ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author:	Gorell	Analyst:	Narinder Dosanjh	Bill Number:	AB 1997
Related Bills:	See Legislative History	Telephone:	845-5275	Amended Date:	April 1, 2014
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Employer Qualified Wages Credit\Unmanned Aerial Vehicle Manufacturing

SUMMARY

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

This bill would also make changes to the Sales and Use Tax Law. These changes do not affect the department and are not discussed in this analysis.

RECOMMENDATION

No position.

Summary of Amendments

The April 1, 2014, amendments removed intent language and added the provisions discussed in this analysis. This is the department's first analysis of the bill.

REASON FOR THE BILL

The purpose of the bill is to encourage drone manufacturing to stimulate job creation and the economy.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and would be specifically operative for taxable years beginning on and after January 1, 2015, and before January 1, 2025.

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.[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).

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

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Under current state tax law, the New Employment Credit allows a credit to a qualified employer for each qualified full-time employee hired in the taxable year to perform work in a Designated Geographic Area.

A qualified taxpayer must provide the Franchise Tax Board (FTB) with an annual certification with respect to each qualified full-time employee hired in a previous taxable year, on or before the 15th day of the third month.

Generally, the credit allowed is calculated as 35 percent of qualified wages multiplied by the net increase in qualified employees measured on an annual full time equivalent basis.

The qualified employer may claim the credit for employees hired on or after January 1, 2014, in taxable years beginning on or after January 1, 2014, and before January 1, 2021. Any credits not used in the taxable year may be carried forward up to five years.

THIS BILL

This bill would allow a tax credit for a qualified taxpayer who hires a qualified employee in taxable years beginning on or after January 1, 2015, and before January 1, 2025, based on the following percentage of the qualified wages paid:

- 50 percent of qualified wages paid or incurred beginning on or after January 1, 2015, and before January 1, 2017.
- 40 percent of qualified wages paid or incurred beginning on or after January 1, 2017, and before January 1, 2019.
- 30 percent of qualified wages paid or incurred beginning on or after January 1, 2019, and before January 1, 2021.
- 20 percent of qualified wages paid or incurred beginning on or after January 1, 2021, and before January 1, 2023.
- 10 percent of qualified wages paid or incurred beginning on or after January 1, 2023, and before January 1, 2025.

This bill would define "qualified taxpayer" as any taxpayer that is primarily engaged in aircraft manufacturing described in Industry Group 336411[2] of the 2012 North American Industry Classification System (NAICS) that manufactures unmanned aerial vehicles.

This bill would define "qualified employee" as an individual who is hired by the qualified taxpayer during the taxable year, 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, manufacturing unmanned aerial vehicles.

[2] Aircraft Manufacturing: establishments primarily engaged in one or more of the following: (1) manufacturing or assembling complete aircraft; (2) developing and making aircraft prototypes; (3) aircraft conversion (i.e. major modifications to systems); and (4) complete aircraft overhaul and rebuilding (i.e. periodic restoration of aircraft to original design specifications).

This bill would define "qualified wages" as that portion of wages paid or incurred by the qualified taxpayer during the taxable year with respect 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.

The amount of credit that would be allowed by this bill would be limited to $20,000 per year, per qualified employee. 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 a fraction, that is the number of months that the employee was a qualified employee divided by twelve.

Any unused credit may be carried over up to eight years. The credit allowed by this bill would be in lieu of any other credit or deduction that the qualified taxpayer may otherwise be allowed.

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, 2025.

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.

The bill defines a qualified employee as an individual whose services for the qualified taxpayer are "at least 90 percent directly related" to the qualified taxpayer's line of business. It is unclear what "directly related" is intended to include which could lead to disputes between taxpayers and the department. Further, it is unclear how the 90 percent qualification could be measured. It is recommended the bill be amended for clarity.

The bill defines qualified taxpayer as any taxpayer that is "primarily" engaged in aircraft manufacturing. The absence of definition to clarify the term "primarily" could lead to disputes with taxpayers and would complicate the administration of this credit.

This bill would allow a tax credit for a qualified taxpayer that hires a qualified employee in the taxable year only. If this is contrary to the author's intention, this bill should be amended.

This language of the bill states, "this credit shall be in lieu of any other credit or deduction that the qualified taxpayer may otherwise be allowed pursuant to this part." This could be interpreted to mean that a taxpayer claiming this credit cannot get any other deduction or credit otherwise allowed, even if the deduction or credit is unrelated to the expenditures that provide the basis for this credit. For example, no deduction for wages, pension contributions, depreciation, etc. and no Research and Development (R&D) credit for unrelated R&D expenses. If this is contrary to the author's intent, the bill should be amended to clarify that expenses incurred to generate the credit may not be allowed in the calculation of another credit or as a deduction.

LEGISLATIVE HISTORY

AB 927 (Muratsuchi, 2013/2014) 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.

AB 1326 (Gorell and Bradford, 2013/2014) would have created an income tax credit for wages paid by an employer to produce unmanned aerial vehicles. AB 1326 was held in the Assembly Committee on Appropriations.

SB 414 (Knight, 2013/2014) 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.

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

The costs to administer this bill have yet to be determined. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Estimated Revenue Impact of AB1997* As Amended April 1, 2014 Assumed Enactment After June 30, 2014 ($ in Millions)				
2014-15	2015-16	2016-17	2017-18	2018-19
- $12.0	- $15.0	- $16.0	- $12.0	- $7.9

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

*This analysis assumes that the expense used to generate this credit may not be allowed in the calculation of another credit or taken as a deduction.

LEGAL IMPACT

This bill would restrict the tax credit to unmanned aerial vehicle manufacturers located 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 incentives to stimulate job creation should be more broadly available than this bill would allow.

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