Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Bradford	Analyst:	Victoria Favorito	Bill Number:	AB 2687
Related Bills:	See Legislative History	Telephone:	845-3825	Introduced Date:	February 19, 2010
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Corporation Trade Infrastructure Investments & Import Export Cargo Tax Credits

SUMMARY

This bill would create two different tax credits for corporate taxpayers that invest in, and use, public port facilities in California:

1. Trade infrastructure investment tax credit.
2. Import-export cargo tax credit.

PURPOSE OF THE BILL

The legislative intent section of this bill states its purpose is to encourage private investments in financing improvements to California's public ports and ports infrastructure facilities during the economic downturn.

EFFECTIVE/OPERATIVE DATE

This bill would be effective on January 1, 2011, and would be specifically operative for taxable years beginning on or after January 1, 2011, and before January 1, 2021.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Existing state and federal laws generally allow a depreciation deduction for the obsolescence or wear and tear of property used in the production of income or property used in a trade or business. The amount of this deduction is determined, in part, by the cost (or basis) of the property. In addition, the property must have a limited, useful life of more than one year. The depreciation deduction is generally allowed over a period approximating the property's economic life rather than deducted in the year purchased or acquired. As an incentive for businesses to invest in property, occasionally an accelerated depreciation deduction is allowed. That is, a deduction is allowed at a faster rate than the decline in the property's economic value would warrant.

Board Position:			Department Director	Date
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Depreciable property includes equipment, machinery, vehicles, and buildings, but excludes land. Significant improvements to property are added to the basis of the property and are depreciated over the property's remaining useful life.

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 tax credits or economic development area hiring tax credits). These tax credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

THIS BILL

For taxable years beginning on or after January 1, 2011, and before January 1, 2021, this bill would allow the following tax credits under the Corporation Tax Law:

- A tax credit for trade infrastructure investment constructed in this state would be allowed in an amount not to exceed 5 percent of the amount paid or incurred for capital costs expended after January 1, 2011, and the project receives certification from the Franchise Tax Board (FTB).
- A tax credit for the import/export of cargo would be allowed in an amount not to exceed the product of $5 and the number of tons of additional “qualified cargo”, as provided.

Trade Infrastructure Investment Tax Credit

Under this bill, “capital costs” would mean all costs and expenses incurred by one or more investing taxpayers in connection with the acquisition, construction, installation, and equipping of a qualifying project.

The costs and expenses for a qualifying project would be commencing for acquisition, construction, installation, and equipping commences, and ending on the date on which the qualifying project is placed in service. However, no costs expended prior to January 1, 2011, would be included as "capital costs" eligible for the tax credit.

This bill would define “qualifying project” to include a project to be undertaken by one or more investing taxpayers that meets all of the following requirements:

- The total capital cost of the project may not be less than $5 million.
- The predominant trade or business activity to be conducted at the project site must constitute industrial, warehousing, or port and harbor operations and cargo handling, including any port and port harbor activity.
- The project is certified by the FTB, as specified.

The amounts available to a project would be equal to the project’s share of the total cost of the tax credit, which would be determined by the Legislature based on each project’s percentage of the total amount of project capital costs certified by the FTB as of July 1 of each taxable year.

This bill would authorize the following duties to the FTB:

- To audit the qualifying project and inspect the construction site of the qualifying project.
- To verify that capital cost expenditures have been expended by the investing taxpayer.

If the FTB finds that funds for which an investing taxpayer received tax credits are not invested in and expended with respect to capital costs, this bill would authorize the FTB to recapture the tax credits and assess interest that would be computed from the original due date of the return on which the tax credit was taken.

Import-Export Cargo Tax Credit

This bill would allow a tax credit under the Corporate Tax Law in an amount no more than the amount equal to $5 multiplied by the taxpayer's number of tons of "additional qualified cargo" for the tax year.

This bill defines the following requirements for the import-export cargo tax credit:

- The term "additional cargo" means the amount of qualified cargo moved in the current taxable year over and above the cargo moved in the previous taxable year.
- The term "qualified cargo" means any "breakbulk" or "containerized" cargo that is imported or exported to or from a manufacturing, fabrication, assembly, distribution, processing, or warehouse facility located in California and is moved by way of an oceangoing vessel berthed at a public port facility in California during the taxable year and certified by the FTB as meeting the terms of this section.
- The term "ton" is described as a net ton of 2,000 pounds, and for containerized cargo, it would exclude the weight of the container.

This bill would authorize the FTB to certify additional cargo as qualifying cargo upon making a finding that the terms are met as specified.

Trade Infrastructure Investment and Import-Export Tax Credits

Under this bill, no project would be certified unless the FTB determines that the proposed project would generate sufficient revenue for the state to offset the cost of tax credits provided (tax revenue foregone).

