Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Wyland	Analyst:	David Scott	Bill Number:	SB 235
Related Bills:	See Legislative History	Telephone:	845-5806	Amended Date:	April 1, 2013
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Depreciation Deduction Recovery Period/Exclusion Gain From Sale of Capital Asset/New Jobs Credit/ Research Expenses Credit 20% of Excess Qualified Expenses/Conformity to Election of Alternative Incremental Credit/New Jobs Credit

SUMMARY

This bill would make changes to the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL) to do the following:

Provision #1: Research Expense Credit

This provision would modify the current Research Expense Credit (R&D Credit) by changing the rates used for the general rule for the R&D credit and for the Alternative Incremental Credit (AIC).

Provision #2: Jobs Credit

This provision would create a tax credit for wages paid or incurred by a taxpayer to certain employees.

Provision #3: New Jobs Credit Revisions

This provision would make a number of modifications to the existing New Jobs Credit.

Provision #4: Net Operating Loss Carryback

This provision would revise the applicable percentage of a net operating loss (NOL) allowed to be carried back from a taxable year beginning on or after January 1, 2014.

Provision #5: Depreciation Deduction Recovery Period

This provision would generally allow taxpayers to depreciate property twice as fast as is currently allowed under federal or state law.

Provision #6: Capital Gains

This provision would exclude capital gains from a taxpayer's gross income.

RECOMMENDATION

No position.

Board Position:			Executive Officer	Date
_______ S	_______ NA	___X___ NP		
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Summary of Amendments

The April 1, 2013, amendments added the six provisions discussed in this analysis. The bill as introduced on February 12, 2013, would add a provision to the sales and use tax law. This is the department's first analysis of the bill. This analysis only addresses the provisions of this bill that impact the department's programs and operations.

REASON FOR THE BILL

The reason for this bill is to encourage job creation and investment in California.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of SB 235 As Amended on April 1, 2013 For Taxable Years Beginning On or After January 1, 2014 Enactment Assumed After June 30, 2013 ($ in Millions)					
Fiscal Year	2013-14	2014-15	2015-16	2016-17	2017-18
Provision #1 - Research Credit	- $150	- $90	- $180	- $190	- $190
Provisions #2 & #3 - New Jobs and Targeted Employees Credit	- $900	- $3,600	- $5,000	- $4,600	- $4,800
Provision #4 - NOL Carryback	$0	- $1	- $13	+ $4	+ $4
Provision #5 - Accelerated Depreciation	- $1,000	- $2,200	- $2,000	- $1,500	- $1,300
Provision #6 - Capital Gains Exclusion	- $4,500	- $3,500	- $5,500	- $5,500	- $6,000
Total Impact (Rounded)*	**- $6,500**	**- $9,500**	**- $13,000**	**- $12,000**	**- $12,000**

*May not add due to rounding.

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

PROVISION #1
Research Expense Credit

EFFECTIVE/OPERATIVE DATE

As a tax levy, this provision would be effective immediately upon enactment. The general rate change provision would be specifically operative for taxable years beginning on or after January 1, 2014. The rate change to the AIC would be specifically operative for taxable years beginning on or after January 1, 2010.[1]

[1] The bill language has the operative date for the rate increase beginning on or after January 1, 2010. Then the same paragraph says that the AIC election is operative beginning on or after January 1, 2014. A technical consideration has been added to this analysis for this issue.

ANALYSIS

FEDERAL/STATE LAW

Federal 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 is determined as the sum of the following two components:

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.

For taxable years beginning before January 1, 2008, instead of determining the credit based on 20 percent of qualified research expenses in excess of a base amount, a taxpayer could elect to calculate the credit using a method referred to as the AIC using graduated percentages of 3 percent, 4 percent, and 5 percent, as applied to a percentage of expenses in excess of a specified percentage of average annual gross receipts. This method is no longer available for federal purposes.

Corporate taxpayers, in addition to the two components listed above, are allowed to include 20 percent of expenses paid to fund basic research at universities and certain nonprofit scientific research organizations.

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 was extended through 2013.[2]

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[2] American Taxpayer Relief Act of 2012, (Public Law 112-240).

