SCS Agency
Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Honda | Analyst: Colin Stevens | Bill Number: AB 2458

Related Bills: ______ | Telephone: 845-3036 | Amended Date: 4/29/98

Attorney: Doug Bramhall | Sponsor:

SUBJECT: Y2K Compliance Costs Credit

SUMMARY OF BILL

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would allow a credit equal to 20% of the costs paid or incurred by a taxpayer in California for the repair or replacement of any computer system related to year 2000 (Y2K) issues, as defined.

SUMMARY OF AMENDMENT

The April 29, 1998, amendments remove the prior provisions relating to the Los Angeles Live/Work Economic Revitalization Plan Credit and add the provisions discussed in this analysis.

EFFECTIVE DATE

As a tax levy, this bill would take effect immediately when chaptered and would apply to taxable or income years beginning on or after January 1, 1998, and before January 1, 2000.

SPECIFIC FINDINGS

Federal and state laws allow a variety of special tax credits and deductions designed to promote or influence specific taxpayer behavior believed to generate social or economic benefits for the general public. Included in state and federal law are tax incentives designed to promote business, such as credits for research and development, purchasing manufacturing equipment, the adoption of children, and providing child care facilities to employees. Neither state nor federal laws allow a tax credit for costs paid or incurred for the repair or replacement of a computer system due to Y2K issues. However, Y2K expenses, to the extent considered ordinary and necessary to conduct the taxpayer's business, would be allowed as a deduction from gross income.

Existing state law provides general rules which apply to the division of credits among two or more taxpayers, a husband and wife, and partners in a partnership. Unless specified, no tax credit may reduce regular tax below the tentative minimum tax (TMT).

DEPARTMENTS THAT MAY BE AFFECTED:

____ STATE MANDATE ____ GOVERNOR'S APPOINTMENT

Board Position:	Agency Secretary Position:	GOVERNOR'S OFFICE USE
____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR ___X_____ PENDING	____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR DEFER TO ____________	Position Approved ____ Position Disapproved ____ Position Noted ____
Department/Legislative Director Date G. Alan Hunter 5/14/98	Agency Secretary Date	By: Date:

Under the PITL and B&CTL, **this bill** would allow a credit equal to 20% of the cost paid or incurred in California by a taxpayer which has gross sales not exceeding $10 million for the repair or replacement of a computer system, or portion thereof, in order to prevent or resolve Y2K issues as defined.

This bill would define “Y2K issues.”

Any unused credit not applied against the tax liability in the year allowed may be carried forward and applied against tax liability in succeeding years until exhausted.

The general rules in state law regarding the division of credits would apply, and the credit would not reduce regular tax below tentative minimum tax for alternative minimum tax (AMT) purposes.

Policy Considerations

Credits are generally provided to induce desired behavior. This bill would allow a credit for actions (repair or replacement of a computer) required by the taxpayer to ensure that his or her business can continue to function. If a business intends to continue operating, it will correct Y2K problems

This bill would provide a credit for costs related to computers for personal use as well as those used for business purposes. However, according to the author’s office, the intent was to provide a credit only to businesses required to make changes to become Y2K compliant.

Given the broad definition of “Y2K issues,” this bill could allow a taxpayer whose computer system is already outdated, but still operative to receive a 20% credit for a complete system replacement if the replacement was done to prevent or resolve Y2K issues. In such a case, it may be difficult for department staff to distinguish between expenses incurred to upgrade computers or to address Y2K work.

This credit would not be in lieu of any credit or deduction to which the taxpayer may be eligible. Therefore, if a taxpayer engages in business and incurs Y2K expenses, the taxpayer could deduct the cost of those expenses and claim a credit for those same expenses.

The bill does not describe whether the $10 million in gross sales is limited to sales in California or includes worldwide sales.

The credit is limited to costs paid or incurred in California to repair or replace any computer system or any portion thereof located anywhere. Eligibility for a tax credit on the basis of where a cost is paid or incurred could lead to manipulation and abuse. For example, a California taxpayer could receive a credit for 20% of the costs paid to an out-of-state computer repair firm for the repair of the taxpayer’s out-of-state computers.

Implementation Considerations

Implementing this bill would require some changes to existing tax forms and instructions and information systems, but would not significantly impact the department's programs and operations if the implementation considerations described below are resolved.

The term "gross sales" is not defined. Since this term is generally not used in income tax law, a definition should be provided or another term already defined in income tax law such as "aggregate gross receipts less returns and allowances" should be substituted to ensure that disputes do not arise between taxpayers claiming the credit and the department as to which taxpayers may claim the credit.

In recent credits, the Legislature has limited the number of years the unused credit may be carried forward since most credits are exhausted in eight years. This bill permits an unlimited carryover period for any unused credit.

Technical Consideration

This bill would allow a credit for a taxable or income year in which Y2K expenses are paid or incurred, but limits the credit to any year the taxpayer has gross sales under $10 million. Amendments 1 and 2 are provided for clarity and consistency, to ensure that any reference to a year is a taxable or income year.

FISCAL IMPACT

Departmental Costs

This bill is not expected to significantly impact the department's costs if the implementation concerns are addressed.

Tax Revenue Estimate

Based on limited data and assumptions discussed below, it is projected that this proposal would generate total credits on the order of $150 million. Revenue losses from applied credits would begin in 1998/9 and would extend beyond the two year period for qualifying expenses due to tax liability constraints and the tentative minimum tax limitation. If one-fourth of the total impact occurs in the first fiscal year, one-half in the second year, and the balance over the following two years, revenue losses would occur as follows:

Estimated Revenue Impact of **AB 2458** (As Amended 04/29/98) Taxable/Income Years Beginning In 1998 & 1999 (In $Millions)				
Fiscal Years	1998/99	1999/00	2000/01	2001/02
Revenue Impact (*)	**(40)**	**(75)**	**(25)**	**(10)**

Note: (*) Rounded

Any possible changes in employment, personal income, or gross state product that might result from this measure are not taken into account.

Tax Revenue Discussion

Revenue losses would depend on expenses associated with computer system modifications (the bill's language is very broad) and available tax liabilities of qualified business taxpayers.

According to a Federal Reserve projection, the modification and updating of computer systems to solve the year 2000 issue will cost U.S. businesses approximately $50 billion. Other sources are estimating on the order of $75 billion. For this bill, it is assumed total qualifying expenses would be closer to $75 billion, and the credit would not extend to complete system replacements.

Additional assumptions for the order of magnitude impact are as follows:

- Only businesses would qualify for the credit, and the $10 million gross sales limitation would be based on sales of the combined group in cases of unitary affiliates.
- California Y2K expenditures represent 15% of the nation ($75 billion * 15% = $11.25 billion) of which 85% would be incurred by corporations. Note, this assumes no manipulations to pay Y2K costs in California.
- Of this total, firms with less than $10 million in annual gross sales will make up 5% of expenditures for corporations and 15% for other businesses. This is based on available gross receipts data on corporate returns for 1996.
- Even though eligible computer expenses cover a two-year period, actual applied credits would extend beyond two years due to limited tax liabilities and the tentative minimum tax interaction.

BOARD POSITION

Pending.

Analyst Colin Stevens
Telephone # 845-3036
Attorney Doug Bramhall

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2458
As Amended April 29, 1998

AMENDMENT 1

On page 2, line 13, after "any," insert:

taxable

AMENDMENT 2

On page 3, line 14, after "any," insert:

income