ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Correa	Analyst:	Jane Raboy	Bill Number:	SB 376
Related Bills:	See Legislative History	Telephone:	845-5718	Introduced Date:	February 20, 2013
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Manufacturing Investment Credit/Sales Tax Reimbursement or Use Tax Paid for Tangible Personal Property

SUMMARY

This bill would create a tax credit under the Personal Income Tax Law (PITL) and Corporation Tax Law (CTL).

This analysis will not address the bill's sales and use tax provision as it does not impact the department or state income tax revenue.

RECOMMENDATION

No position.

REASON FOR THE BILL

The reason for this bill is to stimulate manufacturing and job growth by creating a competitive climate for manufacturing investments.

EFFECTIVE/OPERATIVE DATE

As a tax levy, the provisions of this bill would be effective immediately upon enactment. The credit provision is specifically operative for transactions occurring between January 1, 2014, and before January 1, 2017. Credits generated from these transactions would be applied in equal amounts over three successive taxable years commencing with the first taxable year beginning on or after January 1, 2017. The credit provision would be repealed effective December 1, 2020.

ANALYSIS

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

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FEDERAL/STATE LAW

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

Sales or Use Tax Credit

Under the Revenue and Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within economic development areas. The sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified machinery purchased for exclusive use in an economic development area (except a Manufacturing Enhancement Area). The amount of the credit is limited to the tax attributable to economic development area income. Qualified property is defined as follows:

Enterprise Zone (EZ) or Targeted Tax Area (TTA)

1. Machinery and machinery parts used for:
   a. Manufacturing, processing, assembling, or fabricating;
   b. Producing renewable energy resources; or
   c. Air or water pollution control mechanisms.
2. Data processing and communication equipment.
3. Certain motion picture manufacturing equipment.

Local Agency Military Base Recovery Area (LAMBRA)

1. High-technology equipment (e.g., computers);
2. Aircraft maintenance equipment;
3. Aircraft components; or
4. Certain depreciable property.

In addition, qualified property must be purchased and placed in service before the economic development area designation expires. The maximum value of property that may be eligible for the EZ, LAMBRA, and TTA sales or use tax credit is $1 million for individuals and $20 million for corporations.

Limitations on Use of Economic Development Area Sales or Use Tax Credit

For businesses operating inside and outside an economic development area, the amount of credit that may be claimed is limited by the amount of tax on income attributable to the economic development area. Income is first apportioned to California using the same formula as that used by all businesses that operate inside and outside the state (property, payroll, a double-weighted sales factor; for taxable years beginning on or after January 1, 2011, certain corporations may elect to use a single factor, 100 percent sales apportionment formula). Starting in 2013, the default is a single sales factor and the option of using a three-factor that provides a double weight to the sales factor is eliminated. This income is further apportioned to the economic development area using a two-factor formula based on the property and payroll of the business.

Assignment of Credits between Certain Unitary Affiliates

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

PROGRAM BACKGROUND

Prior state law allowed qualified taxpayers a Manufacturers' Investment Credit (MIC) equal to 6 percent of the amount paid or incurred after January 1, 1994, and before January 1, 2004, for qualified property that was placed in service in California.

For purposes of the MIC, a qualified taxpayer was any taxpayer engaged in manufacturing activities described in specified codes listed in the Standard Industrial Classification (SIC) Manual, 1987 edition. Qualified property was any of the following:

1. Tangible personal property defined in Section 1245(a) of the Internal Revenue Code (IRC), used in a qualified SIC Code activity, and used primarily for:
   a. Manufacturing, processing, refining, fabricating, or recycling of property;
   b. Research and development;
   c. Maintenance, repair, measurement, or testing of otherwise qualified property; or
   d. Pollution control that meets or exceeds state or local standards.
2. The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.
3. Special purpose buildings and foundations that were an integral part of specified activities.

For taxpayers engaged in computer programming and computer software related activities, qualified property included computers and computer peripheral equipment used primarily for the development and manufacture of prepackaged software and the value of any capitalized labor costs directly allocable to such property.

The MIC explicitly excluded certain types of property from the definition of qualified property, such as furniture, inventory, and equipment used in an extraction process. Additional exclusions were facilities used for warehousing purposes and equipment used to store finished products, after completion of the manufacturing process, including tangible personal property used in administration, general management, or marketing.

The MIC statute was repealed by its own terms and ceased to be operative as of January 1, 2004, due to a reduction in manufacturing sector jobs.

[1] Revenue and Taxation Code section 23663.

