Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Arambula	Analyst:	Nicole Kwon	Bill Number:	AB 1651
Related Bills:	See Legislative History	Telephone:	845-7800	Amended Date:	May 10, 2007
		Attorney:	Douglas Powers	Sponsor:	

SUBJECT: Qualified Capital Greenhouse Gas Emissions Reduction Equipment Credit

SUMMARY

This bill would create a tax credit for qualified capital equipment used to reduce greenhouse gas emissions.

SUMMARY OF AMENDMENTS

The May 10, 2007, amendments eliminated provisions creating a tax credit for certain qualified businesses that purchase or upgrade qualified environmental machinery and added provisions creating a tax credit for qualified capital equipment used to reduce greenhouse gas emissions.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to encourage and give incentives to businesses to purchase new equipment resulting in lower greenhouse gas emissions.

EFFECTIVE/OPERATIVE DATE

As a tax levy this bill would be effective immediately upon enactment, but expressly operative for taxable years beginning on or after January 1, 2008, and before January 1, 2013.

POSITION

Pending.

SUMMARY OF SUGGESTED AMENDMENTS

Technical amendments are necessary and are provided. Department personnel are available to work with the author to resolve any other issues that arise as the bill moves through the legislative process.

Board Position:			Department Director	Date
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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.

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, 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) and used in a qualified SIC Code activity, that is used primarily for:
    - manufacturing, processing, refining, fabricating, or recycling of property;
    - research and development;
    - 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 the number of manufacturing sector jobs in California no longer meeting the MIC statutory requirements.

THIS BILL

This bill would provide credits for each taxable year beginning on or after January 1, 2008, and before January 1, 2013, based on the following percentages for amounts paid or incurred for qualified capital equipment under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL):

- 15% of the amount paid or incurred for qualified capital equipment for taxable years beginning on or after January 1, 2008, and before January 1, 2010.
- 8% of the amount paid or incurred for qualified capital equipment for taxable years beginning on or after January 1, 2010, and before January 1, 2012.
- 3% of the amount paid or incurred for qualified capital equipment for taxable years beginning on or after January 1, 2012, and before January 1, 2013.

This bill would define "qualified capital equipment" to meet all of the following:

1. Tangible personal property as defined in IRC section 1245(a)(3)(A) and is for use by a qualified taxpayer in a qualified activity.
2. Newly constructed or fabricated.
3. Used exclusively in California by the taxpayer.
4. Certified by the California Climate Action Registry or the State Air Resources Board that it has been properly installed in a qualified facility and is operational.
5. Certified by the California Climate Action Registry or the State Air Resources Board that its operation will result in measurable reductions in greenhouse gas emissions.
6. Produces an eligible greenhouse gas reduction.
7. The original use of the equipment commences with the taxpayer.

This bill would define "qualified cost" to mean any cost that meets all of the following:

1. A cost paid or incurred by the taxpayer for the construction or purchase, including installation costs of qualified capital equipment on or after January 1, 2008, and before January 1, 2013.
2. Any amount upon which the taxpayer has paid, directly or indirectly as a separately stated contract amount or as determined from the records of the taxpayer, California sales or use tax.
3. An amount properly charged to the capital account of the taxpayer.

This bill would define the following terms:

- "Capitalized labor cost" means costs for labor directly allocable to the construction or installation of qualified capital property that is properly charged to the capital account of the taxpayer.
- "Eligible greenhouse gas reduction" means a measurable reduction in the greenhouse gas emissions of the facility in which the qualified equipment is placed in service and maintained, beyond the requirement of the law.
- "Greenhouse gas emission" has the same meaning as defined in the Health and Safety Code, section 38505(g).
- "Purchase" means any transaction that is treated as a sale for sales and use tax purposes.

This bill would provide a carryover provision for unused credits for eight years.

This bill would provide a repeal date of December 1, 2013.

<u>IMPLEMENTATION CONSIDERATIONS</u>

On page 3, line 10 and page 5, line 10, "beyond those required by law" should be added after "greenhouse emissions" in order for the department to verify and rely on the certification issued by the California Climate Action Registry or the State Air Resources Board that the operation of qualified capital equipment resulted in measurable reductions in greenhouse gas emissions.

<u>TECHNICAL CONSIDERATIONS</u>

The attached amendments are provided to address the grammatical errors in the bill.

LEGISLATIVE HISTORY

AB 1285 (Parra, 2007/2008) would allow a taxpayer a qualified research expense credit for an amount paid or incurred to develop technologies to reduce greenhouse gas emissions. AB 1285 is currently in the Assembly Revenue & Taxation Committee.

