See Legislative History | Telephone: 845-4624 | Introduced Date: February 23, 2006

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Manufacturers' Investment Credit/6% Of Qualified Cost Of Qualified Property Placed In Service In This State

SUMMARY

This bill would create a tax credit for purchasers of certain property used in manufacturing.

This analysis addresses only those provisions of the bill affecting the Franchise Tax Board (FTB).

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to increase the incentive for manufacturing businesses to remain or locate in California.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and by the specific terms of the bill, would be operative for taxable years beginning on or after January 1, 2006.

POSITION

Pending.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

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 that proposed in this bill.

Previous state law allowed qualified taxpayers a Manufacturers' Investment Credit (MIC) 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.

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For purposes of the 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:

1) Tangible personal property 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;
   - 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 were 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. Additional exclusions are facilities used for warehousing purposes and equipment used to store finished products, after completion of the manufacturing process, including tangible personal property used in administration, general management, or marketing.

The MIC statute was 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 add a manufacturing incentive credit at a rate of 6% of the qualified cost of qualified property placed in service in this state for qualified taxpayers similar to the prior MIC law. Qualified taxpayers would be required to satisfy all of the following:

- Be engaged, as a principal activity[1], in those lines of business described in Codes 331 to 339999 (Manufacturing), inclusive, of the North American Industrial Classification System (NAICS), 2002 edition.
- Have gross manufacturing activity assets that do not exceed $ 5 million dollars.
- Agree to provide additional information to FTB and permit disclosure of that information for the limited purpose of evaluation by the Legislative Analyst.

[1] Principal activity means more than 50 percent of the qualified person's total business activity.

Generally, "qualified cost" would mean an amount chargeable to the capital account of the qualified taxpayer paid or incurred on or after January 1, 2006, for the construction or acquisition of qualified property.

"Qualified property" would mean tangible personal property or certain structures, as defined. Qualified property would exclude any of the following:

- Furniture.
- Facilities used for warehousing purposes after completion of the manufacturing process.
- Inventory.
- Equipment used in the extraction process.
- Equipment used to store finished products that have completed the manufacturing process.
- Any tangible personal property that is used in administration, general management, or marketing.

The bill would provide for recapture on a pro-rata basis for five years after the property is placed in service.

The bill also would provide a carryover provision for unused credit for seven years.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

The taxpayer's eligibility for the credit would in part be based on the lines of business described in specified sections of the NAICS. The bill references to the NAICS sections are inconsistent. Amendments are required to fix this inconsistency.

This bill would contain conflicting provisions with regard to whether "tangible personal property" would qualify for the credit. Namely, the bill purports to exclude property used in refining but includes property used in the process of converting a natural resource to an intermediate or finished product. In addition, this bill includes NAICS sections for "refining" as qualifying for the proposed MIC. Finally, the bill would allow as "tangible personal property" special purpose buildings and foundations used as an integral part to the refining process or that constitute a research or storage facility used during the manufacturing process. These internal conflicts should be resolved.

TECHNICAL CONSIDERATIONS

The department has identified the following technical concerns. Department staff is available to work with the author's office to resolve this and other concerns that may be identified.

This bill does not define the meaning of gross aggregate gross assets (GAGA). For purposes of this bill it is assumed that GAGA is defined as gross assets or the original basis of equipment prior to any depreciation adjustment.

LEGISLATIVE HISTORY

AB 2076 (Dutton, 2003-2004) would reinstate the previous MIC only for electric services. AB 2076 failed passage in the Assembly Revenue and Taxation Committee.

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 failed passage 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 failed passage 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 failed passage in the Senate Revenue and Taxation Committee.

SB 676 (Alquist, Ch. 751, Stats. 1994) made clarifying changes to the MIC, and added provisions allowing the credit for leased property, but only to the lessee.

SB 671 (Alquist, Ch. 881, Stats. 1993) enacted the MIC.

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. The survey was limited to income or franchise tax benefits related to manufacturing equipment.

Illinois provides a replacement tax investment credit equal to 0.5% of the basis of qualified property placed in service during the tax year (from July 1, 1984 to January 1, 2004), used 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 provided a credit (from December 31, 2004 and before January 1, 2006) of up to 2% to taxpayers with gross receipts of $10 million or less for newly created high-technology activities or manufacturing jobs.

New York provides an investment tax credit to manufacturers for certain 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. Certified pollution control, industrial waste treatment, and acid rain control facilities also qualify for this credit. Research and development property may qualify for an optional rate of 9%.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

The revenue impact of this bill is estimated to be as shown in the following table:

Estimated Revenue Impact of AB 2395 As introduced February 23, 2006 Effective for tax years BOA 1/1/2006 Enacted by 6/1/2006 ($ Millions)				
	2006-07	2007-08	2008-09	2009-10
Manufacturing Investment Credit	-$40	-$45	-$45	-$45

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

Revenue Discussion

This estimate was calculated as follows.

First, the amount of corporate MIC claimed under the proposed language was estimated based on the 2003 corporate sample. For estimation purposes, it is assumed that GAGA is defined as gross assets or the original basis of the equipment prior to any depreciation adjustment. It was estimated that about 6% of the amount of MIC actually claimed in 2003, or $18 million, was attributed to non-extractive assets employed by firms with assets of less than $5 million.

Next, the $18 million in MIC for 2003 was extrapolated into future years. The extrapolation was based upon the latest Department Of Finance forecast for corporate profits. For 2006, this extrapolated MIC credit is $27 million. Finally, the PIT revenue impact was calculated using a multiple of the ratio of PIT MIC credits to corporate MIC credits in 2003. This ratio in 2003 was 11%. Due to the $5 million GAGA limit, it was assumed that this ratio would be much higher, 44%, under this bill. The PIT MIC credit for 2006 was estimated as $13 million ($27 million x 44%).

The total impact for 2006 was the sum of the estimated corporate and PIT credit, $40 million ($13 million + $27 million).

LEGAL IMPACT

If this bill requires taxpayers to place in service qualified property in this state to qualify for this credit, the credit may be subject to constitutional challenge. The U.S. Court of Appeals for the 6th Circuit ruled in *Cuno v. DaimlerChrysler, Inc.* (2004) 386 F. 3d 738, that Ohio's Investment Tax Credit is unconstitutional because it gives improper preferential treatment to companies to locate or expand in Ohio rather than in other states and, therefore, violates the Commerce Clause of the U.S. Constitution. This case is now pending with the U.S. Supreme Court. The Court will issue its decision on this case by the end of June, 2006. Although the outcome of this decision and its effects on the income tax credits of other states, including California, is unknown, targeted tax incentives that are conditioned on activities in California may be subject to constitutional challenge.

POLICY CONCERNS

Most credit bills contain a sunset date. Sunset dates generally are provided in tax incentive bills, credits, or special deductions to allow a periodic review by the Legislature.

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