THIS BILL

This bill would establish a tax credit under the PITL and CTL in an amount equal to 6.5 percent of the gross receipts or sale price on transactions occurring on and after January 1, 2014, and before January 1, 2017, for purchases of qualified tangible personal property, placed in service in this state. The credit would be reported in three equal amounts over the three taxable years beginning with the first taxable year beginning on or after January 1, 2017.

Qualified tangible personal property would mean tangible personal property purchased for use by a qualified person to be used primarily for the following:

1. Any stage of manufacturing, processing, refining, fabricating, or recycling of property;
2. Research and development;
3. Maintenance, repair, measurement, or testing; or
4. Performance of a construction contract by a contractor for property to be used as an integral part of the manufacturing, processing, refining, fabricating, or recycling process, or as a research or storage facility for use in connection with these processes.

This bill would define the following terms and phrases:

1. "Tangible personal property" includes,
    a. Machinery and equipment, including component parts and contrivances;
    b. Specified equipment or devices;
    c. Tangible personal property used in pollution control, as specified;
    d. Special purpose buildings and foundations, as specified; or
    e. Fuels used or consumed in the manufacturing, processing, refining, fabricating, recycling process.
2. "Qualified tangible personal property" excludes,
    a. Buildings used solely for warehousing;
    b. Consumables with a useful life of less than one year, excluding fuels as specified;
    c. Furniture, inventory, and equipment used in the extraction process or equipment used to store finished products that have completed the manufacturing;
    d. Tangible personal property used primarily in administration, general management, or marketing; and
    e. Tangible personal property that is either removed from California, converted from specified use within one year from the date of purchase.
3. "Qualified person" means a taxpayer primarily engaged in the lines of business classified in Code 3111 to 3399 (Manufacturing) of the North American Industry Classification System (NAICS) published by the United States Office of Management and Budget, 2012 edition. Also included is the NAICS Code 5112, software publishers.

4. "Fabricating" means to make, build, create, produce, or assemble components or property to work in a new or different manner.

5. "Manufacturing" means the activity of converting or conditioning tangible personal property by changing the form, composition, quality, or character of the property for ultimate sale at retail or use in the manufacturing of a product to be ultimately sold at retail. Manufacturing includes any improvements to tangible personal property that results in greater service life or greater functionality than that of the original property.

6. "Primarily" means 50 percent or more of the time.

7. "Process" means the manufacture of aerospace or defense hardware or software, aerospace maintenance, aerospace repair and overhaul, parts supply to the aerospace industry, provision of services and support relating to the aerospace industry, research and development of aerospace technology and systems, and the education and training of aerospace personnel.

8. “Research and development” means those activities described in Section 174 of the Internal Revenue Code.

9. “Refining” means the process of converting a natural resource to an intermediate or finished product.

10. “Useful life” for tangible personal property is treated as having a useful life of one or more years for state income or franchise tax purpose.

This bill would allow any unused credit to be carried forward for a maximum of five years if necessary, or until exhausted.

This credit would be repealed by its own language as of December 1, 2020.

IMPLEMENTATION CONSIDERATIONS

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

This bill uses terms in the PITL and CTL provisions that are sales tax terms, for example, “person,” and “qualified person.” "Taxpayer" and "qualified taxpayer" are the customary terms used within a franchise or income tax credit statute to identify the entity eligible to claim and apply a tax credit against a tax liability. These terms have the benefit of past usage and common understanding within the context of a tax credit statute and for consistency and harmony with other tax credit language should be used in this bill. It is recommended that the PITL and CTL provisions be amended to reference terms as defined for franchise and income tax purposes.

This bill would use terms and phrases that are undefined, i.e., “recycling,” “recycling process,” “recycling of property,” “recycling activity,” “integral part,” “standards established by this state or any local or regional governmental agency within this state,” “any stage,” and “placed in service.” The absence of definitions to clarify these terms and phrases could lead to disputes with taxpayers and would significantly complicate the administration of this credit.

This bill would use phrases that could be more broadly interpreted than the author intends, i.e., “at the point any,” “engaged in,” and “to be used primarily.” For example, this bill would allow a tax credit for qualified tangible personal property purchased for use by a qualified person “to be used primarily” in any stage of the manufacturing, as specified. The taxpayer in this case, would be allowed a tax credit on the possibility that the tangible personal property would be used 50 percent or more of the time. If this is contrary to the author’s intent, the author may wish to amend this bill for clarity.

