Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Wyland	Analyst:	Jahna Alvarado	Bill Number:	SB 1239
Related Bills:	See Legislative History	Telephone:	845-5683	Introduced Date:	February 19, 2010
				Amended Date:	March 25, 2010
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Research Expenses Credit/20 Percent Of Excess Qualified Expenses/Conformity To Election Of Alternative Incremental Credit/Employer Hiring Credit/Net Operating Loss Deduction Carryback/Depreciation Deduction Recovery Period

SUMMARY

This bill would make the following changes:

Provision No. 1: Modify the research credit.

Provision No. 2: Create a credit for wages paid by a taxpayer to qualified employees, as defined.

Provision No. 3: Modify the credit for increasing full time jobs.

Provision No. 4: Modify the depreciation recovery period.

Provision No. 5: Modify the net operating loss carryback (NOL) period, as specified.

Provision No. 6: Exclude gain on the sale of a capital asset, as defined, from gross income.

This analysis will not address the bill's change to the Sales and Use Tax Law, as it does not impact the department or state income tax revenue.

SUMMARY OF AMENDMENTS

The March 25, 2010, amendments modified the research credit, new hire credit, and certain NOL carryback provisions, and added provisions to eliminate capital gains from taxable income.

Board Position:			Department Director	Date
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ECONOMIC IMPACT – SUMMARY REVENUE TABLE

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

Estimated Revenue Impact of SB 1239 Operative for Tax Years Beginning On or After January 1, 2010 Assumed Enactment Date by September 30, 2010 ($ in Millions)			
	2010-11	2011-12	2012-13
Research Credit	-$175	-$165	-$155
Net Impact of Employer Wage Credit and Employer Hiring Credit	-$4,400	-$5,000	-$4,500
Accelerated depreciation	-$1,575	-$1,150	-$850
NOL	-$2	-$9	-$12
Capital Gain Income Exclusion	-$9,900	-$5,200	-$8,100
Total Revenue Impact	-$16,052	-$11,524	-$13,617

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

PURPOSE OF THE BILL

According to the author's office the purpose of this bill is to encourage job creation and bolster investment in California by enacting a sales and use tax exemption for manufacturing equipment, eliminating the state income tax on capital gains, establishing hiring credits for new employees, increasing the research and development credit, shortening depreciation schedules, and extending the current net operating loss deduction rules.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately. The operative dates of these changes vary and will be addressed separately for each provision.

POSITION

Pending.

PROVISION 1: RESEARCH EXPENSE CREDIT

OPERATIVE DATE

This provision would be operative for taxable years beginning on or after January 1, 2010.

ANALYSIS

FEDERAL/STATE LAW

Existing federal law allows taxpayers a research credit that is combined with several other credits to form the general business credit. The research credit is designed to encourage companies to increase their research and development activities.

The research credit for personal income tax (PIT) taxpayers is determined as the sum of the following:

1. 20 percent of the qualified research expenses incurred during the taxable year that exceeds the base amount, as defined; and
2. 20 percent of the amount paid or incurred during the taxable year on research undertaken by an energy research consortium.

In addition to the two components listed above, corporate taxpayers are allowed a credit of 20 percent of expenses paid to fund basic research at universities and certain nonprofit scientific research organizations.

Prior to January 1, 2009, federal law allowed a taxpayer to elect the alternative incremental credit (AIC) method to determine their research credit.

To qualify for the credit, research expenses must qualify as an expense or be subject to amortization, be conducted in the U.S., and be paid by the taxpayer. The research must be experimental or laboratory research and pass a three-part test as follows:

1. Research must be undertaken to discover information that is technological in nature. The research must rely on the principles of physical, biological, engineering, or computer sciences.

2. Substantially all of the research activities must involve experimentation relating to quality or to a new or improved function or performance.

3. The application of the research must be intended for developing a new business component. This is a product, process, technique, formula, or invention to be sold, leased or licensed, or used by the taxpayer in a trade or business.

Ineligible expenses include seasonal design factors; efficiency surveys; management studies; market research; routine data control; routine quality control testing or inspection; expenses incurred after production; development of any plant, process, machinery, or technique for the commercial production of a business component unless the process is technologically new or improved. The federal credit does not apply to any expenses paid or incurred after December 31, 2009.[1]

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[1] Emergency Economic Stabilization Act of 2008 (Public Law 110-343).

