Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Runner	Analyst:	Nicole Kwon	Bill Number:	AB 2589
Related Bills:	See Legislative History	Telephone:	845-7800	Introduced Date:	February 24, 2006
		Attorney:	Patrick Kusiak	Sponsor:	

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

SUMMARY

This bill would revise the method for computing the credit utilization limitations on taxpayers conducting business in an enterprise zone (EZ).

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to allow taxpayers to more broadly apply their EZ tax benefits against income generated in any EZ in which the taxpayer is doing business.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and would be specifically operative for taxable years beginning on or after January 1, 2007.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

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

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.

Board Position:			Department Director	Date
______ S	______ NA	______ NP		
______ SA	______ O	______ NAR	S. Stanislaus	4/26/06
______ N	______ OUA	__X__ PENDING		

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, Department of Housing and Community Development (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, 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 (EDA), 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 EDA. Income is first apportioned to California using the same formula 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 EDA 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 for purposes of applying the limitations applicable to the EZ incentives. The taxpayer would use the total income from all EZs to calculate the EZ income tax incentives.

Under the Corporation Tax Law (CTL), this bill would allow a corporation that has businesses located in various EZs to combine all business income attributable to those EZs for purposes of applying the limitations applicable to the EZ incentives. The corporation 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.

<u>IMPLEMENTATION CONSIDERATIONS</u>

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.

<u>TECHNICAL CONSIDERATIONS</u>

The language in this bill is not the correct version of the current statute. Rather than using the current statute, this bill uses the version of AB 830 (Runner, 2005/2006) introduced February 18, 2005, and amended May 2, 2005. Author's office stated that the bill is being amended to reflect the correct version of the current statute.

LEGISLATIVE HISTORY

AB 830 (Runner, 2005/2006) and AB 2463 (Runner, 2003/2004) are identical to this bill. Both AB 830 and AB 2463 failed to pass out of the Assembly Revenue & Taxation Committee.

AB 850 (Morrissey, Stat. 1996, Ch. 506) 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

<u>Tax Revenue Estimate</u>

Based on data and assumptions discussed below, this provision would result in the following revenue losses:

Estimated Revenue Impact of AB 2589 Effective for Tax Years BOA 1/1/2007 Assumed Enactment Date After 6/30/06 (Millions)		
2006/07	2007/08	2008/09
-$3	-$14	-$14

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

Tax Revenue Discussion

The revenue impact of this proposal is dependent on increased credit usage by taxpayers that operate within multiple EZs.

Corporate Impact:

For taxable year 2003, approximately 2,750 corporate taxpayers used $181 million in EZ credits. Three hundred of these corporate taxpayers operate within multiple EZs and used $113 million in credits. Taxpayers doing business in multiple EZ reported 62% of all EZ credits used. These corporate taxpayers also reported credit carryover balances of $160 million.

Broadening the credit limitation for corporate taxpayers that operate in multiple EZs for taxable years beginning on or after January 1, 2007, is assumed to increase credit usage by 10%. For taxable year ending 2007, current law credit usage is projected at $240 million. Sixty-two percent or $149 million ($240 million x 62%) represents the portion that would be used by corporate taxpayers that operate in multiple EZs. A 10% increase in usage by this group would result in $15 million ($149 million x 10%). This impact is reduced by 30% to $10 million to reflect only calendar year filers. The 2008 revenue loss of $17 million represents the first year that impacts both calendar and fiscal year filers.

Personal Income Tax Impact:

For taxable year 2003, approximately 4,000 personal income taxpayers used $80 million in EZ credits. Although the percentage of personal income taxpayers that operate in multiple EZs is unknown, the percentage is expected to resemble the proportion of S-corporations that operate in multiple EZs.

Broadening the credit limitation for personal income taxpayers that operate in multiple EZs for taxable years beginning on or after January 1, 2007, is anticipated to increase credit usage by 10%. For taxable year 2007, current law personal income tax credit usage is projected at $100 million. Of this amount, 17% or $17 million ($100 million x 17%) represents the portion that would be used by personal income taxpayers who operate in multiple EZs. A 10% increase in usage by this group would result in revenue losses of approximately $2 million ($17 million x 10%).

Combined Corporate and Personal Income Tax Revenue:

The combined revenue loss for taxable year 2007 is estimated to total $12 million ($10 million corporate + $2 million personal income tax). This amount represents an increase in the amount of credits applied in the current year. This increase is offset (starting in 2008) by the credits that, absent this bill, would have been used in subsequent years. That is, in 2008, additional credits used of $17 million for corporations plus $2 million for personal income taxpayers is offset (reduced) by $5 million to reflect credits applied in 2007 that would have otherwise been applied in 2008. The revenue presented in the chart above represents the cash flow fiscal year impact.

LEGISLATIVE STAFF CONTACT

Nicole Kwon
Franchise Tax Board
845-7800
haeyoung.kwon@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
brian.putler@ftb.ca.gov