Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Alarcon/Arambula	Analyst:	Angela Raygoza	Bill Number:	AB 1651
Related Bills:	None	Telephone:	845-7814	Introduced Date:	February 23, 2007
		Attorney:	Douglas Powers	Sponsor:	

SUBJECT: Qualified Green Machinery Credit

SUMMARY

This bill would provide a tax credit for certain qualified businesses that purchase or upgrade qualified environmental machinery.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to encourage businesses that are located in an Enterprise Zone (EZ) to reduce waste and protect the environment by purchasing or upgrading to environmentally safe equipment and to encourage those businesses that already use such environmentally safe equipment to relocate to an EZ.

EFFECTIVE/OPERATIVE DATE

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

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

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.

Under current state law, a taxpayer engaged in a trade or business within a designated EZ can take a credit for sales or use tax paid or incurred in connection with the purchase of qualified property.

Board Position:			Department Director	Date
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Qualified property must be used exclusively in the EZ and is defined as machinery and machinery parts used for:

- Fabricating, processing, assembling, and manufacturing;
- Production of renewable energy resources;
- Air pollution control mechanisms; or
- Water pollution control mechanisms.

For taxable years beginning on or after January 1, 1998, qualified property also includes:

- Data processing and communications equipment, such as computers, computer-automated drafting systems, copy machines, telephone systems, and fax machines; or
- Motion picture manufacturing equipment central to production and post-production, such as cameras, audio recorders, and digital image and sound processing equipment.

Any taxpayer that elects to claim the sales or use tax credit shall not increase the basis of the qualified property by the amount of the sales or use tax paid or incurred.

The portion of the credit that exceeds the tax liability for the taxable year may be carried over until it is exhausted.

<u>THIS BILL</u>

For taxable years beginning on or after January 1, 2007, this bill would provide a credit, in an amount equal to the amount paid or incurred during the taxable year by a “qualified green business,” for purchasing or upgrading “qualified green machinery.”

The bill would define the following terms:

- “Qualified green business” means a person or entity that meets both of the following criteria:
    1) Has never been fined for an environmental impropriety, and
    2) Is engaged in the conduct of a trade or business within an EZ designated pursuant to Chapter 12.8 of Division 7 of Title 1 of the Government Code.
- “Qualified green machinery” means manufacturing machinery that, as purchased or upgraded, meets all of the following criteria:
    1) Is more fuel efficient than the industry average for the machinery,
    2) Releases less carbon dioxide than the industry average for the machinery, and
    3) Does not release ozone depleting substances.

This bill specifies that no deduction would be allowed for the same expenses for which the credit was allowed.

This bill would allow any unused credit to be carried over until exhausted.

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 the terms "qualified green business" and "qualified green machinery" as requirements that must be met in order to qualify for this credit. The department lacks the expertise to determine whether a business or the machinery involved would meet these criteria. Typically, credits involving areas for which the department lacks expertise are certified by another agency or agencies that possess the relevant expertise. The author may wish to amend the language to specify an entity that would be responsible for certifying that the taxpayer meets the requirements provided for in this bill.

This bill would require that the "qualified green business" be located within an EZ, but is silent on any limits about where the "qualified green machinery" must be used. As a result, an entity located within an EZ may upgrade machinery used outside of the EZ and receive the credit under this bill. If it is the author's intent that the machinery be used only within the EZ to qualify for the credit, it is recommended that limiting language be added to the bill requiring the machinery to be placed in service and used exclusively within the EZ along with a recapture provision for failure to meet the requirement. In addition, it is suggested that the taxpayer be required to provide to FTB upon request substantiation that the property was placed in service in an EZ.

This bill allows the credit in the taxable year in which the equipment is purchased, which may be earlier than the taxable year in which the equipment is actually placed in service (i.e., used) in California. Most credits involving the acquisition and subsequent use of an item of property allow the credit to be claimed in the taxable year of the placed in service date. It is possible that a taxpayer could purchase equipment, claim the credit, and resell the equipment to a third party that may also claim the credit. Adding requirements that the equipment be placed in service in the EZ with an appropriate recapture provision to ensure continued operation in the EZ for a specified recapture period would avoid this scenario.

This bill uses terms that are undefined: "impropriety" and "manufacturing." The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this credit.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. These states have no credit comparable to the credit this bill would allow.

FISCAL IMPACT

The department's costs to administer this bill will be determined once the implementation considerations addressed above have been resolved, but are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue losses:

Estimated Revenue Impact of AB 1651 As Introduced 2/23/07 ($ in Millions)		
2007-08	2008-09	2009-10
-$26	-$142	-$262

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

Revenue Discussion

The revenue impact of this bill is determined by amounts that would be expended by qualified green businesses for purchasing or upgrading qualified green machinery and the amount of credits that can be applied to reduce tax liabilities.

According to departmental data for the 2004 taxable year, the amount of EZ sales or use tax credits applied by taxpayers in industries covered by this bill was $22.1 million. Dividing the credit amount of $22.1 million by the 6% sales or use tax credit rate derives a level of investment of $368 million ($22.1 million ÷ 6% = $368 million). The estimated level of investment for 2004 has grown to years 2007 through 2010 by the projected growth in corporate profits as forecasted by the Department of Finance. At the 2007 level, the level of investment is estimated at $411 million.

It is assumed that two-thirds of this investment would be for qualified green machinery as defined in the bill and used exclusively in an EZ (2/3 x $411 million = $274 million). As the bill does not specify that qualified green machinery be used in an EZ (only that the taxpayer must have some presence in an EZ), the level of investment is doubled to reflect the total amount expended for qualified green machinery, or $548 million in 2007. It is also assumed that three-quarters of businesses investing in qualified green machinery are qualified green businesses as defined in the bill (3/4 x $548 million = $411 million).

The credit is for total costs expended, or 100%. A credit of 100% is anticipated to promote a substantial increase in the level of investment in qualified green machinery. In the year of enactment, 2007, the level of investment would increase 5%, increasing to 30% in 2008 and each year thereafter. In the first year, the increase in investment is calculated to be $432 million. ($411 million x 105% = $432 million).

It is assumed that one-third of credits generated would be applied to reduce tax liabilities in the year generated, resulting in a revenue loss of $142 million in the 2007 taxable year. ($432 million x 33% = $142 million).

Taxable year estimates have been converted to cash flow fiscal year estimates.

POLICY CONCERNS

Generally, credits are provided as a percentage of amounts paid or incurred. This bill would allow a 100% credit, which is unprecedented.

This bill lacks a sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of the credit by the Legislature.

LEGISLATIVE STAFF CONTACT

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