California conforms to the federal credit with the following modifications:

- The state credit is not combined with other business credits;
- Research must be conducted in California;
- The credit percentage for qualified research in California is 15 percent versus the 20 percent federal credit;
- The credit percentage for basic research in California is limited to corporations (other than S Corporations, personal holding companies, and service organizations) and is 24 percent versus the 20 percent federal credit; and
- The percentages for the alternative incremental research portion of the credit are 1.49 percent, 1.98 percent, and 2.48 percent, which varies from the federal percentages (2.65 percent, 3.20 percent, and 3.75 percent) as they existed on the current conformity date of January 1, 2005.[2]

The California research credit is allowed for taxable years beginning on or after January 1, 1987, and is permanent.

Corporate taxpayers that 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. Assigned credits can reduce tax for taxable years beginning on or after January 1, 2010.

THIS PROVISION

Under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL), this provision would do the following for taxable years beginning on or after January 1, 2010:

1. Increase the credit for increasing qualified research expenses from 15 percent to 20 percent; and

2. Increase the state's AIC percentages to equal the federal percentages in effect on January 1, 2005. Thus, the former federal percentages of 2.65 percent, 3.20 percent, and 3.75 percent, would apply for state purposes until the effective date of SB 401 (Stats. 2010, Ch. 14), at which time the percentages would increase to the federal percentages in effect as of January 1, 2009.

Additionally, for the CTL only, this provision would modify the definition of "new business" by replacing references to the Standard Industrial Classification (SIC) Manual with the North American Industry Classification System (NAICS).

IMPLEMENTATION CONSIDERATIONS

Implementing this provision could be accomplished during the department's normal annual updates.

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[2] The federal rates were increased for taxable years beginning on or after January 1, 2007 to 3 percent, 4 percent, and 5 percent respectively. Tax Relief and Health Care Act of 2006, section 104(b) (P.L. 109-432).

TECHNICAL CONSIDERATIONS

This bill would raise the current state AIC percentages only to the federal percentages on January 1, 2005, because the state is currently in conformity with the federal law as of that date. After the effective date of SB 401(Stats. 2010, Ch. 14), as a result of this bill and amendments made by SB 401(Stats. 2010, Ch. 14) to other provisions of California law, the percentages for California purposes would increase to 3 percent, 4 percent, and 5 percent. Because, SB 401 (Stats. 2010, Ch. 14) included amendments to Internal Revenue Code (IRC) section 41 to address amendments made to the federal law from January 1, 2005, through January 1, 2009 (e.g. modified code section reference to continue to prevent the application of the alternative simplified method for state purposes), the revisions made by SB 401(Stats. 2010, Ch. 14) would be undone unless this bill is amended.

LEGISLATIVE HISTORY

AB 1484 (Anderson, 2009/2010) would have made the identical changes to the research credit as this bill. AB 1484 failed to pass out of the Assembly Revenue and Taxation Committee by the constitutional deadline.

SBX6 9 (Dutton, et al., 2009/2010) would make the identical changes to the research credit as this bill. SBX6 9 is scheduled to be heard in the Senate Revenue and Taxation Committee on May 12, 2010.

SBX8 58 (Dutton & Runner, 2009/2010) would have made the identical changes to the research credit as this bill. ABX8 58 failed to pass out of the Senate Committee on Rules.

SB 444 (Ashburn, 2009/2010) would have made the same changes to the research credit as this bill with the exception that SB 444 would have applied to taxable years beginning on or after January 1, 2009. SB 444 failed to pass out of the Senate Revenue and Taxation Committee by the constitutional deadline.

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.

Florida allows corporate taxpayers to claim a corporate income tax credit for tax years beginning on or after January 1, 2007, for certain “eligible costs” for renewable energy technologies investment. *Florida* lacks a comparable credit for personal income taxpayers because Florida has no state personal income tax.

Illinois corporate and individual taxpayers may claim an income tax credit for qualified expenditures that are used for increasing research activities in *Illinois*. The credit equals 6 ½ percent of the qualifying expenditures.

Massachusetts allows corporate taxpayers to claim an excise tax credit for qualified expenditures that are used for increasing research activities in *Massachusetts*. The credit is 15 percent of the basic research payments and 10 percent of qualified research expenses conducted in *Massachusetts*. Effective for taxable years beginning on or after January 1, 2009, and before January 1, 2018, a certified life sciences company is allowed the credit on expenditures for research activity that takes place both within and outside of *Massachusetts*.