This bill is silent on the extent that a “qualified person” or an “affiliate” must be engaged in a specified NAICS code to qualify for the tax credit. As a result, the tax credit would be available regardless of the percentage of specified NAICS code activity. If this is contrary to the author’s intent, this bill should be amended.

This bill would allow a tax benefit generated beginning in January 1, 2017, for an expense or cost of purchasing the qualified tangible personal property beginning as early as January 1, 2014. It is unclear how the taxpayer or the department would document eligibility for the credit because of the delay between the credit generated and the taxable year the credit would be available to reduce tax.

TECHNICAL CONSIDERATIONS

Subdivision (d) of section 23649.1 needs to be amended where the term "net tax” appears, as it should be "tax" to correspond to the definition in the CTL.

Subparagraph (B) of paragraph (6) of subdivision (c) of section 17053.93 needs to be amended to replace the corporation language related to affiliated entities with references to pass-through entities.

LEGISLATIVE HISTORY

AB 829 (Caballero, 2009/2010) was substantially similar to this bill. AB 829 failed passage in the Assembly Revenue and Taxation Committee.

SB 699 (Alquist, 2009/2010) would have allowed a credit for sales or use tax paid on the purchases of tangible property placed in service in the state by qualified manufacturers. SB 699 failed passage in the Senate Committee on Revenue and Taxation.

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.

Illinois allows a replacement tax investment credit equal to 0.5 percent of the basis of qualified property placed in service during the tax year coupled with an additional credit of up to 0.5 percent of the basis of qualified property if the business is new to the state or the *Illinois* base employment for the business increased over the preceding year.

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

New York provides an investment tax credit to manufacturers for certain depreciable equipment or buildings. The credit is 5 percent of up to $350 million of qualified expenditures and 4 percent for qualified expenditures in excess of $350 million. Research and development property may qualify for an optional rate of 9 percent. Under the new Excelsior Jobs Program effective for 2011 through 2015, the investment tax credit is refundable with the refundable credit equal to 2 percent of the cost of qualified investments and capped yearly at $2 million.

FISCAL IMPACT

Department staff is unable to determine the costs to administer this bill until the implementation concerns have been resolved. As the bill continues to move through the legislative process and implementation concerns are resolved, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Estimated Revenue Impact of SB 376 As Introduced February 20, 2013 For Taxable Years Beginning On or After January 1, 2014 and Before January 1, 2017 Enactment Assumed After June 30, 2013 ($ in Millions)				
2013-16	2016-17	2017-18	2018-19	2019-20
+$0	-$200	-$550	-$700	-$700

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 the gross receipts or sales price included in the calculation of the credit to purchases of property placed in service 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[2]

Support: California Manufacturers & Technology Association (Sponsor),
Bayer HealthCare, Dart Container Corporation, Del Monte Foods, General Mills,
Hormel Foods Corporation, Inline Translation Services, Inc.,
International Paper Company, Kimberly-Clark Corporation,
Northrop Grumman Corporation, Owens-Illinois, Inc., Procter & Gamble,
Searles Valley Minerals, The Clorox Company, and
The Plastics Industry Trade Association

Opposition: None identified.

ARGUMENTS

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

Opponents: Some could argue that the manufacturers' investment credit would have a negligible impact on economic growth.

POLICY CONSIDERATION

Conflicting tax policies come into play whenever a credit is provided for an item that is already deductible as a business expense or is otherwise reflected as an adjustment to the basis of property for tax purposes. Providing both a credit and allowing the full amount to be deducted (or added to basis) would have the effect of providing a double benefit for that item or cost. On the other hand, making an adjustment to deny the deduction or reduce basis in order to eliminate the double benefit creates a difference between state and federal taxable income, which is contrary to the state's general federal conformity policy.

[2] As provided by the Senate Member Lou Correa's Senate Bill 376 Fact Sheet as of February 26, 2013.

This bill allows the credit to be reported in three equal amounts over three taxable years beginning on or after January 1, 2017. The tangible personal property purchase date may be earlier than the taxable year in which the tangible personal property is actually placed in service (i.e., used) in California. Most credits involving the acquisition and subsequent use of an item of property allow the credit to be claimed in the taxable year when the property is placed in service, which commences the allowance for depreciation. It is possible that a taxpayer could purchase the tangible personal property, claim the credit, and resell the tangible personal property to a third party that may also claim the credit. If this bill were to require an appropriate recapture provision to ensure continued operation in California for a specified (recapture) period, this potential problem would be avoided. The recapture provision would require the taxpayer to use the tangible personal property for a certain length of time in this state or add all or some portion of the credit amount back to the tax liability.

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