Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Karnette	Analyst:	Anne Mazur	Bill Number:	AB 2731
Related Bills:	See Legislative History	Telephone:	845-5404	Amended Date:	August 24, 2006
		Attorney:	Patrick Kusiak	Sponsor:	City of Long Beach

SUBJECT:	C-17 Globemaster III, Joint Cargo Aircraft, Or KC-X Tanker Wage Credit/Property Credit

SUMMARY

This bill would establish both a wage credit and property credit related to specified military aircraft.

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

SUMMARY OF AMENDMENTS

The August 24, 2006, amendments made the following changes to the bill:

- Deleted provisions that would change provisions of the Welfare and Institutions Code.
- Added provisions that would establish specified franchise and income tax credits.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to attract additional major aircraft manufacturing to California, specifically, the next generation U.S. Air Force air refueling tanker and to retain production of the C-17.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment. The bill specifies that both the wage credit and property credit would apply to taxable years beginning on or after January 1, 2007, and before January 1, 2017.

POSITION

Pending.

Board Position:			Department Director	Date
______ S	______ NA	______ NP	Lynette Iwafuchi	9/5/06
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ANALYSIS

BACKGROUND

Boeing Company is the principal manufacturer of the C-17 military cargo aircraft and has been building this aircraft in California for over ten years. Boeing recently announced that it is directing C-17 program suppliers to stop work on uncommitted airplanes due to lack of U.S. government orders. Existing orders will sustain production through mid-2009. In an August 18, 2006, press release, Boeing states that this move with be the first step in an orderly shut down of the C-17 production supply chain if no additional orders are received. Boeing states that this action will affect the 5,500 Boeing jobs in California, Missouri, Georgia, and Arizona, as well as the C-17 program's nationwide supplier workforce that totals more than 25,000 people.

If funded in federal fiscal year 2007[1], the U.S. Air Force intended to award a contract for its multibillion-dollar KC-135 refueling tanker replacement effort—known as the KC-X program—in late 2007. However, an August 22, 2006, Inside the Air Force article[2], noted that service officials indicated the program would be delayed to fiscal year 2008 in the "hotly contested KC-X competition" if Congress fails to approve funds for program research and development. The article further indicates that Boeing and a Northrop Grumman-European Aeronautic Defense and Space Company team (Northrop-EADS) are the only competitors to date. The latter has indicated that if awarded the contract, the companies plan to build a large assembly plant and employ 2,000 workers in Alabama. Boeing apparently indicated that it would build the tanker in Long Beach. A City of Long Beach study suggests the project would bring 3,500 new jobs to California, including 2,000 new Boeing workers.

In March 2006, U.S. Army and Air Force officials announced that a new Joint Cargo Aircraft, designed to enhance the combat readiness of both services, would be developed by a combined team. It is unclear when the contract would be awarded, but delivery of the new aircraft is apparently expected in 2010.

STATE LAW

Existing state law allows taxpayers to use various credits to offset their tax liability, such as the former manufacturers' investment credit, economic development area sales or use tax credits, and hiring credits.

Existing state law also provides for wage and property credits in connection with the Joint Strike Fighter (JSF) program. JSF credits were structured to make the bid of a California bidder more competitive for that massive aircraft contract for all U.S. military services and certain foreign countries. The credits were adopted while the JSF program was in development. For taxable years beginning on or after January 1, 2001, and before January 1, 2006, taxpayers can use credits against franchise and income tax for costs incurred in connection with the military aircraft known as the JSF. There are two separate credits in that program, one for qualified wages and the other for costs of qualified property. The credits are available under both the personal income tax law (PITL) and corporation tax law (CTL). The JSF wage and property credit provisions are repealed as of December 1, 2006.

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[1] The federal fiscal year ends on September 30.
[2] Inside the Air Force, "USAF will place tanker program 'on pause' without new R&D dollars," John T. Bennett.

THIS BILL

The credits proposed in this bill appear to be modeled on the Joint Strike Fighter wage and property credits that are scheduled to expire in 2006. For purposes of this analysis, the credits proposed in this bill will be referred to as the C-17 Wage Credit and the C-17 Property Credit.

C-17 Wage Credit

This bill would permit a franchise or income tax credit to qualified taxpayers for qualified wages paid or incurred during taxable years beginning on or after January 1, 2007, and before January 1, 2017. The credit amount would be equal to a different percentage—ranging from 50% to 20%—of qualified wages depending on the taxable year in which the qualified wages were paid[3], but could not exceed $10,000 per year, per qualified employee. “Qualified taxpayers” would include any taxpayer under an initial contract or subcontract to manufacture property for ultimate use in a C-17 Globemaster III, a Joint Cargo Aircraft, or a KC-X Tanker. “Qualified wages” would include wages paid or incurred for services performed in California that are at least 90% directly related to the contract or subcontract for the specified aircraft. Such wages must also be considered direct costs, as defined, allocable to property manufactured in California for ultimate use in the specified aircraft.

