Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Gorell and Bradford	Analyst:	Dawn Hadid	Bill Number:	AB 1326
Related Bills:	See Legislative History	Telephone:	845-3391	Introduced Date:	February 22, 2013
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Employer Qualified Wages Credit\Unmanned Aerial Vehicle Manufacturing

SUMMARY

This bill would create a tax credit under Personal Income Tax Law and Corporation Tax Law for wages paid by employers to qualified employees that produce unmanned aerial vehicles (drones).

This analysis will not address the bill's changes to the Sales and Use Tax Law, as they do not impact the department or state income or franchise tax revenue.

RECOMMENDATION

No position.

REASON FOR THE BILL

The reason for the bill is to encourage drone manufacturing to stimulate job creation and the economy via a tax credit.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on and after January 1, 2014, and before January 1, 2024.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

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.

Additionally, current state and federal laws generally allow taxpayers engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business.

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Current federal law allows employers who hire employees from a "targeted group," as defined, to elect to claim a work opportunity tax credit.[1] 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 is limited to $6,000 per year ($12,000-$24,000 per year in the case of any individual who is a qualified veteran).

Under current state tax law, the New Jobs Credit allows a credit to 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 has a cap of $400 million for all taxable years. The FTB is responsible for determining the cut-off date (the last day of the quarter in which the $400 million cap will be reached), after which claims for the credit will no longer be allowed. 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.

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

Under the Revenue and Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within a targeted area. 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 targeted areas and a credit for employees working in a Zone.

Hiring Credit: A business located in a targeted area 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 targeted area 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 targeted area and at least 50 percent of the employee's services must be performed inside the targeted area.

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 Zone, 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.

THIS BILL

This bill would allow a tax credit for each taxable year beginning on or after January 1, 2014, and before January 1, 2024, based on the following percentage of the qualified wages paid to employees for drone manufacturing in this state:

- Fifty percent of qualified wages paid or incurred beginning on or after January 1, 2014, and before January 1, 2016.

[1] Internal Revenue Code (IRC) 51-Work Opportunity Tax Credit

- Forty percent of qualified wages paid or incurred beginning on or after January 1, 2016, and before January 1, 2018.
- Thirty percent of qualified wages paid or incurred beginning on or after January 1, 2018, and before January 1, 2020.
- Twenty percent of qualified wages paid or incurred beginning on or after January 1, 2020, and before January 1, 2022.
- Ten percent of qualified wages paid or incurred beginning on or after January 1, 2022, and before January 1, 2024.

This bill would define “qualified taxpayer” as any taxpayer engaged in aircraft manufacturing described in Industry Group 336411 of the 2012 North American Industry Classification System (NAICS), that manufactures drones.

This bill would define “qualified employee” as an individual whose services for the qualified taxpayer are performed in this state and are at least 90 percent directly related to the qualified taxpayer’s line of business described in Industry Group 336411 of the 2012 NAICS, that manufactures drones.

This bill would define “qualified wages” as that portion of wages paid or incurred by the qualified taxpayer during the taxable year with repect to qualified employees that are direct costs as defined in Section 263A of the Internal Revenue Code allocable to property manufactured in this state by the qualified taxpayer.

Under the provisions of this bill, the credit is allowed to Personal Income Tax Law taxpayers and Corporate Tax Law taxpayers. The maximum credit per year, per qualified employee would be $20,000. In the case of a qualified employee that was employed for part of a taxable year, the maximum credit per year, would be $20,000 multiplied by the fraction that is the number of months that the employee was a qualified employee divided by twelve.

The unused credit may be carried over up to eight years.

This bill would authorize the FTB to prescribe rules, guidelines, or procedures to administer the credit.

The credit would be repealed by its own terms as of December 1, 2024.

IMPLEMENTATION CONSIDERATIONS

The bill defines a qualified employee as an individual whose services for the qualified taxpayer are performed in this state and are at least 90 percent directly related to the qualified taxpayer’s line of business. However, the bill fails to define “directly related,” which could lead to disputes between taxpayers and the department regarding whether an employee would qualify for the credit. It is also unclear whether this requirement is designed to prevent non-manufacturing jobs (i.e., administrative, accounting, legal, or secretarial) from qualifying for this credit. The author may wish to amend the bill for clarity.