State Law

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 for the 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.
- Gross receipts is modified to take into account only those gross receipts from the sale of property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business that is delivered or shipped to a purchaser within this state, regardless of freight on board point or any other condition of sale.
- The AIC is available for taxable years beginning on or after January 1, 2008, but the percentages of 3 percent, 4 percent, and 5 percent are reduced to 1.49 percent, 1.98 percent, and 2.48 percent, respectively.

THIS PROVISION

For taxable years beginning on or after January 1, 2014, this provision would do the following:

- Increase the credit rate to 20 percent for qualified research.
- Continue to allow the election of the AIC.

For taxable years beginning on or after January 1, 2010,[3] this provision would do the following:

- Modify the California rates to use the federal percentages rules[4] for the AIC that were in place prior to the termination of the ability to elect the AIC for federal purposes as of January 1, 2009.

IMPLEMENTATION CONSIDERATIONS

The bill, as written, increases the AIC rates, retroactively, to January 1, 2010. This could result in numerous taxpayers filing amended returns to claim the higher rates for returns with open statutes of limitation. If this is not the author's intent this provision should be amended.

TECHNICAL CONSIDERATIONS

On page 9, line 24, the provision revises the rates for the AIC as of January 1, 2010, but allows the AIC election to begin on or after January 1, 2014. If it is the author's intent that these dates should be the same, this provision should be amended.

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[3] The operative date language for the rate increase and the AIC election is inconsistent and could be contrary to the author's intent. A technical consideration discussed this issue in more detail.

[4] Graduated percentages of 3 percent, 4 percent, and 5 percent, as applied to a percentage of expenses in excess of a specified percentage of average annual gross receipts.

LEGISLATIVE HISTORY

SB 500 (Lieu, 2013/2014), a similar bill, would increase the credit amount to 20 percent of the excess qualified research expenses and conform to the federal AIC percentages. SB 500 is currently in the Senate Rules Committee.

AB 1484 (Anderson, 2009/2010), a similar bill, would have increased the credit amount to 20 percent of the excess qualified research expenses and conformed to the federal AIC percentages. AB 1484 failed to pass out of the Assembly by the constitutional deadline.

AB 2278 (Anderson, 2009/2010), a similar bill, would have eliminated the election to use the AIC from the calculation of the research credit and would instead have allowed an election to use the alternative simplified method. AB 2278 failed to pass out of the Assembly by the constitutional deadline.

SB 444 (Ashburn, 2009/2010), a similar bill, would have increased the credit amount to 20 percent of the excess qualified research expenses and conformed to the federal AIC percentages. SB 444 failed to pass out of the Senate by the constitutional deadline.

SB 1239 (Wyland, 2009/2010), a similar bill, would have increased the credit amount to 20 percent of the excess qualified research expenses and conformed to the federal AIC percentages. SB 1239 failed to pass out of the Senate by the constitutional deadline.

SBX6 9 (Dutton, 2009/2010) a similar bill, would have eliminated the election to use the AIC from the calculation of the research credit and would instead have allowed an election to use the alternative simplified method. SBX6 9 failed to pass out of the Senate 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 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 6½ 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: a general nonrefundable credit available to all businesses and a refundable credit allowed to a qualified business for increasing research activities in a biotechnology and health sciences zone. The credit is equal to 5 percent for qualified research expenses up to $2 million. The amount of the 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. *Michigan* does not allow a credit for pharmaceutical research.

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.

FISCAL IMPACT

This provision would require some changes to existing tax forms and instructions and information systems. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of SB 235 Provision #1 As Amended on April 1, 2013 For Taxable Years Beginning On or After January 1, 2014 Enactment Assumed After June 30, 2013 ($ in Millions)					
Fiscal Year	2013-14	2014-15	2015-16	2016-17	2017-18
Research credit	- $150	- $90	- $180	- $190	- $190

PROVISION #2
Jobs Credit

EFFECTIVE/OPERATIVE DATE

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

ANALYSIS

FEDERAL/STATE LAW

Existing federal and state 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.

