Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Arambula	Analyst:	William Koch	Bill Number:	AB 2640
Related Bills:	See Legislative History	Telephone:	845-4372	Amended Date:	April 8, 2010
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Section 1245 Property Credit For Manufacturer's Investment In Qualified Property/Eliminate Income Exclusion Of Free Or Subsidized Parking For Participating In A California Ridesharing Arrangement

SUMMARY

This bill would do the following:

- create a tax credit for purchases of certain property by manufacturers and
- eliminate free or subsidized parking from the list of items excluded from gross income when received by an employee from an employer for participating in a ridesharing arrangement in California.

SUMMARY OF AMENDMENTS

The April 8, 2010, amendments deleted the sales and use tax exemption for manufacturers and the provisions that would have disallowed the exclusion of gain or loss from certain exchanges of property, and added a provision that would allow a tax credit for purchases of certain property by manufactures.

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

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to address the need for more effective and efficient tax expenditures.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2010.

POSITION

Pending.

Summary of Suggested Amendments

Department staff is available to assist the author's office to resolve the implementation and technical concerns identified in this analysis.

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.

Federal and state laws provide that gross income includes all income from whatever source derived, including compensation for services, business income, gains from property, interest, dividends, rents, and royalties, unless specifically excluded.

Federal Law

Existing federal law does not provide a tax credit comparable to that proposed by this bill.

Current federal law allows employees certain exclusions from gross income for the value of qualified transportation fringe benefits, including employer-provided qualified parking. The term "qualified parking" means parking provided to an employee by an employer (1) on or near the business premises of the employer or (2) at location from which the employee commutes to work by car pool, commuter highway vehicle, mass transit, or transportation provided by any person in the business of transporting persons for compensation or hire, but only if the seating capacity of such transportation accommodates at least six adults, excluding the driver. Parking at or near an employee's residence is not qualified parking. The current maximum monthly value of qualified parking that can be excluded from an employee's gross income is $230. This amount is adjusted for inflation annually.

State Law

Manufacturers' Investment Credit (MIC)

Previous state law allowed qualified taxpayers a MIC equal to 6 percent 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 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;
    - 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 were 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. Additional exclusions are facilities used for warehousing purposes and equipment used to store finished products, after completion of the manufacturing process, including tangible personal property used in administration, general management, or marketing.

The MIC statute was repealed by its own terms and ceased to be operative as of January 1, 2004.

Current state law provides special tax incentives for taxpayers conducting business activities within geographically targeted economic development areas (G-TEDAs). These incentives include a sales or use tax credit as discussed in greater detail below.

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 economic development area (except a Manufacturing Enhancement Area). The amount of the credit is limited to the tax attributable to economic development area income. Qualified property is defined as follows:

Enterprise Zone (EZ) or Targeted Tax Area (TTA):

- Machinery and machinery parts used for:
  - manufacturing, processing, assembling, or fabricating;
  - producing renewable energy resources; or
  - air or water pollution control mechanisms.
- Data processing and communication equipment.
- Certain motion picture manufacturing equipment.

Local Agency Military Base Recovery Area (LAMBRA):

- High-technology equipment (e.g., computers);
- Aircraft maintenance equipment;
- Aircraft components; or
- Certain depreciable property.

In addition, qualified property must be purchased and placed in service before the economic development area designation expires. The maximum value of property that may be eligible for the EZ, LAMBRA, and TTA sales or use tax credit is $1 million for individuals and $20 million for corporations.

Income Exclusions for Transportation Benefits

California conforms to federal law and allows certain exclusions from gross income for the value of qualified transportation fringe benefits, including employer-provided qualified parking. In addition, California law provides an exclusion from gross income of any benefit, except salary or wages, received by an employee from an employer for participation in any ridesharing arrangement in California, including free or subsidized parking. The phrase “free or subsidized parking” means the benefit received from an employer for parking while participating in a ridesharing arrangement within California. Ridesharing arrangements include carpools, vanpools, and buspools. There is no maximum monthly amount that may be excluded from gross income for benefits received for participating in ridesharing arrangements in California.

<u>THIS BILL</u>

This bill would, for taxable years beginning on or after January 1, 2010, provide a tax credit to qualified taxpayers for the purchases of qualified property that is placed in service in California.

- The amount of the credit would be the percentage of the total sales tax reimbursement or use tax paid on a purchase of qualified property, the revenues of which are deposited in the General Fund.

In addition, this bill would:

- Define “qualified property” as any property that is Section 1245 property[1] as defined in Section 1245(a)(3) of the IRC.

