Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Battin	Analyst:	Nicole Kwon	Bill Number:	SB 1194
Related Bills:	See Legislative History	Telephone:	845-7800	Amended Date:	March 24, 2008
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Clean Technology Commerce Zone/Coachella Valley

SUMMARY

This bill would allow various credits and deductions for a new clean technology zone in the Coachella Valley.

SUMMARY OF AMENDMENTS

The March 24, 2008, amendments deleted the intent language to provide tax credits and added provisions to allow various credits and deductions for a zone in Coachella Valley.

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

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to provide a greater incentive and tax break to businesses related to developing or manufacturing clean energy technology to move into and stay in Coachella Valley.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment; each of the various new incentives would expressly be operative for taxable years beginning on or after January 1, 2009, and before January 1, 2014.

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.

Board Position:			Department Director	Date
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Under the Government Code, state law provides for several types of Geographically Targeted Economic Development Areas (G-TEDAs): Enterprise Zones (EZs), Manufacturing Enhancement Areas, Targeted Tax Areas, and Local Agency Military Base Recovery Areas (LAMBRAs).

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, the Department of Housing and Community Development (DHCD) designates EZs from the applications received from the governing bodies. EZs are designated for 15 years. At the end of expiration, a zone can reapply to be designated as an EZ. Current state law allows DHCD to backdate the effective date of the new zone to the date of the previous zone's expiration in order to cover the gap period between expiration and designation and thereby continue to allow the zone to market the tax incentives during the redesignation period.

Under the Revenue and Taxation Code (R&TC), existing state law provides special tax incentives for taxpayers conducting business activities within G-TEDAs. These incentives include a hiring credit, sales or use tax credit, business expense deduction, net interest deduction, and special net operating loss treatment.

For LAMBRAs, the availability of incentives require a net increase in jobs of one or more full time employees in the state; of that increase, one or more employees must work full time in the LAMBRA.

Hiring Credit: A business located in an EZ is eligible for a hiring credit equal to a percentage of wages paid to qualified employees. A qualified employee must be hired after the area is designated as an EZ and meet certain other criteria. At least 90% of the qualified employee’s work must be directly related to a trade or business located in the EZ, and at least 50% of the employee's services must be performed inside the EZ.

The credit is based on the lesser of the actual hourly wage paid or 150% of the current minimum hourly wage (under special circumstances for the Long Beach EZ, the maximum is 202% of the minimum wage). The amount of the credit must be reduced by any other federal or state jobs tax credits, and the taxpayer’s deduction for ordinary and necessary trade or business expenses must be reduced by the amount of the hiring credit.

Taxpayers operating in an EZ are allowed the hiring credit for employing “qualified employees.” “Qualified employees” for EZs are defined by reference to various state and federal public assistance programs. A taxpayer located in an EZ is allowed a credit of up to 50% of wages paid to “qualified employees” in the first year, decreasing by 10% each year thereafter. The taxpayer is required to obtain a voucher certificate for each of its “qualified employees.” The voucher certificates are issued by the Employment Development Department (EDD) or the local (within the same EZ as the workplace of the employee) agency familiar with the public assistance statutes.

Sales or Use Tax Credit: The sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified machinery purchased for exclusive use in an EZ. Currently, the credit is for the total cost of qualified property purchased and placed in service in any taxable year. The total costs of qualified property may be in an amount not to exceed $1 million under the Personal Income Tax Law and to $20 million under the Corporation Tax Law.

Net Interest Deduction: A deduction from income is allowed for the amount of net interest earned on loans made to a trade or business located in an EZ. Net interest is defined as the full amount of the interest less any direct expenses (e.g., commission paid) incurred in making the loan. The loan must be used solely for business activities within the EZ, and the lender may not have equity or other ownership interest in the EZ trade or business.