Current California law allows a New Jobs Tax Credit for taxable years beginning on or after January 1, 2009, for a qualified employer in the amount of $3,000 for each increase in the number of qualified full-time employees hired in the taxable year, determined on an annual full-time equivalent basis.[5] A qualified employer is one that employs 20 or fewer employees. The credit has a cap of $400 million for all taxable years. The Franchise Tax Board (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 statute 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 taxable years.

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 (R&TC), existing state law provides special tax incentives for taxpayers conducting business activities within a G-TEDA including a 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. Any credits not used in the taxable year may be carried forward until they are exhausted.

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[5] ABX3 15 (Stats. 2009, Ch. 10) and SBX3 15 (Stats. 2009, Ch. 17).

Federal and state laws also allow an employer to deduct expenses paid or incurred in the ordinary course of a taxpayer's trade or business, including employee wages and benefits.

The CTL allows the assignment of certain eligible credits to taxpayers that are members of a combined reporting group. "Assignment" refers to the ability of a taxpayer that is a member of a combined reporting group to elect to transfer certain unused credits to a related corporation, as specified. The election to transfer any credit is irrevocable once made and is required to be made on the taxpayer's original return for the taxable year in which the assignment is made.

<u>THIS PROVISION</u>

For taxable years beginning on or after January 1, 2014, this provision would allow a tax credit in an amount equal to the sum of the following percentages of the first $6,000 of wages paid or incurred by a qualified taxpayer during the taxable year to each qualified employee of the qualified taxpayer:

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

This provision 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 or currently receiving unemployment insurance benefits.
    - A person on probation.

- "Qualified taxpayer" means a taxpayer that is a person or entity engaged in a trade or business within California.

This provision would require the taxpayer to do the following:

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

This provision would provide rules for aggregating affiliated employers for purposes of determining the credit. This provision would require that the credit be calculated by using a trade or business' proportionate share of qualified wage expenses. Additionally, 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.

Wages included in the calculation of any deduction or credit otherwise allowed would be excluded from the calculation of the credit this provision would establish.

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

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 provision uses the undefined terms, "wages" and "qualified wages." The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this credit.

This provision is silent as to the length of time a qualified taxpayer is allowed to take a credit for the qualified employee. As a result, the credit would be available on a qualified employee indefinitely, or until the provision ceased to be operative. If this is contrary to the author's intent the provision should be amended.

TECHNICAL CONSIDERATIONS

The definition of "qualified taxpayer" uses the phrase, "taxpayer that is a person or entity engaged in a trade or business within California" which is not clearly worded. Because "taxpayer" in this context includes any individual, fiduciary, estate, or trust subject to the PITL or any partnership, the author may wish to change the phrase to "taxpayer that is engaged in a trade or business within California" which may be less confusing.

This provision provides rules for aggregating affiliated employers for purposes of determining an employee tax credit. Because this provision lacks language to limit the number of employees and the amount of wages paid per employer, the rules for aggregating employers are unnecessary and should be deleted.

LEGISLATIVE HISTORY

AB 234 (Wieckowski, 2011/2012) would have modified the current New Jobs Tax Credit to: (1) increase the types of employers that qualify for the credit, (2) modify the amount of the credit, and (3) change the definition of qualified employee to one that was unemployed for at least 30 days immediately prior to being hiring. AB 234 failed passage out of the Assembly by the constitutional deadline.

AB 1195 (Allen, 2011/2012) would have modified the current New Jobs Tax Credit to increase the allowance of the credit from employers with less than 20 employees to employers with 50 or fewer employees. AB 1195 was held in the Senate Appropriations Committee.

SB 640 (Runner, 2011/2012) would have allowed a tax credit for each qualified employee who received unemployment insurance benefits employed by a qualified taxpayer. SB 640 failed passage out of the Senate Rules Committee by the constitutional deadline.

AB 1973 (Swanson, 2009/2010) would have increased the existing New Jobs Tax Credit from $3,000 to $5,000 for ex-offenders and persons unemployed for 12 consecutive months prior to being hired by a qualified employer. AB 1973 was held in the Senate Appropriations Committee.

AB 2617 (Tran, 2009/2010) would have provided 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. AB 2617 failed passage out of the Assembly Revenue and Taxation Committee by the constitutional deadline.