Minnesota allows two credits for research and development: (1) a general nonrefundable credit available to all businesses, and (2) a refundable credit allowed to a qualified business for increasing research activities in a biotechnology and health sciences zone. Both credits are equal to 5 percent for qualified research expenses up to $2 million. The amount of either credit is reduced to 2.5 percent for expenses exceeding the first $2 million.

Michigan allows corporate taxpayers a credit of 1.9 percent of the expenses of the research and development activities conducted in *Michigan*, and a credit of 3.9 percent of the compensation for services performed in hybrid technology research and development. For taxable years 2009 and 2010, *Michigan* allows corporate taxpayers a credit of 30 percent of the qualified contributions to a qualified research and development business, not to exceed $300,000. *Michigan* does not allow a credit for pharmaceutical research.

Beginning in 2005, *New York* allows a credit for qualified emerging technology companies. The credit is equal to 18 percent of the cost of research and development property, 9 percent of the qualified research expenses, and the cost of qualified high-technology training expenditures, limited to $4,000 per employee, per year. The credit is limited to $250,000 per taxable year. Any excess credit can be refunded or applied as a payment for the following taxable year.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

This provision would result in the following revenue losses:

Estimated Revenue Impact of : Provision No. 1: Research Expense Credit Operative For Taxable Years Beginning On or After January 1, 2010 Enactment Assumed After June 30, 2010 ($ in Millions)				
	2010-11	2011-12	2012-13	2013-14
Revenue impact	-$175	-$165	-$155	-$150

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

ARGUMENTS/POLICY CONCERNS

This provision would continue to allow the AIC and, due to general conformity, would conform to the federal AIC percentages in effect on January 1, 2005, until January 1, 2011 when the general conformity date changes to January 1, 2009. Under federal law, the AIC was terminated at the federal level for taxable years beginning after December 31, 2008.[3] The federal change creates additional differences between federal and California tax law, thereby increasing the complexity of California tax return preparation. .

PROVISION 2: EMPLOYER WAGE CREDIT

OPERATIVE DATE

This provision would be operative for taxable years beginning on or after January 1, 2010.

ANALYSIS

FEDERAL/STATE LAW

Current federal law allows employers who hire employees from a "targeted group," as defined, to elect to claim a work opportunity tax credit (WOTC).[4] The credit is equal to 40 percent of the qualified first-year wages for that year. The amount of the qualified first-year wages that may be taken into account with respect to any individual shall not exceed $6,000 per year ($12,000 per year in the case of any individual who is a qualified veteran).

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.

Under the Government Code, state law provides for several types of geographically targeted economic development areas (G-TEDAs): Enterprise Zones (EZs), Manufacturing Enhancement Areas (MEAs), Targeted Tax Areas (TTAs), and Local Agency Military Base Recovery Areas (LAMBRAs).

Under the Revenue and Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within a G-TEDA. These incentives include a hiring credit, sales or use tax credit, business expense deduction, and special net operating loss treatment. Two additional incentives include net interest deduction for businesses that make loans to businesses within G-TEDAs and a tax credit for employees working in an EZ.

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[3] Emergency Economic Stabilization Act of 2008 (Public Law 110-343).
[4] Internal Revenue Code (IRC) 51

Hiring Credit: A business located in a G-TEDA 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 a G-TEDA and meet certain other criteria. At least 90 percent of the qualified employee's work must be directly related to a trade or business located in the G-TEDA and at least 50 percent of the employee's services must be performed inside the G-TEDA.

The credit is based on the lesser of the actual hourly wage paid or 150 percent of the current minimum hourly wage (under special circumstances for the Long Beach EZ, the maximum is 202 percent 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.

Current law allows a tax credit for taxable years beginning on or after January 1, 2009, for a qualified employer in the amount of $3,000 for each qualified full-time employee hired in the taxable year, determined on an annual full-time equivalent basis. The credit is allocated by the Franchise Tax Board (FTB) and has a maximum cap of $400 million for all taxable years. The credit remains in effect until December 1 of the calendar year after the year in which the cumulative credit limit has been reached and is repealed as of that date. Any credits not used in the taxable year may be carried forward up to eight years.

<u>THIS PROVISION</u>

Beginning on or after January 1, 2010, this bill would provide a tax credit to a qualified taxpayer for wages paid or incurred to a qualified employee in an amount equal to the following:

- 25 percent for each qualified employee that is employed for at least 120 hours, but less than 400 hours.
- 40 percent for each qualified employee that is employed at least 400 hours.

The credit would be allowed for the first $6,000 of wages paid or incurred to each qualified employee during the taxable year.

