

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Arambula Analyst: Darrine Distefano Bill Number: AB 2502

Related Bills: See Legislative History Telephone: 845-4142 Introduced Date: February 23, 2006

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Small Business Tax Credit Transfers To Other Taxes Owed

SUMMARY

This bill would allow a taxpayer to transfer specified excess tax credits and apply them toward specified Board of Equalization (BOE) administered taxes.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to assist small businesses through greater usage of state income tax credits.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2007, and would specifically apply to taxable years beginning on or after that date.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

The BOE requires retailers to collect and remit state sales tax, which generally applies to all retail sales of goods and merchandise, except those sales specifically exempted by law. The use tax generally applies to the storage, use, or other consumption in California of goods purchased from retailers in transactions not subject to the sales tax. Other taxes administered by BOE include the Motor Vehicle Fuel License Tax, Use Fuel Tax, Alcoholic Beverage Tax, Timber Yield Tax, Hazardous Substances Tax, or the Diesel Fuel Tax.

Existing federal and state laws provide various tax credits that are used to reduce the taxpayer's tax liability dollar-for-dollar. One benefit of allowing tax credits rather than deductions is that tax credits are claimed after taxable income has been calculated and, therefore, do not create differences between the taxable income amounts shown on the federal and state income tax

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returns. To the extent that the allowed credit cannot be used, the credit may be carried over to a subsequent tax year.

Under the Revenue and Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within EDAs. These incentives include a sales or use tax credit, hiring credit, business expense deduction, and special net operating loss treatment. Two additional incentives include net interest deduction for businesses that make loans to businesses within the economic development areas and a tax credit for employees working in an EZ.

California conforms to the federal research credit with the following modifications:

- ◆ The state credit is not combined with other business credits.
- ◆ Research must be conducted in California.
- ◆ The credit percentage for qualified research in California is 15% versus the 20% federal credit.
- ◆ The credit percentage for basic research in California, limited to corporations, is 24% versus the 20% federal credit.
- ◆ The percentages for the alternative incremental research portion of the credit in California are 1.49%, 1.98%, and 2.48% versus the 2.65%, 3.2%, and 3.75% federal credit.

The federal credit does not apply for expenses incurred on or after December 31, 2005. There is pending federal legislation, S 2020, which would extend the credit to apply to expenses incurred during 2006.

THIS BILL

Under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL), this bill would allow a taxpayer that employs less than 50 people to transfer excess credits (credit amounts that exceed the net tax) from the research credit, hiring credit, and EZ sales or use tax credit and apply the excess to the tax liability incurred under the following general fund taxes administered by BOE: Sales and Use Tax, Motor Vehicle Fuel License Tax, Use Fuel Tax, Alcoholic Beverage Tax, Timber Yield Tax, Hazardous Substances Tax, or the Diesel Fuel Tax.

This bill requires BOE to create a form that allows the taxpayer to apply for the tax credit transfer.

This bill requires BOE to publish rules and regulations necessary to establish procedures, processes, and requirements to implement the program.

This bill would allow Franchise Tax Board's (FTB) to retain its authority to audit a taxpayer that has utilized and transferred the credit under this program. This bill would also allow BOE to retain its authority to audit or contract with FTB to audit a taxpayer.

This bill would require the BOE, on or after October 1, 2009, to report to the Legislature on the use of excess credits transferred and applied to the Sales and Use Tax, Motor Vehicle Fuel License Tax, Use Fuel Tax, Alcoholic Beverage Tax, Timber Yield Tax, Hazardous Substances Tax, or the Diesel Fuel Tax.

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.

This bill allows only the EZ sales or use tax credit to be transferred and applied to specified BOE administered taxes. TTA and LAMBRA incentives also include the sales or use tax credit. The author may wish to add the sales or use tax credit provisions for the TTA and LAMBRAs.