SB 1056 (Denham, et. al, 2009/2010) would have provided a tax credit in an amount equal to 25 percent of the qualified wages, not to exceed $6,000, paid to employees who are qualified veterans. SB 1056 failed passage out of the Senate Committee on Revenue and Taxation.

SB X6 7 (Denham, et. al, 2009/2010) would have provided a tax credit in an amount equal to 25 percent of the qualified wages, not to exceed $6,000, paid to employees who are qualified veterans. SB X6 7 failed passage out of the Senate Committee on Revenue and Taxation.

SB 508 (Dutton, 2009/2010), SBX6 11 (Dutton, 2009/2010), and SBX8 59 (Dutton, 2009/2010) are identical. These bills would have provided a tax credit for the first $6,000 of wages paid or incurred to an individual documented by the Employee Development Department. SB 508 failed passage out of the Senate Revenue and Taxation Committee by the constitutional deadline; SBX6 11 (Dutton, 2009/2010) failed passage out of the Senate Revenue and Taxation Committee; and SBX8 59 failed passage out of the Senate Rules Committee by the constitutional deadline.

ABX3 15 (Krekorian, Chapter 10, Statutes of 2009) and SBX3 15 (Calderon, Chapter 17, Statutes of 2009) created the New Jobs Tax Credit to provide for a tax credit of $3,000 for each full-time equivalent increase over the prior year.

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.

Illinois allows a credit in an amount equal to 10 percent, but no greater than $1,200 of the gross wages paid by a taxpayer to a qualified veteran in the course of that veteran's sustained employment during the taxable year.

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

This provision would require a calculation for the credit that could require new forms or worksheets to be developed. As a result, this bill could impact the department's printing, processing, and storage costs for tax returns. The additional costs will be developed as the bill moves through the legislative process.

ECONOMIC IMPACT-

The economic impacts of provisions #2 and #3 have been combined and are shown below in the provision #3 analysis.

LEGAL IMPACT

This provision would restrict wages included in the calculation of the credit to wages paid for services performed in California. This provision 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.

PROVISION #3
Revisions to New Jobs Credit

EFFECTIVE/OPERATIVE DATE

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

ANALYSIS

<u>FEDERAL/STATE LAW</u>

Existing federal and state 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.

Current California law allows a New Jobs Tax Credit for taxable years beginning on or after January 1, 2009, for a qualified employer in the amount of $3,000 for each increase in the number of qualified full-time employees hired in the taxable year, determined on an annual full-time equivalent basis.[6] A qualified employer is one that employs 20 or fewer employees. 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 statute 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 taxable years.

THIS PROVISION

This provision would, for taxable years beginning on or after January 1, 2014, modify the existing New Jobs Tax Credit under the PITL and CTL by eliminating the following:

- The definition of "qualified employer," that specifies that the credit is for taxpayers that employed 20 or fewer employees.
- The specified cap of $400 million and all provisions related to tracking the amount of the credit and establishing a cut-off date once the cap is reached.
- FTB's obligation to post data related to the usage of the credit on its website.
- The requirement that the credit may only be claimed on an original timely filed return.

In addition, this provision would alter the calculation of a net increase in full-time employees.

TECHNICAL CONSIDERATIONS

On page 15 of the bill, line 36 the term "employee" was inadvertently struck out and replaced with "taxpayer" in the subparagraph that is defining a "qualified full-time employee" that was salaried. The amendment should have been to change "qualified employer," on line 39 to "qualified taxpayer". This provision should be amended.

On page 17, line 5, and also on page 37, line 28, the phrase "current taxable year" was replaced with the phrase "preceding taxable year". As a result the provision would allow a credit based on the number of employees added as a result of acquiring an existing trade or business. If this is contrary to the author's intent, this provision should be amended.

LEGISLATIVE HISTORY

AB 234 (Wieckowski, 2011/2012) would have modified the current New Jobs Tax Credit to: (1) increase the types of employers that qualify for the credit, (2) modify the amount of the credit to, and (3) change the definition of qualified employee to one that was unemployed for at least 30 days immediately prior to being hiring. AB 234 failed passage out of the Assembly by the constitutional deadline.

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[6] ABX3 15 (Stats. 2009, Ch. 10) and SBX3 15 (Stats. 2009, Ch. 17).

