Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Ashburn	Analyst:	Jahna Alvarado	Bill Number:	SB 1074
Related Bills:	See Legislative History	Telephone:	845-5683	Introduced Date:	February 17, 2010
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Manufacturer's Investment Credit/6 Percent Of Cost Of Qualified Property Used In Green Technology & Renewable Energy Resources Business

SUMMARY

This bill would create an income and franchise tax credit for taxpayers engaged in green technology and renewable energy resources activities, as specified.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to spur job creation and innovation in the State's green technology and renewable energy resources sectors.

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, with regard to qualified costs incurred on or after January 1, 2010.

POSITION

Pending.

SUMMARY OF SUGGESTED AMENDMENTS

Amendments are provided to resolve the technical concerns discussed below.

ANALYSIS

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.

Board Position:			Department Director	Date
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FEDERAL LAW

Existing federal law does not have a credit comparable to that proposed in this bill.

STATE LAW

Previous state law allowed qualified taxpayers a Manufacturers' Investment Credit (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, due to a reduction in manufacturing sector jobs.

Under the Revenue and Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within economic development areas. 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.

<u>Limitations on Use of Economic Development Area Sales or Use Tax Credit</u>

For businesses operating inside and outside an economic development area, the amount of credit that may be claimed is limited by the amount of tax on income attributable to the economic development area. 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, a double-weighted sales factor; for taxable years beginning on or after January 1, 2011, certain corporations may elect to use a single factor, 100 percent sales apportionment formula). This income is further apportioned to the economic development area using a two-factor formula based on the property and payroll of the business.

Assignment of Credits between Certain Unitary Affiliates

Corporate taxpayers who are members of a combined reporting group may make a one time, irrevocable assignment of eligible credits, as defined, to an eligible assignee, as defined, in taxable years beginning on or after July 1, 2008. Assigned credits can reduce tax for taxable years beginning on or after January 1, 2010.

THIS BILL

This bill would allow a credit for taxable years beginning on or after January 1, 2010, of 6 percent of the qualified cost paid or incurred on or after January 1, 2009, by a qualified taxpayer for qualified property placed in service in this state during the year. The language in this bill for the proposed credit is substantially similar to the prior MIC law.

This bill would define “qualified cost” as any cost that is all of the following:

- A cost paid or incurred by the qualified taxpayer for the construction, reconstruction, or acquisition, or lease, of qualified property on or after January 1, 2010,
- An amount that the qualified taxpayer has paid sales or use tax on, and
- An amount that is properly chargeable to the capital account of the qualified taxpayer.

This bill would define “qualified taxpayer” as any taxpayer that is primarily engaged in any of the following activities:

- Green technology that is either consistent with meeting the goals and objectives of green house gas emissions standards or promotes the reduction of wasteful, inefficient, unnecessary, or uneconomic uses of energy;
- Production of products, systems, or management of cost-effective water use efficiency practices to curtail the waste of water and to ensure that water use does not exceed reasonable needs;
- Production of products, systems, or management of the utilization of recycled or reusable materials in the manufacturing process;
- Production or application of cogeneration technology, as defined;
- Production of products, systems, or management of the conservation of energy; or
- Production of products, systems, management, or the use of solar, biomass, wind, geothermal, hydroelectric under 30 megawatts, or any other source of energy, that would reduce the use of fossil and nuclear fuels.

This bill would define a pass through entity as any partnership or S corporation and would specify that the determination of whether a pass through entity is a “qualified taxpayer” would be made at the entity level and any credit passed through to the partners or shareholders, as specified.

This bill would define “qualified property” as property that is any of the following:

- Tangible personal property as defined in IRC section 1245(a) that is used by a qualified taxpayer for any of the following:
    - The manufacturing, processing, refining, fabricating, or recycling of property;
    - In research and development;
    - To maintain, repair, measure, or test property, as specified;
    - For pollution control that meets or exceeds standards as specified; or
    - For recycling.

