Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Arambula	Analyst:	Darrine Distefano	Bill Number:	AB 2553
Related Bills:	See Legislative History	Telephone:	845-4142	Introduced Date:	February 23, 2006
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: California Air Quality Zones/Qualified Capital Expenditures Credit & Depreciation Deduction

SUMMARY

This bill would provide income tax incentives for certain expenditures that create jobs and reduce pollution.

This bill would also make changes to provisions relating to air quality zones that would not impact the department and will not be addressed in this analysis.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to establish and retain businesses in identified air quality zones by providing tax incentives that create jobs and reduce air pollution.

EFFECTIVE/OPERATIVE DATE

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

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Existing state and federal laws generally allow a depreciation deduction for the obsolescence or wear and tear of property used in the production of income or property used in a trade or business. The amount of this deduction is determined, in part, by the cost (or basis) of the property. In addition, the property must have a limited, useful life of more than one year. The depreciation deduction is generally allowed over a period approximating the property's economic life rather than deducted in the year purchased or acquired. As an incentive for businesses to invest in property, occasionally an accelerated depreciation deduction is allowed. That is, a

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deduction is allowed at a faster rate than the decline in the property's economic value would warrant.

Depreciable property includes equipment, machinery, vehicles, and buildings, but excludes land. Significant improvements to property are added to the basis of the property and are depreciated over the property's remaining useful life.

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Previous state law allowed qualified taxpayers a Manufacturers' Investment Credit (MIC) equal to 6% of the qualified costs paid or incurred on or after January 1, 1994, and before January 1, 2004, for qualified property that was placed in service in California.

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 in California.

<u>THIS BILL</u>

Under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL), this bill would provide a 10 percent credit for an amount paid or incurred for qualified capital expenditures.

This bill defines "qualified capital expenditures" as expenditures required to be capitalized and meet the following requirements:

- Expenditures made within a California Air Quality Zone.
- Expenditures certified by the regional air quality district in which the zone is located as improving the air quality based on the following considerations:
  - ✓ The amount of the expenditures.
  - ✓ The amount and type of emission reductions and mitigation to be achieved.
  - ✓ The cost-effectiveness of the expenditures.
  - ✓ The extent that the expenditures reduce emissions in residential areas, specifically in areas that include low-income communities, schools, and workplaces.
  - ✓ The expenditures are required according to a federal or state mandate.

This bill would allow any excess credit to be carried over indefinitely.

In addition to the credit, this bill would allow a taxpayer to elect to depreciate the entire cost of any qualified capital expenditure over three years using the straight-line method of depreciation, beginning in the year the costs are paid or incurred and the following two years.

<u>IMPLEMENTATION CONSIDERATIONS</u>

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.

While this bill defines “qualified capital expenditures,” it is unclear if the term applies to new expenditures placed in service or to provide a benefit for expenditures already in use or to both.

Because the credit and deduction could apply to new property, the original use of which commences with the taxpayer, a taxpayer could sell an item of qualified property among affiliates and continually generate new credits and apply the special depreciation rules provided under this bill. The author may wish to add a recapture mechanism that requires the taxpayer to use the expenditure for a certain length of time in this state. For an expenditure used less than the specified period, all or some portion of the deduction amount should be added back to the taxpayer’s taxable income and tax liability.

This bill would allow the deduction for the year “costs are paid or incurred.” Most depreciation and property credit provisions require an asset to be “placed in service” to trigger eligibility for the tax benefit. Requiring that the equipment be "placed in service" within this state ensures that the asset will be used in California.

The author may want to consider providing rules for how leased equipment is intended to be treated for purposes of this special depreciation rule. As drafted, the bill limits the taxpayer that leases the equipment to a manufacturer for use in this state from claiming the accelerated depreciation otherwise allowed by this bill.

This bill would allow a taxpayer to elect the straight-line method of depreciation in place of any other method. The bill is silent about whether the election is irrevocable. As a result, the department would treat the election as though it were revocable. This would allow a taxpayer to change the method of depreciation at any time during the three years. If that is not the author’s intention, the bill should be amended to specify that the election would be irrevocable.

TECHNICAL CONSIDERATIONS

AB 2595 has identical provisions relating to the depreciation deduction; however, AB 2595 allows the costs for “qualified manufacturing equipment” to be depreciated, instead of “qualified capital expenditures,” as identified in this bill. The author may wish to use one term -- either “qualified capital expenditures” or “qualified manufacturing equipment” -- in both bills to maintain consistency.

LEGISLATIVE HISTORY

AB 2595 (Arambula, 2005/06) would allow a taxpayer to depreciate qualified manufacturing equipment. This bill is currently referred to the Assembly Jobs, Economic Development, & the Economy Committee and the Assembly Revenue & Taxation Committee.

FISCAL IMPACT

The department's costs to administer this bill cannot be determined until implementation concerns have been resolved but are anticipated to be minor.

This bill would require a calculation for the credit that would require a new form or worksheet to be developed. As a result, this bill would impact the department’s printing, processing, and storage costs for tax returns. The additional costs will be identified and, if needed, an appropriation requested as the bill moves through the legislative process.

ECONOMIC IMPACT

Revenue Estimate

The estimated revenue losses from this bill are as follows:

Estimated Revenue Impact of AB 2553 Effective Tax Years Beginning On or After 1/1/2007 Assumed Enactment Date After 6/30/06 **(Millions)**			
2005-06	**2006-07**	**2007-08**	**2008-9**
-$0	-$80	-$380	-$640

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

Revenue Discussion

For the legislative year 2005-06, the California Air Resources Board (ARB) had requested a $1 billion bond be placed on the ballot as an incentive fund for the upgrading of equipment to meet air pollution regulations. The incentive was to be 10% of the cost of the equipment. The ARB estimated the total cost of the capital expenditure for all California business at $10 billion. This bill would provide a tax credit equal to 10% for the same capital expenditure. The ARB estimated the $1 billion in incentive funds would be expended over the next ten years ($10 billion / 10 years). Using those same assumptions for the tax credit provided by this bill, it is estimated the revenue impact would be a $100 million loss annually.

This bill would also allow a taxpayer to take a deduction for depreciation with respect to those qualified capital expenditures over a three year period. Using the department's depreciation model to accelerate the expenditures in three years instead over the normal useful life of 3-20 years, the changes in the depreciation schedule for $1 billion dollar annual investment by businesses ($10 billion / 10 years) is estimated to reduce revenues by $225 million the first year, $370 million the second year and $570 million the third year.

Tax year estimates presented in the table above were converted to the cash-flow estimates. Cash flow estimates reflect the ability of some taxpayers to accelerate tax benefits by adjusting their estimated tax payments.

LEGAL IMPACT

This bill contains provisions that would target certain incentives to California.

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. The U.S. Supreme Court is currently reviewing this case. A decision will be rendered by the end of June, 2006. Although the outcome of this decision and its affects 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.

ARGUMENTS/POLICY CONCERNS

Most credits contain a sunset date. Sunset dates generally are provided to allow periodic review by the Legislature.

In addition, most credits contain a limit on the number of years for the carryover period of excess credits. Without a time limit the department would be required to retain the carryover on the tax forms indefinitely because presently the bill would allow an unlimited credit carryover period. Recent credits have been enacted with a carryover limitation because experience shows credits are typically used within eight years of being earned.

Although this bill would limit a qualified taxpayer to a 10% credit, the amount of the credit that may be taken is unlimited. Credits that could potentially result in significant revenue loss are sometimes limited either on a per-project or per-taxpayer basis.

LEGISLATIVE STAFF CONTACT

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