AB 1195 (Allen, 2011/2012) would have modified the current New Jobs Tax Credit to increase the allowance of the credit from employers with less than 20 employees to employers with 50 or fewer employees. AB 1195 was held in the Senate Appropriations Committee.

AB 1596 (Cook, 2011/2012) would have modified the current New Jobs Tax Credit to increase the availability of the credit from employers with less than 20 employees to employers with 50 or less employees. AB 1596 was held in the Assembly Revenue and Taxation Committee.

AB 1973 (Swanson, 2009/2010) would have increased the current New Jobs Tax Credit from $3,000 to $5,000 for ex-offenders and persons unemployed for 12 consecutive months prior to being hired by a qualified employer. AB 1973 was held in the Senate Appropriations Committee.

ABX3 15 (Krekorian, Chapter 10, Statutes of 2009) and SBX3 15 (Calderon, Chapter 17, Statutes of 2009) created the New Jobs Tax Credit to provide for a tax credit of $3,000 for each full-time equivalent increase over the prior year.

PROGRAM BACKGROUND

As of April 6, 2013, the total number of Personal Income Tax and Business Entity returns claiming the New Jobs Tax Credit was 27,417 and the amount of credits claimed totaled $155.5 million. The cut-off date will be the last day of the calendar quarter within which the FTB estimates it will have received timely filed original returns claiming the credit that cumulatively total $400 million.

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, Illinois, Michigan, Minnesota, and *New York* do not provide a credit similar to the New Jobs Tax Credit.

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. A taxpayer may claim a credit of $100 per month of eligible employment per participant, up to $1,200 per participant.

FISCAL IMPACT

This provision would require some changes to existing tax forms and instructions and information systems. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

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.

ECONOMIC IMPACT-Provisions #2 and 3

Revenue Estimate

Estimated Revenue Impact of SB 235 Provisions #2 and #3 As Amended on April 1, 2013 For Taxable Years Beginning On or After January 1, 2014 Enactment Assumed After June 30, 2013 ($ in Millions)					
Fiscal Year	2013-14	2014-15	2015-16	2016-17	2017-18
New Jobs and Targeted Employees Credit	- $900	- $3,600	- $5,000	- $4,600	- $4,800

PROVISION #4
Net Operating Loss (NOL) Carryback

EFFECTIVE/OPERATIVE DATE

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

ANALYSIS

FEDERAL LAW

Federal law generally defines an NOL as the excess of deductions allowed over the gross income.

When a taxpayer has an operating loss for a taxable year, the operating loss that may be deducted in subsequent years is called an NOL. An operating loss occurs when a taxpayer's allowed deductions exceed their gross income for that year. 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. For NOLs arising in tax years ending after December 31, 2007, an eligible small business could elect to increase the NOL carryback period for an applicable 2008 or 2009 NOL from 2 years to 3, 4, or 5 years.

Federal law modifies some of the provisions for the payment of interest and the statute of limitations for assessing additional tax when taxpayers take advantage of NOL carrybacks. In addition, federal law modifies the statute of limitations for assessing additional tax, and the provision for payment of interest on refunds applicable to NOL carrybacks.

STATE LAW

In general, a California taxpayer calculates its NOL in accordance with federal rules. NOLs attributable to taxable years beginning on or after January 1, 2008, may be carried forward 20 years. For NOLs attributable to taxable years beginning before January 1, 2013, NOL carrybacks are unavailable. California conforms to the federal NOL carryback rules for NOLs attributable to taxable years beginning on or after January 1, 2013, with the following modifications:

1. An NOL may be carried back only 2 years. (Federal law has special rules that in some cases allow an NOL to be carried back for a longer period).
2. The amount of an NOL carryback attributable to taxable year 2013 is limited to 50 percent of the NOL.
3. The amount of an NOL carryback attributable to taxable year 2014 is limited to 75 percent of the NOL.
4. The amount of an NOL carryback attributable to taxable year 2015 and thereafter is 100 percent of the NOL.

Generally for taxpayers subject to the Personal Income Tax Law (PITL), NOL deductions were suspended for taxable years 2008 through 2011. For taxable years 2010 and 2011, the suspension applied to taxpayers with modified adjusted gross income of $300,000 or more.