This bill would define the following:

- "Qualified employee" means an individual who is any of the following, as documented by the Employee Development Department (EDD):
    - A recipient of CalWORKs benefits;
    - A parolee;
    - A veteran, as defined in Section 980 of the Military and Veterans Code;
    - An eligible recipient of unemployment insurance benefits;
    - A recipient of unemployment insurance benefits; or
    - A person on probation.
- "Qualified taxpayer" means a taxpayer that is a person or entity engaged in a trade or business within California.

This bill would require the qualified taxpayer to comply with the following:

- Obtain a certificate from the EDD certifying that a qualified employee is employed with the qualified taxpayer, and
- Retain a copy of the certificate and provide it upon request to FTB.

This bill would provide rules for aggregating affiliated employers for purposes of determining the credit. This bill would require that the credit be calculated by using a trade or business' proportionate share of qualified wage expenses. In addition, for any calendar year ending after an acquisition of a major portion of a trade or business of another employer or of a separate unit, the employment relationship between a qualified employee and an employer would not be treated as terminated if the qualified employee continues to be employed in that trade or business.

This provision would disallow the credit for any wages that were subject to any other credit or deduction.

This bill would allow the credit to be carried over to future years until exhausted.

IMPLEMENTATION CONSIDERATIONS

The term “wages” is undefined. The absence of a definition to clarify “wages” could lead to disputes with taxpayers and would complicate the administration of this credit. It is recommended to limit creditable wages to wages subject to California’s Unemployment Insurance Code.

This provision would allow a credit for wages paid during a taxable year to any qualified employee without regard to the individual’s hire date. If it is the author’s intention to provide an incentive to employer’s to expand their existing workforce, the author may wish to amend this bill to limit the credit to qualified employees hired on or after a specified date.

This bill is silent on the timing of obtaining the voucher from EDD or requiring the credit to be reported on an original return. This could result in an increase in amended returns claiming the credit that this provision would allow. If it is the author’s intention to provide an incentive for future behavior, the author may wish to amend this bill.

TECHNICAL CONSIDERATIONS

This bill provides rules for aggregating affiliated employers for purposes of determining an employee tax credit. Because this bill lacks language to limit the number of employees and the amount of wages paid per employer, the rules for aggregating employers are unnecessary. It is recommended that the bill be amended to delete these provisions.

It appears that the author intends to limit this credit to the payment of California wages. If this is the author’s intent, it is recommended to limit the creditable wages to wages subject to California’s Unemployment Insurance Code.

Subdivision (a) of sections 17053.76 and 23622.9 need to be amended where the term "taxpayer" appears, as it should be "qualified taxpayer" to correspond to the definition in subdivision (c).

A reference to controlled groups of corporations is irrelevant under the PITL. On page 10, strikeout lines 24-26 that refer to California Revenue and Taxation Code section 23622.9 (e).

LEGISLATIVE HISTORY

AB 340 (Knight, 2009/2010) would have provided a tax credit for a qualified employer in an amount equal to 5 percent of the wages of all qualified employees employed by the qualified employer during the taxable year. This bill failed passage out of the Assembly Revenue and Taxation Committee by the constitutional deadline.

AB 1973 (Swanson, 2009/2010) would provide a tax credit for a qualified employee who is an ex-offender employed as a part-time or full-time. The amount of the credit is equal to 20 percent of the gross salary for a qualified employee. This bill is currently in the Assembly Revenue and Taxation Committee.

AB 2617 (Tran, 2009/2010) would provide a tax credit to a qualified taxpayer for qualified wages in an amount equal to 15 percent of the wages paid or incurred during the taxable year. This bill is currently in the Assembly Revenue and Taxation Committee.

AB 2630 (Emmerson, 2009/2010) would provide a tax credit of $3,000 for each net increase in full-time employees hired during the taxable year by a qualified employer until the state employment rate is 5.5 percent or lower. This bill is currently in the Assembly Revenue and Taxation Committee.

SB 508 (Dutton, 2009/2010) would have provided for a substantially similar credit as this provision, with the exception that SB 508 would have applied to taxable years beginning on or after January 1, 2009. SB 508 failed passage out of the Senate Revenue and Taxation Committee by the constitutional deadline.

SB 612 (Runner, 2009/2010) would have provided a tax credit of $500 per month for each qualified employee employed by a taxpayer. This bill failed passage out of the Senate Revenue and Taxation Committee by the constitutional deadline.