An investing taxpayer seeking certification of a qualifying project would be required to submit an application to the FTB and require the applicant to pay a fee to cover the costs of the FTB's review and evaluation of the project application.

This bill would require the FTB to notify the investing taxpayer as follows:

- Within 90 days, if an appropriation by the Legislature has been determined for purposes of funding the tax credit.

- Within 90 days of the adoption of a state budget, if no appropriation is made.

This bill would allow the credits to be carried forward for ten years, until exhausted.

This bill would require the FTB to develop a “dynamic revenue anticipation model” designed to estimate economic impacts from the completion of a qualified project, including the amount of state and local tax revenues and user fees generated, jobs created, and overall impact on the economy.

In administering the tax credits, the FTB would be authorized to determine, through the promulgation of rules, which projects and capital cost expenditures qualify for tax credits.

Under this bill, the FTB would be required to submit notice of its certification of a project to the Department of Finance, the Joint Legislative Budget Committee, and the Legislative Analyst.

This bill would require the Legislative Analyst's Office to prepare a written report outlining the overall impact of the effectiveness of the tax credits and the economic impact of the tax credits on the port and maritime industry located in California and regionally.

Dynamic Revenue Anticipation Model

This bill would require the FTB to develop a “dynamic revenue anticipation model” designed to estimate the following economic impacts from completion of a qualifying project:

- The total state tax revenues generated by the project and project-related economic activity.
- The total local tax and user fee revenues generated by the project and project-related economic activity.
- The total jobs created by the project and project-related economic activity, including the impact of the project on the employment of California residents.
- The impact of the qualifying project on the overall economy of the state.

The provisions of this bill would be operative until December 1, 2021, and prohibits any tax credits from being granted after such date.

<u>IMPLEMENTATION CONSIDERATIONS</u>

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.

It appears that this bill is structured as an "allocated tax credit" subject to legislative funding; however, it is unclear what methods are to be used to allocate the tax credit. It is recommended that the bill be amended to provide clarification of the mechanics of applying for and receiving allocation of this tax credit, including how the FTB would allocate if applications for tax credit exceed the dollars available to allocate.

This bill is unclear about "when" the tax credit would actually be allowed–it appears the tax credit could be allowed BEFORE expenditures are actually paid or incurred. It is also unclear whether the taxpayer would receive the entire tax credit in one year or multiple years without regard to when the expenses are incurred.

A traditional dynamic revenue model is a computer model used to evaluate relationships between various industries in the economy as well as relationships among the economy's labor, capital, and product markets. The "dynamic revenue anticipation model" this bill would require would not be a true dynamic revenue model because it would ignore consideration of other economic impacts and would only consider four economic impacts as specified. Thus, the model would not accurately measure the magnitude of each of the responses to tax changes as they propagate throughout the economy. In addition, the cost of developing and maintaining this dynamic revenue model would not be feasible because this model would only apply to tax credits unique to this bill.

The terms of this bill are unclear regarding what variables to use in the "dynamic revenue anticipation model" to estimate the economic impacts from a completed qualifying project. The economy contains many facets, and the bills is silent regarding which aspects of the economy need to be considered in the revenue analysis.

The assumptions that would be used to determine if a qualifying project produces sufficient revenue to offset the cost of the credits would be dependent on changes in California tax law or industry conditions at particular point in time. Timely notification to the investing taxpayer of the status of a project would prove difficult to implement.

This bill would require the FTB to estimate total jobs created by the project and project related economic activity, including the impact of the project on the employment of California residents. Assessing employment impacts would be beyond the scope of the department's expertise. The Employment Development Department possesses the relevant expertise appropriate to the subject.

Program Background

In August 1994, the State of California adopted legislation[1] to require the California Department of Finance (DOF) to conduct revenue estimates for proposed tax changes that have a static impact of at least $10 million. Funds were subsequently appropriated to construct, maintain, and utilize a computable general equilibrium (CGE) model for this purpose, and dynamic revenue estimates were prepared for a number of years.

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[1] Senate Bill 1893 (Chapter 393, Statutes of 1994).

In January, 2000, the dynamic estimating requirement repealed due to a sunset provision. Although dynamic estimates continued to be prepared for several more years using the model, the requirement was never re-adopted. Future issues involving dynamic analysis that California and other states face include the following:

- The reliability and acceptability of the results,
- The issue of how the results should be used, and
- Whether conducting dynamic analyses make sense from a benefit-cost perspective.

California's CGE model still does exist, is periodically updated, and gets some use for purposes other than revenue estimating. For example, both the California Air Resources Board and Energy Commission utilize the model to varying degrees in analyzing various policy proposals and changes in the environmental area.