AB 811 (Levine, 2007/2008) would authorize a credit for amounts paid or incurred for the construction of an eligible renewable resource. AB 811 is currently in the Assembly Revenue & Taxation Committee.

AB 2924 (Arambula, 2005/2006) would have allowed three new credits for certain capital expenditures and also would have permitted accelerated depreciation of the expenditures. AB 2924 was held in the Assembly Revenue & Taxation Committee.

AB 2553 (Arambula, 2005/2006) would have allowed a credit for amounts paid for qualified capital expenditures and allow a taxpayer to depreciate those qualified capital expenditures over three years. AB 2553 was held in the Senate Appropriations Committee.

AB 2595 (Arambula, 2005/2006) would have allowed a taxpayer to depreciate qualified manufacturing equipment. AB 2595 was vetoed by Governor Schwarzenegger.

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 income or franchise tax benefits related to manufacturing equipment.

Illinois provided a replacement tax investment credit equal to 0.5% of the basis of qualified property placed in service during the tax year (from July 1, 1984 to January 1, 2004) used by a taxpayer primarily engaged in manufacturing, retailing, coal mining, or fluorite mining.

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

Michigan provided a credit (from December 31, 2004 and before January 1, 2006) of up to 2% to taxpayers with gross receipts of $10 million or less for newly created high-technology activities or manufacturing jobs.

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

This bill would not significantly impact the department's costs

ECONOMIC IMPACT

<u>Revenue Estimate</u>**:**

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

Estimated Revenue Impact of AB1651 As Amended 5/10/07 ($ in Millions)		
2007-08	2008-09	2009-10
-$15	-$70	-$105

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

<u>Revenue Discussion</u>

The revenue impact of the bill would be determined by the amount of qualified costs in excess of standard costs for qualified capital equipment and the amount of credits that qualified taxpayers can apply to reduce tax liabilities.
According to the Annual Survey of Manufacturers, California businesses spent $11.2 billion on new and used machinery and equipment in 2005. The $11.2 billion includes capitalized labor costs related to construction or installation of machinery and equipment. This level of investment for 2005 is grown to years 2008 through 2010 by the projected growth in corporate profits as forecasted by the Department of Finance. At the 2008 level, the investment is estimated at $13.6 billion of which 96% is new machinery and equipment, or $13.1 billion.

For purposes of an estimate, it is assumed that one-quarter of the $13.1 billion is for qualified capital equipment as specified in the bill, or $3.3 billion ($13.1 billion x 1/4 = $3.3 billion). A qualified taxpayer is an individual or entity that reports greenhouse gas emissions on a voluntary or mandatory basis. At present, all reporting is on a voluntary basis. It is assumed that one-third of qualified capital equipment would be eligible for the credit in 2008, or $1.1 billion ($3.3 billion x 1/3 = $1.1 billion).

The credit is limited to an amount in excess of “standard costs” for equipment required to meet existing law or regulations. The State Air Resources Board has indicated that “standard costs” are unlikely to be established before 2010. Therefore, estimates assume that excess of standard costs is 100% of qualified costs until “standard costs” are actually developed.

For 2008, applying the applicable credit percentage of 15% to $1.1 billion results in credits generated of $165 million ($1.1 billion x 15% = $165 million). It is assumed only half of credits generated would be applied in the year generated, or about $80 million ($165 million x 50%) for the 2008 taxable year. Carryover credits are assumed applied ratably over the succeeding five years. Taxable year estimates are converted to cash flow fiscal year estimates.

LEGAL IMPACT

This bill would require taxpayers to place in service the qualified properties in the state to qualify for the credit. This requirement may be subject to constitutional challenge under the Commerce Clause of the United States Constitution.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 1651
As Amended May 10, 2007

AMENDMENT 1

On page 2, line 4 and page 4, line 9, after "1, 2008," strikeout "ending."

AMENDMENT 2

On page 2, line 26 and page 4, line 31, replace "emission" with "emissions."

AMENDMENT 3

On page 3, line 10 and page 5, line 10, between "greenhouse" and "emissions", insert:

gas

AMENDMENT 4

On page 3, line 14 and page 5, line 14, replace "any costs" with "any cost."

AMENDMENT 5

On page 3, line 34 and page 5, line 34, between "existing" and "law," insert:

emissions

AMENDMENT 6

On page 3, line 35 and page 5, line 35, replace "a rule or regulation" with "rules or regulations."

AMENDMENT 7

On page 3, line 37 and page 5, line 37, between "existing" and "requirements," insert:

emissions