- Define “qualified taxpayer” as a purchaser engaged in any of those lines of business described in Codes 311111 to 339999 (manufactures), inclusive, of the North American Industrial Classification System (NAICS) Manual published by the United States Office of Management and Budget, 2007 edition.

- Provide that no credit, no further credit in any subsequent year, and no credit carryover shall be allowed if the qualified property for which the credit was allowed is disposed of or removed from this state within one year of the date of purchase.

- Allow the credit to be carried to be carried over until exhausted

[1] In general, IRC section 1245 property includes, but is not limited to, tangible personal property (excluding buildings and inventory) that is subject to depreciation. This includes most equipment and furnishings. Office supplies and other small non-depreciable items are not included.

- Require the Franchise Tax Board (FTB) to estimate the aggregate revenue increases generated from the disallowance of the income exclusion discussed below on a quarterly basis, and establish a cutoff date in which the credit would no longer be allowed for that taxable year. The cutoff date would be the last day of the calendar quarter within which the aggregate revenue increases reaches a baseline amount of $100,000,000 for the first taxable calendar year in which the credit is in effect. For each subsequent taxable year, the cutoff date would be the last day of the calendar quarter within which the FTB estimates the revenue increases has reached the baseline amount, as adjusted for inflation or deflation, as measured by the Consumer Price Index or other method utilized by the FTB.

- Allow the tax credit to taxpayers taxable under the Personal Income Tax Law and the Corporation Tax Law on a first come-first-served basis for each taxable year until the cutoff date.

This bill would also, for taxable years beginning on or after January 1, 2010, eliminate free or subsidized parking from the list of items excluded from gross income when received by an employee from an employer for participating in a ridesharing arrangement in California. However, this bill would leave unchanged California's conformity to federal law that allows certain exclusions from gross income for the value of qualified transportation fringe benefits, including employer-provided qualified parking.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns for this bill. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

1. The requirement for the FTB to establish a cutoff date for the tax credit proposed by this bill based on an estimate of the revenue gains attributable to this bill reaching a baseline amount during each taxable year cannot be implemented by the department for a number of reasons. Tax returns are filed annually, and the FTB has no way to accurately estimate revenue gains from specific changes of law during each taxable year. If the FTB were required to determine the revenue gains from this specific bill, tax forms and the FTB's computer systems would need to be modified to capture the required data. The amounts would remain unknown until tax returns were processed for each taxable year, which, in the case of taxpayers filing on extension, would be ten months after the end of each taxable year. If the revenue gains attributable to this bill do not reach the baseline amount, no cutoff date would be reached for the tax credit each year and the credit would be allowed without limitation, which could be contrary to the author's intent.

2. It appears the author's intent is to eliminate the income exclusion of parking subsidies, but this bill would leave unchanged California's conformity to federal law that allows certain exclusions from gross income for qualified transportation fringe benefits. As a result, eliminating the income exclusion of free or subsidized parking for participating in a ridesharing arrangement in California would have no revenue impact unless the bill is amended to modify California's conformity to Section 132(f)(C) of the IRC.

3. The taxpayer's eligibility for the credit would in part be based on the lines of business "described in" specified sections of the NAICS Manual. The term "described in" has resulted in disputes between the department and taxpayers under the prior MIC law. If it is the author's intent to allow this credit for taxpayers whose principal business activity is classified as manufacturing, the author may wish to substitute "properly classified under" for the term "described in" for clarity.

4. The methodology in this bill for FTB to adjust the baseline amount for inflation or deflation, relating to the cutoff date for the tax credit, is imprecise, which could lead to disputes between taxpayers and the department. The author may wish to amend this bill to provide for an inflation adjustment method similar to that found in Section 17041(h) of the Revenue and Taxation Code.

5. The language for the provisions of the bill that would disallow the tax credit if the qualified property is disposed of or removed from this state within one year of the date of purchase is inconsistent with standard credit recapture language, which could lead to disputes between taxpayers and the department. The author may wish to amend this bill to include the standard credit recapture language, which the department is available to provide.

6. The language for the provisions of the bill that would allow the tax credit on a first come-first served basis before the cutoff date during each taxable year lacks a requirement for the taxpayer to subsequently file an income tax return to allow the credit, which could lead to disputes between the department and taxpayers.

TECHNICAL CONSIDERATIONS

The following technical considerations were identified to provided clarity and consistency within the bill.

Page 2, line 9, strikeout "percentage" and insert "portion".

Page 3, line 4, strikeout "purchaser" and insert "taxpayer".

Page 3, line 14, strike out "of purchase" and insert "the qualified property was placed in service in this state."

Page 7, line 16, strikeout "percentage" and insert "portion".

Page 7, line 23, strikeout "purchaser" and insert "taxpayer".