The bill would describe the specified aircraft as “the military transport aircraft developed and produced under the C-17 Globemaster III program, the next generation Joint Cargo Aircraft program, or the next generation aerial refueling aircraft known as the KC-X Tanker program by the Boeing Company at the City of Long Beach.”

The credit would not be allowed unless the credit amount was reflected in, and resulted in a reduction of, any bid upon which a contract is based. The bill would require related information to be made available to the FTB upon request.

A taxpayer would be permitted to carry over any excess credit for 8 years. The credit provisions would be established under both PITL and CTL and would be repealed on December 1, 2017.

C-17 Property Credit

This bill would permit a franchise or income tax credit to qualified taxpayers in the amount of 10% of the qualified cost of qualified property placed in service in California generally during taxable years beginning on or after January 1, 2007, and before January 1, 2017.

“Qualified costs” must satisfy the following conditions:

- Costs incurred by the qualified taxpayer must be for the construction, reconstruction, or acquisition of qualified property within the dates indicated in the previous paragraph. Special allocation rules would apply for contracts in existence on or before January 1, 2007.
- Except as otherwise provided, the qualified taxpayer must pay sales or use tax on the property.
- The costs must be properly chargeable to the capital account of the qualified taxpayer.

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[3] The following percentages apply: 50% for wages paid in taxable year 2007, 40% for taxable year 2008, 30% for taxable year 2009, and 20% for taxable years 2010 through 2016.

"Qualified taxpayers" would include any taxpayer under an initial contract or subcontract to manufacture property for ultimate use in a C-17 Globemaster III, a Joint Cargo Aircraft, or a KC-X Tanker.

"Qualified property" would mean property that is described as either: (1) tangible personal property (TPP) defined in Internal Revenue Code (IRC) Section 1245(a)(3)(A) for use primarily in qualified activities to manufacture a product for ultimate use in the specified aircraft, or (2) the value of capitalized labor costs that are direct costs as defined in IRC Section 263A allocable to the construction or modification of the previously described TPP. Special rules would apply with respect to qualified property that is acquired by or subject to lease by the qualified taxpayer.

The bill would describe the specified aircraft as "the military transport aircraft developed and produced under the C-17 Globemaster III program, the next generation Joint Cargo Aircraft program, or the next generation aerial refueling aircraft known as the KC-X Tanker program by the Boeing Company at the City of Long Beach."

The credit would be disallowed if the qualified property is removed from California, is disposed of to an unrelated party, or is used for an ineligible purpose within one year of the date the property is first placed in service. Any previously allowed credits would be required to be recaptured.

The credit would not be allowed unless the credit amount was reflected in, and resulted in a reduction of, any bid upon which a contract is based. The bill would require related information to be made available to the FTB upon request.

No credit would be allowed if the now expired manufacturers' investment credit was claimed in connection with the same property.

A taxpayer would be permitted to carry over any excess credit for 8 years. The credit provisions would be established under both the PITL and CTL and would be repealed on December 1, 2017.

The bill would permit FTB to adopt implementing regulations.

IMPLEMENTATION CONSIDERATIONS

Because this bill appears to be modeled on the existing JSF wage and property credits—set to expire at the end of 2006—issues that have arisen in the implementation and administration of those credits would arise for the credits proposed by this bill as well. FTB issued extensive regulations[4] to facilitate compliance with and administration of the JSF credits.

Significant implementation concerns relate to contract issues. Department staff is available to assist the author in resolving any of the following concerns.

- The bill refers to an "initial" contract or subcontract and would require that the credit be reflected in the bid process; however, the bill would also, with respect to the property credit, provide special allocation rules for contracts already in existence before January 1, 2007. Presumably,

[4] California Code of Regulations 17053.36-0 - 9, 17053.37-0 - 11, 23636-0 – 9, 23637-0 – 11.

pre-existing contracts would not reflect the credit and therefore would be ineligible for the credit. The credit would not be allowed unless the credit amount was reflected in, and resulted in a reduction of, any bid upon which a contract is based. Therefore, it appears taxpayers would be able to claim the credit for wages or property only when new contracts that reduce the bid amount by the amount of the credit have been executed. However, if the new contract constitutes a "successor contract" that contains substantially the same subject matter as the old contract, it is treated as binding on January 1, 2007, and would not be eligible for the credits.

- The bill refers to an "initial" contract or subcontract. It is unclear whether an "initial contract" would include modifications to that contract. The nature of federal contracting may make it difficult and impractical to amend existing contracts to take advantage of this credit.
- Implementation issues would arise from using the JSF credit language, such as the term "initial contract or subcontract," for the credits proposed in this bill because the JSF credits were designed to increase the competitiveness of a California bidder to obtain a federal contract for a new aircraft. The "successor or replacement contract" rules would preclude credits from being applied to expenses incurred or property investments in manufacturing aircraft under long-standing contracts.
- The bill would describe the aircraft programs as those developed and produced by the Boeing Company of the City of Long Beach, which implies that only Boeing would be eligible for the credits. However, the bill also refers to subcontractors. The author may wish to clarify the taxpayers that would be eligible for the credits.
- While the bill would require the credits to be reflected in a bid, it does not indicate whether the bid must also include a statement showing how the credits were computed. For purposes of examining the credit, the author may want to consider specifying some minimum level of detail to be included in the bid with respect to computation of the credits.