Department staff is available to work with the author’s office to resolve these and other concerns that may be identified.

<u>TECHNICAL CONSIDERATIONS</u>

Section 3, subdivision (d) needs to be amended where the word “net tax” appears, as it should be “ tax” as defined in the Revenue and Taxation Code 23036.

Section 3, Subdivision (a) needs to be amended where the year “2013” appears, as it should be “2014” and where the year “2023” appears, amended to “2024” for consistency.

LEGISLATIVE HISTORY

AB 927 (Muratsuchi, 2013) would create a tax credit for an aerospace employer that hires certain new employees. AB 927 is currently in the Assembly Revenue and Taxation Committee.

SB 414 (Knight, 2013) would create two income tax credits for qualified employers engaged in the aerospace sector. The first tax credit would be for costs paid to reimburse qualified employees for tuition costs. The second tax credit would be for wages paid to certain qualified employees that receive an undergraduate or graduate degree in the state. SB 414 is currently in the Senate Governance and Finance Committee.

AB 2365 (Correa, 2004) would have created an income tax credit for taxpayers that increase the number of manufacturing jobs in California. AB 2365 was held in the Assembly Committee on Appropriations.

AB 2304 (Wyman, 2002) would have created an income tax credit for wages paid by an employer for work performed on items installed in aircraft. AB 2304 was held 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.

Florida allows businesses located in an Enterprise Zone 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.

Minnesota allows business located in a Job Opportunity Building Zone, and a Biotechnology and Health Sciences Industry Zone a credit based in part on wages paid to individuals working within the zone.

New York allows certified taxpayers that meet set requirements in an Empire Zone, and a Zone Equivalent Area a credit based on wages.

Massachusetts and *Michigan* do not offer wage credits.

FISCAL IMPACT

Department staff is unable to determine the costs to administer this bill until the implementation concerns have been resolved.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Estimated Revenue Impact of AB1326 As Introduced February 22, 2013 For Taxable Years Beginning On or After January 1, 2014 Assumed Enactment After June 30, 2013 ($ in Millions)		
2013-14	2014-15	2015-16
-$31	-$40	-$60

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

LEGAL IMPACT

This bill would restrict wages included in the calculation of the credit to wages paid for services performed in California. This bill could raise constitutional concerns under the Commerce Clause of the United States Constitution because it could appear to improperly favor in-state activity over out-of-state activity. On August 28, 2012, (*Cutler* v. Franchise Tax Board), the Court of Appeal issued a unanimous opinion holding that California's Qualified Small Business Stock statutes were unconstitutional. Specifically, the Court of Appeal held that the statutory scheme's requirement of a large California presence in order to qualify for an investment incentive discriminated against interstate commerce, and therefore violated the federal dormant commerce clause. While no court decision has yet invalidated, as a general matter, state income tax credits that provide an incentive for in-state activity, i.e., property placed in service in the state, employees employed in the state, etc., targeted tax credits such as the one proposed by this bill may be subject to constitutional challenge.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some could argue that this bill would stimulate job creation by offering a tax incentive to taxpayers that have the ability to employ new workers and expand their current workforce.

Opponents: Some may argue that this bill fails to stimulate job creation because the employer could receive the credit for employees that are currently on the payroll.

POLICY CONCERNS

This bill would allow a credit for wages that are currently deductible as business expenses. Generally, a credit is allowed in lieu of any deduction or credit already allowable for the same item of expense in order to eliminate multiple tax benefits for the same item of expense.

Tax credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake. This bill could incentivize behavior that has occurred in the past because the bill fails to specify the date that an individual must begin employment with the qualified employer in order to be considered a qualified employee. As a result, a qualified employer may be eligible for a credit for all or part of their existing workforce.

LEGISLATIVE STAFF CONTACT

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