ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Dutton | Analyst: Norman Catelli | Bill Number: SB 631

Related Bills: See Legislative History | Telephone: 845-5117 | Introduced Date: February 22, 2005

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Manufacturers Investment Credit/Real Investment in California's Economy Program

SUMMARY

This bill, to be known as the *Real Investment in California's Economy Program*, would:

- Reinstate indefinitely the Manufacturers' Investment Credit (MIC),
- Extend the MIC to activities related to electric services (power generation, transmission, or distribution), and
- Extend the MIC to activities related to providing broadband services or leasing equipment to a broadband services provider.

This analysis addresses only those provisions of the bill affecting 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

FEDERAL/STATE LAW

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 the previous MIC.

Board Position:			Department Director	Date
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Previous state law allowed qualified taxpayers a credit 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.

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 that is 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;
- The 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 are 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.

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 reinstate the previous MIC for taxable years beginning on or after January 1, 2006.

This bill also would extend the previous MIC to those activities related to electric services (power generation, transmission, or distribution) described in SIC Manual Code 4911. This bill also adds taxpayers engaged in activities related to electric services to the list of taxpayers eligible to claim the MIC for special purpose buildings and foundations.

In addition, this bill would extend the previous MIC to persons providing broadband services or leasing equipment to a broadband services provider and adds property capable of providing broadband services to the definition of qualified property.

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 uses terms that are undefined, for example, “broadband service provider” and “personal property capable of providing broadband services.” The absence of definitions to clarify these terms could lead to disputes between taxpayers and the department and would complicate the administration of this credit.

The definition of “qualified taxpayer” includes subsidiaries, affiliates, partners, or coventurers of a taxpayer that provides broadband services. Generally, a credit is only allowed to the taxpayer that earned the credit. If the author’s intent is to allow the credit to be assigned to these persons, this bill would be difficult for FTB to implement. An example of the kind of issue that needs to be addressed is the responsibility between the assignor and assignee with respect to a credit that is partially or completely disallowed in a subsequent audit by FTB. In addition, if the assignor or assignee has signed a waiver of the statute of limitations during an audit, it may also be necessary for the other party to sign a waiver. In the course of auditing one party, it may become necessary to disclose tax information about the other party.

TECHNICAL CONSIDERATIONS

On page 24, line 14, the date reads “January 1, 200**5**.” The correct date should be “January 1, 200**6**.”

LEGISLATIVE HISTORY

AB 1998 (Dutton, 2003-2004) would have reinstated the MIC and expanded it to include electric services. AB 1998 was held in the Assembly Revenue and Taxation Committee.

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 identifying 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, used by a taxpayer primarily engaged in manufacturing, retailing, coal mining, or fluorite mining, provided the taxpayer’s base employment in Illinois has increased by 1% over the prior year.

Massachusetts provides a 3% credit based on the cost of qualified property used for manufacturing, farming, fishing, or research and development.

Michigan provides a certified, graduated investment tax credit based on adjusted gross receipts of a firm. The credit is a percentage (0.85% to 2.3%) of the net costs of qualifying tangible, depreciable assets located in Michigan.

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

If this bill were amended to resolve these implementation considerations, implementing this bill would be accomplished during the normal annual update.

ECONOMIC IMPACT

Revenue Estimate

Based on the assumptions and data discussed below, the revenue loss from this bill is as follows:

Estimated Revenue Impact for SB 631 Operative for Taxable Years Beginning on or After January 1, 2006 Assumed Enactment After June 30, 2005 (In Millions)		
2005-06	2006-07	2007-08
-$110	-$340	-$435

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

Revenue Discussion

For purposes of this estimate, it is assumed that qualifying taxpayers that provide broadband services would be those taxpayers engaged in the line of business described in Codes 5181 to 518112 (Internet Service Providers and Web Search Portals) inclusive, of the North American Industry Classification System (NAICS), 2002 edition.

In addition, this revenue estimate assumes that this credit would not be assignable to other taxpayers.

The revenue effect of the MIC credit is generally determined by the following formula:

"Qualified costs" incurred in "qualifying activities" by a "qualified taxpayer" multiplied by 6% equals the gross amount of the MIC credit earned.

The amount of MIC credit allowed to reduce tax liability is limited by the amount of alternative minimum tax, if any, for the year. Other tax rules require a carryover credit to be applied to the limitation amount until exhausted. The newly earned credit may be applied to any remaining tax liability balance. The amount of the newly earned credit actually applied to tax liability is the revenue impact. Any credit not applied to the current year tax liability is a carryover to the next year.

This bill would reinstate the MIC and expand the credit to taxpayers engaged in activities described in SIC Code 4911 and taxpayers that provide broadband services or leases equipment to a broadband services provider. The revenue effect of this bill was determined by applying the above methodology to a forecast of qualifying costs, qualifying activities, and qualified taxpayers. This forecast was based on available U.S. Census information identifying capital expenditures by qualifying businesses and actual departmental data regarding the previous MIC credit.

This estimate is based on a micro simulation model of California tax returns for taxable year 2002. These numbers were grown to approximate 2003 and beyond. The above estimate represents only that portion of applied credits with respect to newly generated credits pursuant to this bill. Prior year carryover credits will continue to be applied as allowed by prior law. Therefore, any revenue loss would be as a result of newly generated credits. The fiscal year cash flow patterns are based on the department's analysis of how manufacturers adjusted their tax payments to reflect the reduction in liability resulting from the previous MIC.

LEGAL IMPACT

This bill contains provisions that would target certain manufacturing 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. Ohio is seeking review by the U.S. Supreme Court. 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.

POLICY CONCERNS

This bill would expand the activity test for qualified property to include electric services. As a result, taxpayers that qualify for the MIC under SIC Codes other than 4911 could claim the MIC for existing auxiliary activities. For example, a manufacturing plant that includes on its premises a co-generation facility that produces electricity to run the manufacturing line would qualify for the MIC under the revised activity test. Under previous law, while this co-generation facility may be assigned the same SIC Code as the manufacturing activity it supports, the costs of the property in the co-generation facility would not qualify for the MIC since the property is not used in a qualified activity.

This bill does not contain a sunset date. Sunset dates generally are provided in tax incentive bills, such as credits and special deductions, to allow periodic review by the Legislature.

The NAICS is a unique, new system for classifying business establishments. Adopted in 1997 to replace the old SIC system, it is the industry classification system used by the statistical agencies of the U.S., Canada, and Mexico. Since the SIC system is no longer being used or updated, newer business establishments are not being included in this incentive proposal and available statistical information is becoming obsolete. This obsolescence makes it difficult to use external information for analytical purposes, e.g., revenue forecasting.

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