Page 7, line 33, strikeout "of purchase" and insert "the qualified property was placed in service in this state."

LEGISLATIVE HISTORY

MIC

SB 445 (Ashburn, 2009/2010) would have created a tax credit, similar to the previous MIC, for purchases of certain property used in manufacturing. SB 445 was held in the Senate Revenue and Taxation Committee.

AB 2076 (Dutton, 2003/2004) would have reinstated the previous MIC only for electric services. AB 2076 failed passage in the Assembly Revenue and Taxation Committee.

AB 1998 (Dutton, 2003/2004) would have reinstated the previous MIC for taxable years beginning on or after January 1, 2005, and extended the MIC to activities related to electric service (power generation, transmission, or distribution). AB 1998 failed passage in the Assembly Revenue and Taxation Committee.

AB 2070 (Houston, 2003/2004) would have reinstated the previous MIC for taxable years beginning on or after January 1, 2005. AB 2070 failed passage in the Assembly Revenue and Taxation Committee.

SB 1295 (Morrow, 2003/2004) would have reinstated the previous MIC for taxable years beginning on or after January 1, 2004, and would have increased the rate of credit from 6 percent to 8 percent. SB 1295 failed passage in the Senate Revenue and Taxation Committee.

SB 676 (Alquist, Stats. 1994, Ch. 751) made clarifying changes to the MIC and added provisions allowing the credit for leased property, but only to the lessee.

SB 671 (Alquist, Stats. 1993, Ch. 881) enacted the MIC.

Income Exclusion for California Ridesharing Arrangements

SB 1904 (Morgan, Stats. 1988, Ch. 1437) enacted the exclusion from gross income of the value of benefits received by an employee from an employer for participating in a ridesharing arrangement in California.

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.

MIC

Illinois provides a replacement tax investment credit equal to 0.5 percent 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.

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

New York provides an investment tax credit to manufacturers for certain depreciable equipment or buildings. The credit is 5 percent of up to $350 million of qualified expenditures and 4 percent 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 percent.

No comparable credit for *Florida* or *Minnesota* was found.

Income Exclusions/Credits for Transportation Benefits

Illinois allows taxpayers to deduct, if included in adjusted gross income, ride-sharing or other benefits received by a driver in a ridesharing arrangement.

Massachusetts provides a tax credit equal to 30 percent of the total purchase or lease costs for shuttle vans used in an employer-sponsored ridesharing program.

Minnesota provides a tax credit equal to 30 percent of the difference between the price the employer paid for a transit pass and the price charged to an employee for a transit pass.

The statutes of *Florida*, *Michigan*, and *New York* do contain provisions relating to the disallowance of transportation benefits similar to this bill.

FISCAL IMPACT

The department's costs to administer this bill cannot be determined until the implementation concerns identified have been resolved.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Estimated Revenue Impact of AB2640 For Tax Years Beginning On or After January 1, 2011 Enactment Assumed September 30, 2010 ($ in Millions)			
	2010-11	2011-12	2012-13
Section 1245 Property Tax Credit	-$630	–$580	-$610
Eliminate Free of Subsidized Parking for California Ridesharing Arrangements	$0.0	$0.0	$0.0
TOTAL	**-$630**	**-$580**	**-$610**

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

POLICY CONCERNS

If this bill is intended to provide an incentive for future investments in the state's manufacturing sector, the inclusion of a prospective operative date may be appropriate to more fully act as an inducement for future action or behavior, rather than providing a benefit for action taken without regard to the credit proposed by this bill.

This bill fails to limit the amount of the credit that may be taken. Credits that could potentially be quite costly are sometimes limited either on a per-project or per-taxpayer basis.

Conflicting tax policies result when a credit is provided for an item that is already deductible as a business expense or is depreciable (double tax benefit). For example, under this bill a taxpayer could depreciate the full costs of the qualified property and be allowed this credit. On the other hand, making an adjustment to reduce basis to eliminate the double benefit creates a difference between state and federal taxable income, which is contrary to the state's general federal conformity policy.

This bill lacks a sunset date. Sunset dates generally are provided in tax incentive bills to allow periodic review by the Legislature. The author may wish to amend this bill to include a sunset date or benchmark, for example, the number of new full time manufacturing jobs created over a period of time in the state to allow periodic review of the effectiveness of the credit by the Legislature.

LEGISLATIVE STAFF CONTACT

Legislative Analyst	Revenue Manager	Legislative Director
William Koch	Monica Trefz	Brian Putler
(916) 845-4372	(916) 845-4002	(916) 845-6333
william.koch@ftb.ca.gov	monica.trefz@ftb.ca.gov	brian.putler@ftb.ca.gov