Generally for Corporation Tax Law (CTL) taxpayers, NOL deductions were suspended for taxable years 2008 through 2011. For taxable years 2010 and 2011, the suspension applied to taxpayers with pre-apportioned income of $300,000 or more.

The NOL carryback provisions, in the PITL and CTL, disregard the NOL suspension period and allow taxpayers to carryback a net operating loss, from a taxable year beginning on or after January 1, 2013, two years to a taxable beginning on or after January 1, 2011.

THIS PROVISION

This provision would increase the allowable carryback percentage from 75 percent to 100 percent for NOLs attributable to taxable year 2014.

FISCAL IMPACT

This provision would require some changes to existing tax forms and instructions and information systems. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of SB 235 Provision #4 As Amended on April 1, 2013 For Taxable Years Beginning On or After January 1, 2014 Enactment Assumed After June 30, 2013 ($ in Millions)					
Fiscal Year	2013-14	2014-15	2015-16	2016-17	2017-18
NOL Carryback	$0	- $1	- $13	+ $4	+ $4

PROVISION #5
Depreciation Deduction Recovery Period

EFFECTIVE/OPERATIVE DATE

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

ANALYSIS

"Depreciation" is the term generally used to describe any method of recovering (commonly referred to as "expensing") the cost of an asset, across its useful life, roughly corresponding to normal wear and tear. For tax purposes, "depreciation" is an income tax deduction that allows a taxpayer to recover (i.e., "expense") the cost or other basis of certain property that is used in a business or used in an income-producing activity. Most types of tangible property other than land are depreciable, such as buildings, machinery, vehicles, furniture, and equipment. Likewise, certain intangible property, such as patents, copyrights, and computer software, is depreciable. Taxpayers may also depreciate capital improvements to property that they lease.

Depreciation begins when a taxpayer places property in service for use in a trade or business or for the production of income. The property ceases to be depreciable when the taxpayer has fully recovered the property's cost or other basis or when the taxpayer retires it from service, whichever happens first.

FEDERAL LAW

Prior to 1981, federal tax depreciation somewhat mirrored financial accounting depreciation. The cost of an asset was recovered over the estimated useful life of the asset, using either a constant charge (straight-line) or an accelerated method.

Accelerated Depreciation Methods

Accelerated Cost Recovery System (ACRS)

ACRS was enacted as part of a 1981 federal stimulus act, and it accelerated the rate that the cost of depreciable assets could be recovered; that is, ACRS increased the amount of periodic depreciation associated with a given asset by dividing the asset's cost into fewer periods, thus accelerating the process of depreciation.

Modified Accelerated Cost Recovery System (MACRS)

MACRS replaced ACRS with the passing of the Tax Reform Act of 1986, and is the current cost-recovery system allowed under federal law. MACRS allows a less accelerated rate of recovery than ACRS, but allows a more accelerated rate of recovery than the pre-1891 useful-life rules.

Bonus Depreciation

For certain types of property, federal law has provided temporary periods in which an additional first-year depreciation deduction equal to a percentage of the adjusted basis of the depreciable property is allowed, commonly referred to as “bonus depreciation.” The amount of “bonus depreciation” that may be claimed as an expense in the year an asset is placed in service has varied, ranging from 30 percent to 100 percent of the adjusted basis of the property, depending on the period, and the “bonus depreciation” amount that may be deducted is in addition to the otherwise allowable depreciation deduction of the property. For property placed in service in 2013, the amount of “bonus depreciation” that may be deducted is 50 percent of the property’s adjusted basis.

No Distinction Between Personal Income Taxpayers, S Corporations, or C Corporations

The federal depreciation rules apply to all types of taxpayers, including personal income taxpayers, S corporations, and C corporations.

STATE LAW

California law generally conforms to the federal depreciation rules for personal income taxpayers and S corporations, whereas C corporations are generally required to depreciate property based on its useful life, as discussed below.

Accelerated Depreciation Methods

ACRS

California has never conformed to the federal ACRS depreciation rules.

MACRS

California conforms with modifications to MACRS for personal income taxpayers and S corporations, but has never conformed to MACRS for C corporations.