- Computers and computer peripheral equipment used by a qualified taxpayer that is primarily used to develop or manufacture the following:
    - Cogeneration technology;
    - Technology or products for the conservation of energy;
    - Technology or products for the use of solar, biomass, wine, geothermal; hydroelectricity under 30 megawatts; or
    - Any other source of energy that would reduce the use of fossil and nuclear fuels.
- Capitalized labor costs directly allocable to the construction or modification of qualified property, as defined.
- Special purpose buildings and foundations.
- Computer software that is used primarily for a green technology or renewable energy resources activity, as defined by this bill.

This bill would specifically exclude the following from the definition of “qualified property”:

- Furniture;
- Facilities used for warehousing purposes after completion of the manufacturing process;
- Inventory;
- Equipment used in the extraction process;
- Equipment used to store finished products that have completed the manufacturing process; and
- Any tangible personal property that is used in administration, general management; or marketing.

This bill would allow the credit for “qualified property” acquired by or subject to lease by a “qualified taxpayer” as specified.

This bill would require a lessor of “qualified property” to provide a statement to the lessee that includes the lessor’s original cost for the “qualified property” and the amount of the cost that sales or use tax had been paid on as specified. Additionally, this bill would require that the statement be made available to the Franchise Tax Board (FTB) upon request.

This bill would define a number of terms, including “fabricating,” “manufacturing,” “primarily,” “process,” “processing,” “refining,” “research and development,” “special purpose building and foundation,” and “small business.”

This bill would disallow this credit if in the same taxable year that the “qualified property” is first placed into service, the “qualified property” is:

- Removed from the state,
- Disposed of to an unrelated party, or
- Used for a purpose that does not qualify for the credit.

This bill would require that the credit be recaptured if, within one year from the date that the "qualified property" is first placed into service, the "qualified property" is:

- Removed from the state,
- Disposed of to an unrelated party, or
- Used for a purpose that does not qualify for the credit.

This credit would be eligible for assignment among members of a unitary group as specified.

The bill would provide a carryover provision for any unused credit for seven years, or nine years in the case of a "small business", as defined, or until the credit is exhausted, whichever is shorter.

This bill would allow FTB to prescribe appropriate regulations to carry out the purpose of this bill, including any regulations necessary to prevent the avoidance of the application of the effect this bill would have through split-ups, shell corporations, partnerships, tiered ownership structures, or otherwise.

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 would allow an investment credit for property that is primarily used in the state for specified green technology, resource conservation, or alternative energy activities. The department lacks expertise in these areas. Typically, credits involving areas for which the department lacks expertise are certified by another agency or agencies that possess the relevant expertise. The certification language would specify the responsibilities of both the certifying agency and the taxpayer. The taxpayer could then be required to provide this certification to the department upon request. For example, the State Air Resources Board could serve as the certifying agency for research that is "consistent with meeting the goals and objectives of compliance with greenhouse gas emissions standards as set forth in the Health and Safety Code."

This bill would allow a credit to "qualified taxpayers," and would define this term as taxpayers that are "primarily engaged" in specified green activities, (i.e., "the production, of products, systems, or management of cost-effective water use efficiency practices to curtail the waste of water and ensure that water use does not exceed reasonable needs."). Because the activities are undefined, it is unclear how a taxpayer's eligibility for this credit would be determined and could lead to disputes between taxpayers and the department. The author may wish to amend this bill to clarify the business activities that would qualify for the credit. For example, under the prior MIC, a qualified taxpayer was any taxpayer engaged in manufacturing activities described in specified codes listed in the SIC Manual, 1987 edition.

This bill uses terms and phrases that are undefined, (e.g., "computer software," "consistent with meeting," "efficiency practices," "management," "primarily engaged," "promotes the reduction of wasteful, inefficient, unnecessary, or uneconomic uses of energy"). The absence of definitions to clarify these terms could lead to disputes between taxpayers and the department, thus complicating the administration of this credit. The author may wish to amend this bill for clarity, and to the extent these terms have been defined in the MIC regulation,[1] the author may wish to use existing definitions.

Because the definition of qualified property fails to require that property be used for specified green activities, this bill would allow a credit for all qualified property purchased by a taxpayer that is a qualified taxpayer. If it is the author's intention to limit the credit to qualified property used in a specified green activity, this bill should be amended.