ABX3 15 (Stats. 2009, Ch. 10) and SBX3 15 (Stats. 2009, Ch. 17) established a tax credit of $3,000 for each net job increase.

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.

Florida allows businesses located in an EZ a credit based on wages paid to new employees. Other wage-based credits are offered to businesses that are located in high crime areas or in rural areas.

Illinois allows a job tax credit for taxpayers conducting a trade or business in an EZ or a High Impact Business. The credit is $500 for each eligible employee hired to work in the zone during the tax year. It is available for eligible employees hired on or after January 1, 1986.

Massachusetts allows a Full Employment credit to employers who participate in the Full Employment Program and continue to employ a participant for at least one full month. The taxpayer may claim a credit of $100 per month of eligible employment per participant, up to $1,200 per participant.

Michigan and *Minnesota* do not offer wage credits.

New York allows a wage credit to a business that hires a full time employee (either one in targeted group or not) for a newly created job in an Empire Zone.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This provision would result in the following revenue losses:

Estimated Revenue Impact of Provision 2: Employer Wage Credit For Taxable Years Beginning On or After January 1, 2010 Enactment Assumed By September 30, 2010 ($ in Millions)			
Fiscal Year	**2010-11**	**2011-12**	**2012-13**
Breakdown of Individual Components			
Employer Wage Credit	-$3,500	-$4,000	-$3,600
Overlap of Both Credits (Interaction Offset)	+$220	+$240	+$220
Extend New Jobs Credit	-$1,100	-$1,200	-$1,100
Combined Revenue Effects of BOTH jobs credit provisions			
Fiscal Year	**2010-11**	**2011-12**	**2012-13**
Sum of Employer Wage Credit and Employer Hiring Credit	**-$4,400**	**-$5,000**	**-$4,500**

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

ARGUMENTS/POLICY CONCERNS

This provision lacks a sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of the credit by the Legislature.

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

PROVISION 3: EMPLOYER HIRING CREDIT

OPERATIVE DATE

This provision would be specifically operative for taxable years beginning on or after January 1, 2010.

ANALYSIS

FEDERAL/STATE LAW

Current federal law allows employers who hire employees from a "targeted group," as defined, to elect to claim a work tax opportunity credit (WOTC).[5] The credit is equal to 40 percent of the qualified first-year wages for that year. The amount of the qualified first-year wages that may be taken into account with respect to any individual shall not exceed $6,000 per year ($12,000 per year in the case of any individual who is a qualified veteran).

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.

Under the Government Code, state law provides for several types of geographically targeted economic development areas (G-TEDAs): Enterprise Zones (EZs), Manufacturing Enhancement Areas (MEAs), Targeted Tax Areas (TTAs), and Local Agency Military Base Recovery Areas (LAMBRAs).

Under the Revenue and Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within a G-TEDA. These incentives include a hiring credit, sales or use tax credit, business expense deduction, and special net operating loss treatment. Two additional incentives include net interest deduction for businesses that make loans to businesses within G-TEDAs and a tax credit for employees working in an EZ.

Hiring Credit: A business located in a G-TEDA 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 a G-TEDA and meet certain other criteria. At least 90 percent of the qualified employee's work must be directly related to a trade or business located in the G-TEDA and at least 50 percent of the employee's services must be performed inside the G-TEDA.

[5] Internal Revenue Code (IRC) 51

The credit is based on the lesser of the actual hourly wage paid or 150 percent of the current minimum hourly wage (under special circumstances for the Long Beach EZ, the maximum is 202 percent 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.

Current law allows a tax credit for taxable years beginning on or after January 1, 2009, for a qualified employer in the amount of $3,000 for each qualified full-time employee hired in the taxable year, determined on an annual full-time equivalent basis. The credit is allocated by the Franchise Tax Board (FTB) and has a maximum cap of $400 million for all taxable years. The credit remains in effect until December 1 of the calendar year after the year in which the cumulative credit limit has been reached and is repealed as of that date. Any credits not used in the taxable year may be carried forward up to eight years.

THIS PROVISION

Beginning on or after January 1, 2010, this provision would modify the employer hiring credit as follows:

- Replace the term "qualified taxpayer" with "taxpayer," thus expanding eligibility for the credit of $3,000 for each net increase in qualified full-time employees hired during the taxable year to all taxpayers;
- Redefine the calculation of the net increase in qualified full-time employees, as specified;
- Eliminate the requirement that the credit be claimed on an original return;
- Eliminate the $400 million cap on the total aggregated employer hiring credit;
- Reduce the credit by wages that would be subject to any other credit or deduction; and
- Eliminate the sunset date for this credit.