Bonus Depreciation

California has never conformed to the federal bonus depreciation rules.

Specific California Depreciation Rules

Personal Income Tax

The PITL generally conforms to the federal MACRS rules as in effect on January 1, 2009, with modifications, including the following:

- California does not conform to the MACRS 15-year recovery periods for depreciation of certain leasehold improvements, retail property, and restaurant property;
- California does not conform to the MACRS rules that allow geological and geophysical costs incurred in connection with oil and gas exploration in the United States to be recovered over two years (seven years for major integrated oil companies);
- California does not conform to the MACRS rule that allows motorsports entertainment complexes to be recovered over seven years;
- California does not conform to the MACRS recovery periods for qualified Indian reservation property; and
- California allows a faster recovery period for grapevines replaced due to phylolloxera infestation or Pierce's disease.

S Corporations

S corporations are allowed to use MACRS, with the same modifications that apply to personal income taxpayers.

C Corporations

The CTL generally does not allow use of MACRS for corporate taxpayers. Instead, the CTL allows the use of a depreciation system generally known as the Asset Depreciation Range (ADR) system that, similar to the federal depreciation rules that applied prior to 1981, generally allows tangible property to be depreciated based on its useful life. The ADR system generally requires the use of longer useful lives and fewer accelerated recovery methods than are allowed under MACRS.

<u>THIS PROVISION</u>

This provision would require all California taxpayers to depreciate property using the following recovery periods:

- For property placed in service on or after January 1, 2014, the applicable recovery period would be one-half of the recovery period otherwise allowable under state law, or one-half-of the recovery period allowable under federal law as in effect on January 1, 2009.[7]

  Taxpayers would not be allowed to use one-half of the recovery period of federal bonus depreciation because, under federal law as in effect on January 1, 2009, bonus depreciation expired for taxable years beginning on or after January 1, 2009 (and for certain longer-lived and transportation property, it expired for taxable years beginning on or after January 1, 2010).

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[7] To the extent that California conforms to the federal depreciation rules under IRC sections 167 and 168, California conforms to those sections as of the "specified date" of January 1, 2009; see R&TC sections 17024.5(a)(1)(O) and 23051.5(a)(1).

- For property placed in service before January 1, 2014, taxpayers would be allowed to either to use the remaining recovery period to depreciate that property under the recovery period already being used, or elect to use a recovery period of one-half of the recovery period otherwise allowable under state law, or one-half of any recovery period allowable under federal law as in effect on January 1, 2009, for the remaining depreciable costs of such property.

IMPLEMENTATION CONSIDERATIONS

This provision is silent on how and when an election would be made to change the remaining recovery period. The provision is also silent on whether the election would be irrevocable. The absence of guidance could lead to disputes with taxpayers and would complicate the administration of this provision.

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. A review of these states' laws found that none of them allow depreciation recovery periods that are one-half of the federal recovery periods.

Michigan conforms to the federal depreciation rules for individuals and corporations, including bonus depreciation. *Illinois, Massachusetts, Minnesota,* and *New York* generally conform to the federal depreciation rules for individuals and corporations, except that bonus depreciation is unavailable. *Florida* does not impose a personal income tax; for its corporation income tax, *Florida* generally conforms to the federal depreciation rules, except that bonus depreciation is unavailable.

FISCAL IMPACT

This provision would require some changes to existing tax forms and instructions and information systems. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of SB 235 Provision #5
As Amended on April 1, 2013
For Taxable Years Beginning On or After January 1, 2014
Enactment Assumed After June 30, 2013
($ in Millions)

Fiscal Year	2013-14	2014-15	2015-16	2016-17	2017-18
Accelerated Depreciation	- $1,000	- $2,200	- $2,000	- $1,500	- $1,300

PROVISION # 6
Capital Gains Exclusion

EFFECTIVE/OPERATIVE DATE

As a tax levy, this provision would be effective upon enactment and operative for taxable years beginning on or after January 1, 2013.

ANALYSIS

FEDERAL/STATE LAW

Internal Revenue Code (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.[8] 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 or exchanged, 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.