TECHNICAL CONSIDERATIONS

The definition of "qualified property" should be amended. The term "wine" should be "wind" to correspond to the definition of "qualified taxpayer." Amendments 3 and 6 are provided to correct this drafting error.

Subdivision (d), paragraphs (1) and (2), of the Personal Income Tax Law and Corporate Tax Law provisions should be amended where the term "Section 1245(a)" appears, as it should be "Section 1245(a)(3)(A)" to correspond to the definition of "tangible personal property" in the Internal Revenue Code. Amendments 1, 2, 4, and 5 are provided to correct this reference error.

LEGISLATIVE HISTORY

SB 445 (Ashburn, 2009/2010) would have reinstated the previous MIC for taxable years beginning on or after January 1, 2009, with regard to costs paid or incurred on or after January 1, 2009. SB 445 failed to pass out of the Senate Committee on Revenue and Taxation by the constitutional deadline.

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.

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. The survey was limited to income or franchise tax benefits related to manufacturing equipment.

[1] Cal. Code Regs., tit. 18, §§ 17053.49-2, sub. (i), & 23649-2, sub. (i).

Florida allows a corporate income tax credit for tax years beginning on or after January 1, 2007, and before January 1, 2011, for certain “eligible costs” for renewable energy technologies investment. To be eligible for this credit, a taxpayer must apply for, and receive an allocation from, the Florida Energy and Climate Commission (prior to July 1, 2008, to the Department of Environmental Protection). Allocations are made on a first-come first-served basis and the certificate of allocation must be filed with the tax return. *Florida* lacks a comparable credit for personal income taxpayers because *Florida* has no state personal income tax.

Illinois provides for a “High Impact Business Credit” for investments in qualified property placed in service by a High Impact Business designated by the Department of Commerce and Economic Opportunity. The credit is 0.5 percent of the property's basis and may not be claimed until minimum investment requirements are met. Establishing a new wind farm is one of several activities that could qualify for this credit.

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

Michigan offers several energy-related credits that include a plug-in traction battery pack credit, an advanced battery engineering credit, an integrative cell manufacturing facility credit, a battery and energy storage manufacturing facility credit, and an advanced lithium ion battery pack manufacturing credit. A taxpayer must show the creation of a specified minimum number of new jobs to claim the credit for advanced lithium ion battery pack manufacturing, the integrative cell manufacturing facility credit, or the battery and energy storage manufacturing facility credit. To claim any of these credits, a taxpayer must have entered into an agreement with the Michigan Economic Growth Authority.

No comparable credit for *Minnesota* was found.

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.

FISCAL IMPACT

This bill would require a calculation for the credit that would require a new form or worksheet to be developed. As a result, this bill would impact the department’s printing, processing and storage costs for tax returns. The additional costs have not been determined at this time. As the bill continues to move through the legislative process and implementation concerns are resolved, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue losses:

Estimated Revenue Impact of SB 1074 As Introduced February 17, 2010 Operative for Taxable Years Beginning On or After January 1, 2010 Enactment Assumed After September 30, 2010 ($ in Millions)			
	2010-11	2011-12	2012-13
Total revenue impact	-$55	-$80	-$95

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

ARGUMENTS/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 this credit.

This bill fails to limit the amount of the credit that may be taken. Credits that could potentially be 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 qualified taxpayer could deduct the expenses for the costs of construction, reconstruction, or leasing 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, (i.e., the number of new full time jobs created in the state's green technology sector over a period of time), to allow periodic review of the effectiveness of the credit by the Legislature.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 1074
As Introduced February 17, 2010

AMENDMENT 1

On page 3, line 14, strikeout "Section 1245(a)" and insert:

Section 1245(a)(3)(A)

AMENDMENT 2

On page 3, line 33, strikeout "Section 1245(a)" and insert:

Section 1245(a)(3)(A)

AMENDMENT 3

On page 3, line 37, strikeout "wine" and insert:

wind

AMENDMENT 4

On page 11, line 5, strikeout "Section 1245(a)" and insert:

Section 1245(a)(3)(A)

AMENDMENT 5

On page 11, line 24, strikeout "Section 1245(a)" and insert:

Section 1245(a)(3)(A)

AMENDMENT 6

On page 11, line 28, strikeout "wine" and insert:

wind