TECHNICAL CONSIDERATIONS

On page 7 and page 16 of the bill, Sections 17053.39(e)(4) and 23639(e)(4), respectively, the term "Joint Strike Fighter" is referenced. It appears this reference is unintentional and instead should reference the C-17 Globemaster III, a Joint Cargo Aircraft, or a KC-X Tanker.

LEGISLATIVE HISTORY

AB 2790 (Stats. 1998, Ch. 322) established the Joint Strike Fighter wage credit and qualified property credit similar to the credits proposed in this bill. The JSF credits expire for taxable years beginning on or after January 1, 2006, and related statutes are repealed December 1, 2006.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

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

Estimated Revenue Impact of AB 2731 Effective for Tax Years BOA January 1, 2007 Assumed Immediate Enactment ($ in Millions)		
2007/2008	2008/2009	2009/2010
– $10	– $20	– $25

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

Revenue Discussion

Because these credits may only be claimed if the credit is reflected in a contractor's or subcontractor's bid, they cannot be claimed for any projects already in progress. It is expected that the next major contract to be awarded for qualifying aircraft will be a $20 billion contract for new refueling tankers. This estimate assumes that spending on this contract will begin in the second half of 2007. The estimate further assumes that this contract will be awarded to a contractor that plans to perform significant amounts of work in California. If either of these assumptions proves incorrect, revenue losses could be substantially lower than shown above.

According to information provided by the City of Long Beach, this credit may apply to aircraft programs that will generate 3,500 California jobs for contractors and subcontractors once the program is fully phased-in. This information also suggests that average annual wages for these employees will be about $55,000. The wage credit is limited to the lesser of $10,000 per employee or a percentage of wages paid or incurred per tax year: 50% for 2007, 40% for 2008, 30% for 2009, and 20% for 2010-2016. For most employees, employers will be limited to the $10,000 credit limit. Once the new contracts are fully implemented total wage credits are estimated to be approximately $25 million. This estimate includes full-year employees as well as employees who work on a qualified project less than a full year.

It is assumed that a contract's creditable investment expenses are equivalent to half the value of creditable wages. Total wages for taxable year 2009 are estimated to be $200 million (3,500 jobs x $55,000 per job). The investment credit is equal to 10% of qualified cost, for property placed in service in California. Thus, the investment credit would be about $10 million per year. ($200m / 2 x 10%).

This estimate assumes that the new contracts will be fully phased-in by taxable year 2009, and total credits generated will total $35 million. ($25m wages + $10m investment.) The estimate for taxable year 2009 is used to determine the impact of the start-up period (2007 and 2008). Of the 2009 credit estimate, it is assumed that generated credits for taxable year 2007 and 2008 will total 25% and 80% respectively. This estimate assumes that in the project start-up phase a larger portion of contract expenses is devoted to investment; therefore, creditable investments were increased 50% for 2007 and 2008.

Based on these assumptions, it is estimated that total credits generated will be $10 million in taxable year 2007, $33 million in 2008, and $36 million in 2009. For each year that credits are generated, it is assumed that only 70% will be claimed and applied over a four-year period: $7 million for 2007, $23 million for 2008, and $25 million for 2009. The revenue estimate in the chart above is rounded to the nearest $5 million and adjusted to reflect fiscal years.

POLICY CONCERNS

- The JSF program was massive because all U.S. military departments and many foreign countries use fighter aircraft. The JSF credits were enacted in anticipation of that program prior to the inception of the bid process, allowing for the bids to reflect and be reduced by anticipated credits. The C-17 credits would extend the identical scheme to the manufacture of existing aircraft and an as yet unarticulated future program for the next generation of cargo and tanker aircraft for the Air Force. It is unclear how taxpayers under existing C-17 contracts could take advantage of the credits.

- There was a three-year lag between the time the JSF credit provisions were enacted and the first year the credits were available, but due to the timing of the federal contract award, taxpayers were unable to claim the credits until long after the first year the credit was available. A similar, if not more problematic, situation would occur for the credits proposed by this bill. The credits are available for expenses incurred or property invested starting in 2007; however, the contracts may not be awarded until much later than 2007 when the high percentages allowed in the early years of the wage credit would no longer be available. An alternative would be to provide that the percentages would apply beginning in the first year a taxpayer is awarded a contract, with subsequent reductions in the percentage as provided in this proposal.

- Under current law, aircraft manufacturers located in the Long Beach Enterprise are eligible to receive hiring credits at a rate that is higher—for wages up to 202% of the minimum versus 150%—than is available to taxpayers conducting activities in other enterprise zones.

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