Under federal law, there are circumstances when a percentage of a capital gain may be excluded from a taxpayer’s gross income. Because capital assets are personal in nature versus used in a trade or business, provisions related to capital gains and losses are more commonly found under the income tax laws for individuals.

For example, federal law allows a capital gain exclusion from the sale of a personal residence. An individual may exclude up to $250,000 of gain, while a married couple filing a joint return may exclude up to $500,000. As a second example, a holder of small business stock[9] may exclude 75 percent[10] of the gain on the sale or exchange of the stock.

Complex rules allow non-corporate taxpayers to apply maximum tax rates from 0 percent to 28 percent to the taxation of a net capital gain, whereas for corporate taxpayers, capital gains are taxed at ordinary income tax rates.

Generally, capital gains and losses are classified as long-term or short-term, depending on how long the property was held before it was sold. Current federal law provides that property held more than one year will result in long-term capital gain or loss. If the property is held less than a year, the capital gain or loss is short-term. These distinctions are essential to arrive at the correct amount of net capital gain or loss.

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[8] IRC section 1221(a).

[9] A special security subject to rules designed to encourage investment in small business.

[10] The American Recovery and Reinvestment Act of 2009 (P.L.111-5) changed the exclusion percentage to 75 percent (rather than 50 percent or 60 percent) for exchanges of small business stock held more than 5 years and acquired after February 17, 2009, and before January 1, 2011.

"Net capital gain" means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year. When calculating the net capital gain (also called "netting"), the following definitions apply:

- The term "net long-term capital gain" means the excess of long-term capital gains for the taxable year over the long-term capital losses for such year.
- The term "net long-term capital loss" means the excess of long-term capital losses for the taxable year over the long-term capital gains for such year.
- The term "net short-term capital gain" means the excess of short-term capital gains for the taxable year over the short-term capital losses for such year.
- The term "net short-term capital loss" means the excess of short-term capital losses for the taxable year over the short-term capital gains for such year.

STATE LAW

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. Capital gains are taxed at ordinary income tax rates under personal income tax law.

THIS PROVISION

This provision would exclude from gross income any gain from the sale of a capital asset for PITL and CTL taxpayers.

The provision would define a "capital asset" to mean a capital asset as defined in Section 1221 of the IRC.

LEGISLATIVE HISTORY

AB 577 (Miller, 2011/2012) would have allowed taxpayers to exclude certain capital gains from gross income. AB 577 failed to pass out of the Revenue and Taxation Committee by the constitutional deadline.

SB X6 10 (Dutton, 2009/2010) would have allowed taxpayers to exclude 50 percent of net capital gains from gross income. SBX6 10 was introduced on February 24, 2010, and was held in the Senate Revenue and Taxation Committee.

SB X8 43 (Dutton, 2009/2010) would have allowed taxpayers to exclude 50 percent of net capital gains from gross income. SBX8 43 was introduced on February 12, 2010, and was held in the Senate Rules Committee.

SB 472 (Dutton, 2009/2010) would have allowed taxpayers to exclude from gross income 50 percent of a capital gain. SB 472 was held in the Senate Revenue & Taxation Committee.

SB 568 (Hollingsworth, 2009/2010) would have allowed a taxpayer to elect to pay a 2 percent tax on any "net capital gain" as defined under federal law. SB 568 failed to pass out of the Senate by the constitutional deadline.

AB 876 (Harkey, 2009/2010) would have excluded from gross income, the gain on sale of a capital asset purchased in calendar year 2009 and held more than one year. AB 876 failed to pass out of the Assembly 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.

A review found that these states generally follow the federal capital gains rules for excluding capital gains from gross income.

FISCAL IMPACT

This provision would require some changes to systems, processing and forms. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of SB 235 Provision #6 As Amended on April 1, 2013 For Taxable Years Beginning On or After January 1, 2014 Enactment Assumed After June 30, 2013 ($ in Millions)					
Fiscal Year	2013-14	2014-15	2015-16	2016-17	2017-18
Capital Gains Exclusion	- $4,500	- $3,500	- $5,500	- $5,500	- $6,000

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some might argue that this bill would provide incentives to California businesses and investors to generate needed employment and investment in this state.

Opponents: Some might argue that additional tax expenditures should not be created in light of the state's fragile economy.

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