The FTB current practice for developing revenue estimates

The FTB revenue estimates use state tax databases, federal tax information where applicable, subject matter research, and DOF's economic and revenue projections. The FTB revenue estimates always assume a constant Gross State Product. That is, they do not allow for revenue changes from increases or decreases in overall economic activity, including payrolls. The FTB revenue estimates are not static as FTB considers behavioral changes. For example, in estimating the revenue impact of a new tax credit, estimates of the increase in the activity that qualifies for the credit are made.

Please see Appendix A for a discussion of dynamic revenue analysis methods.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and *New York* laws do not provide a credit comparable to the credit allowed by this bill. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

Tax Credits

Louisiana provides an "investor tax credit" and an "import export credit" similar to this bill. The "investor tax credit" is equal to 5 percent per year of the total cost or a qualifying project in a Louisiana port jurisdiction and the "import export credit" that equals $5 per ton of cargo imported or export through the Louisiana Ports.

Dynamic Revenue Estimate Model

As of the date of this analysis, there are no states that use a dynamic revenue estimation model to assess the impact of tax policy changes.

FISCAL IMPACT

Credits

Staff have determined that implementing this bill would have a significant impact to the department. The additional costs have not been determined at this time. As the implementation concerns are resolved and the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

Dynamic Model

The initial cost of developing a dynamic revenue estimating model specific to the terms of this bill would be a onetime cost of $100,000. The ongoing costs to maintain and operate the model would be $85,000. By fiscal year, the costs would be $157,000 in 2010/2011 and $85,000 thereafter.

ECONOMIC IMPACT

Revenue Estimate

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

Estimated Revenue Impact of AB 2687 Operative for Tax Years Beginning On or After January 1, 2011 Assumed Enactment Date before June 30, 2010 ($ in Millions)		
2010/11	2011/12	2012/13
-$32	-$130	-$180

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure. Specifically, this analysis does not consider the additional tax revenue that might be generated by qualified private capital expenditures on public port facilities, or the import-export cargo. It also does not consider the additional administrative cost created by this bill.

ARGUMENTS/POLICY CONCERNS

As introduced, this bill would provide tax credits to taxpayers for investments in California ports and ports facilities. Adding a requirement that would establish tax credits only for properties located in California may be subject to constitutional challenge under the Commerce Clause of the United States Constitution.

This bill would require the FTB to implement a certification procedure that would practically guarantee that all projects applying for the credit would be certified as generating revenue greater than the cost of the credit, even in cases where this bill would result in a net loss of revenue to the state.

For example, an investing taxpayer funds a project (which would have been undertaken whether or not a tax credit is offered) and the project generates $1,000 in taxes (revenue to the state). Under this bill, FTB would certify the project cost if it is less than the $1,000 (revenue to the state) and ignores the consideration that the project would have already been undertaken. Thus, the credit would result in a net loss of revenue to the state.

Under this bill, multiple taxpayers would be able to claim the infrastructure investment credit for the same qualifying project, limited only by the total aggregate capital costs of that project. California would be providing a 100 percent tax credit, which is unprecedented for a project owned by investors.

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Appendix A

Dynamic Revenue Analysis

Revenue estimates that do not take into consideration behavioral changes of any kind attributable to the passage of statutory changes would be considered static estimates. On the other end of the spectrum, revenue estimates that do consider behavioral changes that might be anticipated from statutory changes would be referred to as dynamic estimates. Dynamic revenue analysis evaluates relationships between various industries in the economy including relationships among the economy's labor, capital, and product markets. The two types of modified forms of dynamic forecasting are as follows:

- *Macro dynamic revenue analysis* - Dynamic revenue analysis evaluates relationships between various industries in the economy, in addition to relationships among the economy's labor, capital, and product markets. Dynamic revenue analyses take into account the direct behavioral responses that tax changes produce in taxpayers, the indirect behavioral effects they produce in individuals and businesses as well as the induced macroeconomic feedback effects associated with all of the direct and indirect behavioral responses.

- *Micro dynamic revenue analysis* - Micro dynamic revenue analysis estimates the direct impact a tax law change would have on revenue. Implicitly, this approach assumes that tax law changes would have little or no impact on taxpayer behavior or on the overall level of economic activity in various sectors of the economy.

Despite the best efforts of economists to develop dynamic estimates that are as accurate as possible, limitations in terms of regional data and reliable assumptions about exactly how different types of tax provisions affect state economies do exist. This tends to inherently limit the acceptance and usefulness of dynamic estimates. Other issues include how the results would be used, and whether conducting dynamic analyses make sense from a benefit-cost perspective. Thus, making improvements in these areas is an important requirement if dynamic modeling is to become more reliable and widely accepted[2].

[2] Revenue Estimation and Tax Conference report by Jon David Vasché Director of Economics and Taxation California Legislative Analyst's Office. Link: http://www.taxadmin.org/fta/meet/06re_data/pres/vasche.pdf