IMPLEMENTATION CONSIDERATION

Because a trade or business can be acquired only once, employees of a trade or business acquired during the preceding taxable year would in subsequent taxable years, be categorized as employed by the qualified taxpayer. As a result, the modification that would include employees of a trade or business acquired in a preceding year in the calculation of the increase in full-time equivalents could result in an erroneous base amount of qualified employees. It is recommended that this bill be amended to refer to acquisitions in the current taxable year.

This provision would, for taxable years beginning on or after January 1, 2010, eliminate the existing $400 million cap on the total amount of credit that could be allowed. This could result in credits for taxable year 2009 being denied if the cap is exceeded during taxable year 2009. The author may wish to eliminate the cap for taxable years 2009 to eliminate the possibility of the credit being disallowed for a partial taxable year.

Because this provision would eliminate the requirement that the credit be reported on an original return, this provision could reward existing behavior rather than providing an incentive to influence prospective taxpayer behavior. If it is the author's intent to incentivize future behavior, then the author may wish to amend this bill to maintain the requirement that the credit be reported on an original return.

TECHNICAL CONSIDERATIONS

Under this provision, the credit would be disallowed for any wages for which any other credit or deduction had been claimed. If it is the author's intent to preclude taxpayers from claiming multiple tax benefits based on wages paid or incurred, it is suggested that this provision be amended for consistency with existing tax credit carryover language.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This provision would result in the following revenue losses:

Estimated Revenue Impact of Provision 3: Employer Hiring Credit For Taxable Years Beginning On or After January 1, 2010 Enactment Assumed By September 30, 2010 ($ in Millions)			
Fiscal Year	**2010-11**	**2011-12**	**2012-13**
Breakdown of Individual Components			
Employer Wage Credit	-$3,500	-$4,000	-$3,600
Overlap of Both Credits (Interaction Offset)	+$220	+$240	+$220
Employer Hiring Credit	-$1,100	-$1,200	-$1,100
Combined Revenue Effects of BOTH jobs credit provisions			
Fiscal Year	**2010-11**	**2011-12**	**2012-13**
Sum of Employer Wage Credit and Employer Hiring Credit	**-$4,400**	**-$5,000**	**-$4,500**

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

ARGUMENTS/POLICY CONCERNS

This provision would eliminate the existing sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of the credit by the Legislature.

PROVISION 4: DEPRECIATION DEDUCTION RECOVERY PERIOD

OPERATIVE DATE

This provision would be specifically operative for property placed in service before, on or after January 1, 2010.

ANALYSIS

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. 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.

FEDERAL/STATE LAW

Existing federal law uses the Modified Accelerated Cost Recovery System (MACRS) for property placed in service after 1986. Under MACRS, the depreciation deduction is computed using the “applicable depreciation method,” the “applicable recovery period,” and the “applicable convention.” MACRS provides three applicable depreciation methods: (1) 200 percent declining balance, (2) 150 percent declining balance, and (3) straight-line. The applicable recovery period ranges from 3 to 50 years, depending on the type of property. The applicable convention requires that property placed in service be treated as placed in service on the mid-point of one of the following three methods: (1) the taxable year (half-year convention), (2) the month (mid-month convention), or (3) the quarter (mid-quarter convention).

Existing federal law provides an alternative depreciation system (ADS), which generally provides longer recovery periods than the standard MACRS recovery periods and requires use of the straight-line depreciation method. Six types of property are subject to ADS: (1) tangible property used predominantly outside the United States, (2) tax-exempt use property, (3) tax-exempt bond financed property, (4) imported property covered by an Executive Order, (5) property for which the taxpayer has made an election, and (6) any plants produced in a farming business for which the taxpayer has made an election to exempt the crop from the uniform capitalization rules.

Under the existing PITL, California generally conforms to the federal MACRS and ADS. Existing state CTL does not conform to the federal MACRS or ADS. Instead, property must be depreciated over its estimated useful life, which is the period over which the asset may reasonably be expected to be useful in the trade or business. Taxpayers may elect to use the useful life specified under the federal Class Life Asset Depreciation Range System (ADR). ADR groups assets into more than 100 classes and assigns an asset guideline period, or useful life, to each class. For purposes of grapevines (in the agricultural class), the ADR asset guideline period is ten years.