Business Expense Deduction: A business located in an EZ may elect to deduct as a business expense a specified amount of the cost of qualified property purchased for exclusive use in the EZ. The deduction is allowed in the taxable year in which the taxpayer places the qualified property in service. For EZs, the maximum deduction for all qualified property is the lesser of 40% of the cost or the following:

	The applicable … amount is:
Taxable year of designation	$100,000
1st taxable year thereafter	100,000
2nd taxable year thereafter	75,000
3rd taxable year thereafter	75,000
Each taxable year thereafter	50,000

Net Operating Loss (NOL): A business located in an EZ may carry over 100% of the EZ NOLs to deduct against EZ income in future years. The NOL carryover is determined by computing the business loss that results from business activity in the EZ. The carryover period for NOLs is 15 years.

For businesses operating inside and outside an EZ, the amount of credit or NOL deduction that may be claimed is limited by the amount of tax on income attributable to the EZ. Income is first apportioned to California using the same formula as that used by all businesses that operate inside and outside the state (property, payroll, and a double-weighted sales factor). This income is further apportioned to the EZ using a two-factor formula based on the property and payroll of the business.

THIS BILL

In the new Clean Technology Commerce Zone (CTCZ) within the Coachella Valley, this bill would create the following credits and deductions for taxable years beginning on or after January 1, 2009:

1. A sales or use tax credit for taxes paid or incurred on "qualified property" purchased by the taxpayer. This bill would specify the following:
    - The amount of the credit, including any credit carryover from prior years, would not exceed the amount of tax that would be imposed on the income attributable to business activities within the CTCZ.
    - "Qualified property" means any property that is used exclusively in the CTCZ.

- “Qualified taxpayer” means a person or entity engaged in a trade or business that primarily develops, manufactures, produces, distributes, installs, delivers, or in any other manner advances this state’s goals of renewable energy usage.
- In the case where a credit is allowed for qualified property under more than one section, the taxpayer is required to make an election as to which credit applies to the taxpayer, on the return filed for each year.
- Any election made by a taxpayer would be irrevocable except with the consent of the Franchise Tax Board.
- If the qualified property is disposed of or no longer used by the taxpayer in the CTCZ at any time before the close of the second taxable year after the property is placed in service, the amount of the credit previously claimed shall be added to the taxpayer’s tax liability in the taxable year of that disposition or nonuse.

2. A hiring credit for “qualified taxpayers” who hire qualified employees. This credit would be up to 50% of wages paid to “qualified employees” in the first year of employment, decreasing by 10% each year thereafter. This bill would specify the following:
   - “Qualified taxpayer” means a person or entity engaged in a trade or business that primarily develops, manufactures, produces, distributes, installs, delivers, or in any other manner advances this state’s goals of renewable energy usage.
   - “Qualified wages” mean the wages paid or incurred by the employer to qualified employees. In addition, qualified wages mean the portion of hourly wages not to exceed 150% of the current minimum hourly wage.
   - “Qualified years one through five wages” means, with respect to any individuals, qualified wages received during the 60-month period beginning with the day the individual commences employment within the CTCZ.
   - “Qualified employee” means an individual that meets both of the following:
     1. At least 90% of services are directly related to the conduct of the qualified taxpayer’s trade or business located in the CTCZ, and
     2. Performs at least 50% of his or her services for the qualified taxpayer during the taxable year in the CTCZ.

3. A net interest deduction for any lender that loans money to a “qualified taxpayer” in the CTCZ for purposes of advancing clean technology. The deduction would be an amount equal to the net interest earned on that loan during the taxable year.

4. A business expense deduction of 40% of the cost of all qualified property purchased to be used exclusively in a trade or business conducted within the CTCZ. This bill would specify the following:
   - “Taxpayer” means a taxpayer that conducts a trade or business within the CTCZ and, for the first two taxable years, has a net increase in jobs of one or more employees in the CTCZ.

5. An NOL to deduct against CTCZ income. The NOL carryover would be determined by computing the business loss that results from business activity in the CTCZ. The carryover period for NOLs would be 15 years.

This bill would provide a repeal date of December 1, 2014.