The provisions of this bill would be limited to employers with fewer than 50 employees. It is unclear how the credit or the taxpayer would be treated if the taxpayer exceeds the 50-employee limitation after initially claiming the credit. For example, employers could have more than 50 employees at different times throughout the year due to seasonal hiring but maintain a base of fewer than 50 permanent employees. Generally, credits include recapture provisions to resolve subsequent disqualification issues.

The employee limitation in the bill could possibly be avoided by large businesses that create smaller subsidiaries. To avoid this result, the author may wish to require that all taxpayers "related" to the entity with the unused credit be aggregated to determine whether the 50-employee limitation is satisfied.

The bill is silent regarding when the transfer of excess credits can be made. Without specific language to clarify when a credit would be available for transfer, problems will arise during processing or during an audit.

The bill should identify who can transfer the credit: the taxpayer that earned the credit, an affiliate, or an authorized representative. It is unclear who is authorized to make the transfer even though the credits are on the taxpayer's return.

With pass-through entities, all PIT taxes and credits flow from the business entity through to individual. For all BOE taxes, the business entity is responsible for paying those taxes, not individuals. The bill is silent regarding how the application of excess credits for pass-through entities would be handled.

The transfer of credits may be affected by the different due dates for tax returns. BOE has different due dates for the filing of its returns than FTB. Most taxpayers file their tax return with FTB on a calendar or fiscal year basis. BOE taxpayers file their return on either a monthly, quarterly, calendar, or fiscal year basis depending on their reporting period for the particular tax being credited.

A requirement for transferring excess credits is revenues must be derived from the imposition of the tax allocated to the General Fund and not a special fund. The bill needs to clarify whether the term "tax" means BOE taxes or PITL and CTL taxes.

LEGISLATIVE HISTORY

AB 2562 (Vargas, 2001-02) would have allowed a taxpayer that qualified for a credit while operating a business in an EZ to transfer that credit or a subsequent carryover of that credit to any other taxpayer in this state. This bill remained in the Governmental Organization Committee.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, the PITL and CTL revenue loss from this bill would be as follows:

Estimated Revenue Impact of AB 2502 For Taxable Years Beginning On Or After January 1, 2007 Enactment Assumed After June 30, 2006 (\$ Millions)			
	2006-07	2007-08	2008-09
Credit Transfers	no impact	-\$40	-\$30

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

Revenue Discussion

For the 2003 tax year, the latest for which data is available, there are an estimated \$7 billion in unused credits of the types that would qualify for transfer under this bill. Based on current trends in accumulation of credit carryovers, it is projected that by the time this bill would take effect in 2007; this reserve will rise to about \$12 billion.

Because the majority of carryover credits are research credits, which are disproportionately generated by large firms, it is assumed that only 1% of these credits (\$120 million) are attributable to businesses with fewer than 50 employees. It is further assumed that about one-third of unused credits would actually be used against BOE administered taxes each year, so the amount of credits transferred in 2007 would be \$40 million (\$120 million x 1/3).

The estimate assumes that small businesses would generate \$12 million in new unused credits each year. Thus, there would be approximately \$90 million in available unused credits in 2008 (\$120 million - \$40 million already used + \$12 million newly generated), 1/3 of which would be transferred to BOE taxes. The estimate assumes that the transfers would occur in the same quarter that the taxpayer's income tax is due (i.e. A calendar year filer that has excess credits at the end of 2007 would transfer those credits to BOE in April of 2008 when the tax return is due to FTB).

ARGUMENTS/POLICY CONCERNS

The Sales and Use Tax allows the taxpayer to seek reimbursement from the consumer. Therefore, if excess credit is transferred for a BOE tax that has been reimbursed, the taxpayer would essentially receive a refund of the credit. The author may wish to add language that would require the taxpayer to carry over any excess credits to subsequent tax year liabilities if the taxpayer was reimbursed for any BOE tax.

LEGISLATIVE STAFF CONTACT

Darrine Distefano
Franchise Tax Board
845-4142

darrine.distefano@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333

brian.putler@ftb.ca.gov