Current California law uses the following depreciation methods for tangible property:

1. Straight-line method;
2. 200 percent declining balance method;
3. Sum of the years-digit method; and
4. Any other consistent method productive of an annual allowance that, when added to all allowances for the period commencing with the taxpayer's use of the property, exceed the total of those allowances that would have been used had those allowances been computed under the 200 percent declining balance method.

Methods under (2), (3), and (4) above may be used for tangible property with a useful life of three or more years.

THIS PROVISION

This provision would, for property placed in service before, on, or after January 1, 2010, reduce the depreciation recovery period to one half of the applicable recovery period under specified provisions of the IRC or one half the recovery period under current state law. For property placed in service before January 1, 2010, the remaining applicable recovery period shall be one half of the applicable recovery period under specified provisions of the IRC or one half the recovery period under current state law.

IMPLEMENTATION CONSIDERATIONS

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

Because this bill would reset the remaining depreciation recovery period for any property placed in service before January 1, 2010, to one half of the applicable recovery period under federal or state law, the recovery period for any asset that has been depreciated for more than half of the current recovery period would be extended. For example, if a 10 year asset had been depreciated for 8 years, the remaining 2 year recovery period would be extended to 5 years. If it is the author's intention to reduce by one half the remaining recovery period, (e.g., from 2 years to 1 year in the example above), for assets placed in service before the effective date of this provision, this provision should be amended.

It is unclear whether this provision would allow a taxpayer to select from the depreciation methods under IRC 167, IRC 168, or state law. It is suggested that this provision be amended for clarity.

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.

Florida conforms to the IRC as amended on January 1, 2007. *Florida* does not impose a personal income tax. For corporations, Florida conforms to the federal depreciation rules that were in effect as of January 1, 2007.

Illinois automatically conforms each taxable year to the IRC, and generally conforms to the federal depreciation rules except that bonus depreciation is not allowed.

Massachusetts conforms to the IRC as of January 1, 2005, and generally conforms to the federal depreciation rules except that bonus depreciation is not allowed.

Michigan automatically conforms each taxable year to the IRC, and the depreciation rules are the same as the federal rules.

Minnesota conforms to the IRC as amended through May 18, 2006, and generally conforms to the federal depreciation rules except that bonus depreciation is not allowed.

New York automatically conforms each taxable year to the IRC, and the depreciation rules are generally the same as the federal rules, with modifications to bonus depreciation.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

This provision would result in the following revenue losses:

Estimated Revenue Impact of **PROVISION 4: Depreciation Deduction Recovery Period** Operative for Tax Years Beginning On or After January 1, 2010 Assumed Enactment Date By September 30, 2010 ($ in Millions)			
	2010-11	2011-12	2012-13
Revenue Impact	-$1,575	-$1,150	-$850

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

<u>PROVISION 5: NET OPERATING LOSS (NOL) CARRYBACK</u>

OPERATIVE DATE

This provision would be specifically operative with respect to NOLs attributable to taxable years beginning on or after January 1, 2011.

ANALYSIS

When a taxpayer has an operating loss for the taxable year, the operating loss that may be used in other years is called an NOL. An operating loss occurs when a taxpayer's allowed deductions exceed their gross income for that year.

FEDERAL/STATE LAW

Federal law provides, in general, that an NOL can be carried back 2 years and forward 20 years and deducted. Special rules are provided for the carryback of NOLs relating to issues such as specified liability losses, casualty or theft losses, disaster losses of a small business, and farming losses.

Recent changes in federal law extend the carryback period up to five years for specified losses as described below.

The American Recovery and Reinvestment Act allows certain taxpayers to make an irrevocable election to carry back applicable 2008 losses for up to five years (the normal carryback period is two years). The "applicable 2008 losses" are losses incurred in one taxable year that either begins or ends in 2008 by eligible small businesses (those whose average gross receipts are equal to or less than $15 million over a three-year period).

The Worker, Homeownership, and Business Assistance Act of 2009 allows taxpayers, other than taxpayers that received benefits under the Troubled Asset Relief Program, with business losses to make an irrevocable election to carry back losses incurred in one year (ending after 2007 and beginning before 2010) for up to five years.

In general, a California taxpayer calculates its NOL in accordance with federal rules. For NOLs attributable to taxable years beginning before January 1, 2011, NOL carrybacks are disallowed. NOLs attributable to taxable years beginning on or after January 1, 2008, may be carried forward 20 years. California conforms to the federal NOL carryback rules for NOLs attributable to taxable years beginning on or after January 1, 2011, with the following modifications:

1. An NOL may be carried back only two years.
2. The amount of NOL carryback attributable to taxable year 2011 is limited to 50 percent of the NOL.
3. The amount of NOL carryback attributable to taxable year 2012 is limited to 75 percent of the NOL.