IMPLEMENTATION CONSIDERATIONS

The department has identified a number of implementation concerns relating to the use of extensive portions of existing incentive provisions in creating the new CTCZ under various sections of the R&TC. The department has been made aware of these from its experience in administering the existing incentive provisions for G-TEDAs. Unless these implementation concerns are addressed, enactment of this bill in its current form would hinder the department's ability to administer the provisions of this bill. In addition, 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.

The apportionment language in this bill starts with total income rather than California total income currently used in the G-TEDAs. In addition, payroll and property factors necessary to compute income in the CTCZ are not defined. The author may want to amend this bill to refer to the provisions in the current G-TEDAs in the R&TC.

This bill defines "qualified taxpayer" to mean a person or entity engaged in a trade or business that primarily develops, manufactures, produces, distributes, installs, delivers, or in any other manner advances this state's goals of renewable energy usage. This definition would allow taxpayers not located within the CTCZ to claim the credit. Under current EZ provisions, a taxpayer is required to engage in a trade or business within an EZ. The author may want to amend the language to mirror the current statute of EZ by requiring the qualified taxpayer to be located within the CTCZ.

For the net interest deduction, this bill does not require the qualified taxpayer to engage in the business in the CTCZ. This could be interpreted to include interest received from any taxpayer engaged to advance the state's renewable energy goals. In addition, the deduction appears to be based on when the loan is made rather than when the interest is paid. The author may want to amend the language to specify that the qualified taxpayer needs to be located in the CTCZ and the taxpayer is allowed to claim the net interest deduction when the interest is paid.

This bill defines "qualified property" to mean <u>any</u> property that is used exclusively in the CTCZ. The definition of qualified property needs to be clarified to specify the usage of the property. The author may want to amend the language to mirror the definition specified under current EZ statute.

Even though the phrase "qualified years one through five wages" is defined in the bill, the meaning of the phrase would be subject to different interpretations. To prevent disputes between taxpayers and the department, the author may want to clarify the meaning of "qualified years one through five wages."

If a credit is allowed for qualified property under more than one R&TC section, this bill specifies that the taxpayer must elect which credit applies on the return filed for each year. It is recommended that the bill be amended to specify that the taxpayer needs to make the election on the original return filed to prevent a taxpayer from making the election more than once for multiple tax benefits.

It is recommended that the definition of “CTCZ” be clarified. This bill does not specify the exact location or boundaries of a CTCZ. The department would have difficulty verifying if the taxpayer is within the CTCZ. In addition, this bill does not specify how a CTCZ would be designated or who will be authorized to designate a CTCZ. Currently, existing state law allows the governing body of a city or county to apply for designation as an EZ. Using specified criteria, the DHCD designates EZs from the applications received from the governing bodies. The author may want to use similar criteria to designate a CTCZ.

This bill would allow an unlimited carryover period. Consequently, the department would be required to retain the credit on the tax forms indefinitely. Recent credits have been enacted with a carryover period limitation; experience shows credits are typically exhausted within eight years of being earned.

TECHNICAL CONSIDERATIONS

On page 9, line 32 and page 31, line 7, this bill adds reference to R&TC section 23622.5. Under current R&TC, there is no section 23622.5.

On page 10, lines 3 and 4, refer to a practice of a licensee that appears to be inconsistent with this bill.

On page 10, line 13, the phrase “determined under those regulations” is mentioned without prior mention of what those regulations are.

LEGISLATIVE HISTORY

AB 1134 (Dymally, 2007/2008) would have designated ten new medical EZs and allowed various credits for those zones. The bill failed to pass out of the first house by January 31 of the second year of the session.

AB 1651 (Arambula, 2007/2008) would have enacted a tax credit for equipment used to reduce greenhouse gas emissions. The bill failed to pass out of the first house by January 31 of the second year of the session.

AB 2488 (Houston, 2007/2008) would provide an alternative depreciation deduction to taxpayers for the cost of acquiring machines or equipment that reduce greenhouse gas emissions or produce, generate, or store renewable energy from specified sources. AB 2488 is currently at the Assembly Revenue & Taxation Committee.

OTHER STATES’ INFORMATION

The states surveyed include *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.

Although each of these states have economic development programs to encourage job growth, those programs are generally targeted to specific distressed areas or disadvantaged employees and are not comparable to the provisions of this bill.

FISCAL IMPACT

This bill would require a calculation for the credit that would require a new form or worksheet to be developed. The department's costs to administer this bill cannot be determined until implementation concerns have been resolved, but are anticipated to be minor.

ECONOMIC IMPACT

Revenue Estimate

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

Estimated Revenue Impact of SB 1194 As Amended 03/24/2008 Effective for Tax Years BOA 2009 and Before 2014 Enactment Assumed After 6/30/2008		
2008-09	2009-10	2010-11
<-$500,000	-$1 million	-$1.2 million

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

Revenue Discussion

The number of qualified taxpayers that would take advantage of the tax incentives provided under the CTCZ would determine the revenue impact of this bill.

The revenue estimate is based on the actual data for the hiring credit, the sales or use tax credit, the business expense deduction, the NOL, and the net interest deduction for lenders under the Coachella Valley EZ. The total tax reduction from credits and other tax benefits is estimated to be $2.6 million for 2005. The revenue estimates for this bill are arrived at utilizing the following steps:

1. Total credits of $2.6 million are grown to tax year 2009 using the corporate profits growth rate used in the Governor’s budget, or $3.1 million. Because the bill does not clearly limit the CTCZ to be established within the Coachella Valley, the projected credit was increased by 20% to account for a wider coverage of the CTCZ. Thus, the projected 2009 total credit is approximately $3.7 million (1.2 x $3.1 million).

2. Because the bill does not specifically describe what constitutes clean energy technology, it is assumed that about 5% of businesses within the CTCZ would actually be engaged in developing, manufacturing, producing, distributing, and installing clean technology.

3. As the bill does not indicate if businesses that use clean technology in the course of their ordinary business are included along with those that develop, manufacture, produce, distribute, and install clean technology, the share of businesses covered under the bill is increased from 5% to 10%.

4. The bill appears to have a broader definition of "qualified property" for sales or use tax credit and "qualified employee" for hiring credit than the definition used under current EZ law. In addition, the bill is unclear for the definition of NOL, net interest deduction, and business expense deduction. Given the broader interpretation of terms (for specifics, please see Implementation Considerations discussion), the rate is increased from 10% to 30%.

5. The 30% is then applied to projected 2009 credits of $3.7 million to derive tax benefits of approximately $1.1 million (30% of $3.7 million) that would be applied under the CTCZ. The total tax reduction for 2009 is reduced to $1 million because NOLs of approximately $0.1 million would only be available for businesses in 2010. For 2010, 2011, and 2012, the tax reductions are estimated to be approximately $1.1 million, $1.2 million, and $1.3 million, respectively.

Taxable year estimates are converted to fiscal year estimates in the table above. For 2008-09, 2009-10, and 2010-11, the revenue loss is approximately $0.3 million, approximately $1.0 million, and approximately $1.2 million, respectively.

POLICY CONSIDERATIONS

This bill would allow taxpayers that are claiming credits and deductions for the Coachella Valley EZ to claim multiple tax benefits for the same item of expense.

Federal law prohibits discriminatory state taxation of interest on federal obligations, such as interest received from a U.S. Treasury Bill. This bill provides a deduction to financial corporations for interest earned on certain loans. This bill could be interpreted as discriminatory because all interest earned on a federal obligation (e.g. a Treasury bill) is subject to California's franchise tax but only a portion of the interest that would be earned from a loan made to the taxpayer in a CTCZ would be subject to the California franchise tax.

LEGISLATIVE STAFF CONTACT

Legislative Analyst	Revenue Manager	Asst. Legislative Director
Nicole Kwon	Rebecca Schlussler	Patrice Gau-Johnson
(916) 845-7800	(916) 845-5986	(916) 845-5521
haeyoung.kwon@ftb.ca.gov	rebecca.schlussler@ftb.ca.gov	patrice.gau-johnson@ftb.ca.gov