Current state law conforms to the federal carryback period for a Real Estate Investment Trust (REIT) and a corporate equity reduction interest loss, which is zero.

THIS PROVISION

This provision would allow 50 percent of an NOL attributable to a taxable year beginning on or after January 1, 2011, and before January 1, 2012, and 100 percent of an NOL attributable to a taxable year beginning on or after January 1, 2012, to be carried back to the two preceding taxable years.

This provision would also modify the rules for determining whether a trade or business qualifies as a new business for purposes of the NOL by replacing the reference to the SIC Manual with a reference to the NAICS, as specified.

IMPLEMENTATION CONSIDERATIONS

Because this provision would modify the rules for determining whether a trade or business qualifies as a new business for taxable years beginning on or after January 1, 2010, this change could result in the extension of NOL carryover periods for NOLs attributable to prior taxable years. If this is not the author's intent, the author may wish to amend this provision to apply to NOLs attributable to taxable years beginning on or after January 1, 2010.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This provision would result in the following revenue losses:

Estimated Revenue Impact of **PROVISION 5: Net Operating Loss Carryback** Operative for Tax Years Beginning On or After January 1, 2010 Assumed Enactment Date By September 30, 2010 ($ in Millions)			
	2010-11	2011-12	2012-13
Revenue Impact	-$2	-$9	-$12

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

PROVISION 6: EXCLUDE CAPITAL GAINS FROM GROSS INCOME

EFFECTIVE/OPERATIVE DATE

This provision would be operative for taxable years beginning on or after January 1, 2010.

ANALYSIS

Gross income means all income from whatever source derived, including gains from dealings in capital assets, unless specifically excluded.

FEDERAL/STATE LAW

IRC sections 1201 through 1257 provide the rules governing the tax treatment of capital gains and losses, identifying holding periods, and determining the gain or loss from the sale or exchange of a capital asset. In general, property held for personal use or investment purposes is a capital asset.[6] Examples of capital assets include held-for-investment stocks and securities as well as an owner-occupied personal residence. Property used in a taxpayer's trade or business is not a capital asset.

When a capital asset is sold, the difference between the selling price and the asset's adjusted basis, which is usually what was paid for the asset, is a capital gain or loss.

California generally follows the federal rules for defining capital assets, identifying holding periods, and determining the gain or loss from the sale or exchange of a capital asset with the following exceptions:

- Capital gains are taxed at ordinary income tax rates under PITL,
- Small business stock exclusion equals 50 percent,
- Small business stock exclusion rules require certain California activity, and
- 50 percent of the excluded small business stock gain is an alternative minimum tax preference item.

THIS PROVISION

This provision would exclude from gross income, the gain from the sale or exchange of any capital asset.

The definition of "capital asset" under section 1221 of the IRC would apply to this provision.

IMPLEMENTATION CONSIDERATIONS

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

This provision has no requirement for the netting of capital gains and losses before determining the amount of capital gain exclusion. This conflicts with current federal and state laws relating to capital gains and losses. If the intent of the author is to maintain the current netting rules for capital gains and losses, amendments would be necessary.

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[6] Internal Revenue Code (IRC) section 1221(a).

LEGISLATIVE HISTORY

SB 472 (Dutton, 2009/2010) would amend PITL and CTL and allow a 50 percent exclusion from gross income for any gain from the sale or exchange of a capital asset held for more than three years. SB 472 is currently in the Senate Revenue and Taxation Committee.
SB 568 (Hollingsworth, 2009/2010) would apply to PITL and CTL and allow a taxpayer to elect to pay a 2 percent tax on any "net capital gain" as defined under federal law. This bill is currently in the Senate Revenue and Taxation Committee.

OTHER STATES' INFORMATION

The laws of *Florida*, *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York* were reviewed because their tax laws are similar to California's tax laws. Review found that these states generally follow the federal capital gain rules for excluding certain capital gains from gross income.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This provision would result in the following revenue losses:

Estimated Revenue Impact of **PROVISION 6: Exclude Capital Gains From Gross Income**

Operative for Tax Years Beginning On or After January 1, 2010
Assumed Enactment Date By September 30, 2010
($ in Millions)

	2010-11	2011-12	2012-13
Revenue Impact	-$9,900	-$5,200	-$8,100

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

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