

# ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Ortiz Analyst: Jeani Brent Bill Number: SB 1272

Related Bills: SB 974 (1998) Telephone: 845-3410 Introduced Date: 02/26/1999

Attorney: Doug Bramhall Sponsor: \_\_\_\_\_

**SUBJECT:** Northgate Enterprise Zone/Expand to Include 250 Acres of McClellan Air Force Base

SUMMARY

Under the Government Code, this bill would require the Trade and Commerce Agency (TCA) to designate a portion of McClellan Air Force Base as an extension of the Northgate Enterprise Zone. The designation would be binding for 15 years. All tax incentives available to businesses operating in enterprise zones would be available to businesses operating in the expanded portion of the Northgate Enterprise Zone.

EFFECTIVE DATE

This bill would be effective January 1, 2000, and the tax incentives would apply to transactions (such as the purchase of qualified property) on or after the date the enterprise zone extension is designated.

PROGRAM HISTORY/BACKGROUND

California has four types of economic development areas that have similar tax incentives:

- Enterprise Zones,
- Local Agency Military Base Recovery Areas (LAMBRA),
- Targeted Tax Area (TTA), and
- Manufacturing Enhancement Areas (MEA)

The following table shows the incentives available to each of the economic development areas.

Types of Incentives	EZ	LAMBRA	TTA	MEA
Sales or Use Tax Credit	X	X	X	
Hiring Credit	X	X	X	X
Employee Wage Credit	X			
Business Expense Deduction	X	X	X	
Net Interest Deduction	X			
Net Operating Loss	X	X	X	

SPECIFIC FINDINGS

**Under the Government Code, existing state law** allows the governing body of a city or county to apply for designation as an enterprise zone. Using specified

<p>Board Position:</p> <p>_____ S      _____ NA      _____ NP</p> <p>_____ SA      _____ O      _____ NAR</p> <p>_____ N      _____ OUA      <u>  X  </u> PENDING</p>	<p>Department Director      Date</p> <p><b>Gerald Goldberg</b>      <b>4/20/1999</b></p>
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criteria, the Trade and Commerce Agency (TCA) designates enterprise zones from the applications received from the governing bodies. Enterprise zones are designated for 15 years (except enterprise zones meeting certain criteria may be extended to 20 years), and TCA has designated each of the 39 enterprise zones authorized under existing law. When an enterprise zone expires, TCA is authorized to designate another in its place (or redesignate the existing zone) to maintain a total of 39 enterprise zones. TCA may approve the geographic expansion of enterprise zones up to 15% in size and, for certain small enterprise zones, up to 20% in size.

TCA may audit enterprise zone programs and determine a result of superior, pass, or fail, and may dedesignate failing programs. Any business located in a dedesignated zone that has elected to avail itself of any state tax incentive for any taxable or income year prior to dedesignation may continue to avail itself of those tax incentives for a period equal to the remaining life of the enterprise zone, provided the business otherwise is still eligible for those incentives. Once an enterprise zone is dedesignated, TCA may designate another enterprise zone in its place to maintain a total of 39 enterprise zones, even though taxpayers in the dedesignated zone may continue to use the tax incentives that the taxpayers qualified for prior to dedesignation.

**Under the Revenue and Taxation Code, existing state law** provides special tax incentives for taxpayers conducting business activities within an enterprise zone. These incentives include a sales or use tax credit, hiring credit, business expense deduction, special net operating loss treatment, and net interest deduction. In addition, a wage credit may be claimed by specified employees of businesses operating within an enterprise zone. See attachment A for a detailed discussion of each tax incentive.

**This bill** would require TCA to designate a portion of McClellan Air Force Base as an extension of the Northgate Enterprise Zone, with a connecting corridor between it and the existing Northgate Enterprise Zone. The designation would be binding for 15 years.

**Under this bill**, all businesses located in the additional area, including both the 250 acres of McClellan Air Force Base and the entire corridor area (the size of which is not defined in the bill), would be allowed the tax incentives currently allowed to businesses operating in the Northgate Enterprise Zone.

#### Implementation Considerations

Implementing this bill would occur during the department's normal annual system update.

#### Technical Considerations

The provision in this bill that states the additional area shall be deemed designated pursuant to Government Code Section 7073 is unnecessary to allow the tax incentives. Under the Revenue and Taxation Code, any designation made under Government Code Chapter 12.8 would qualify for the tax incentives.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue loss from this bill is estimated as follows:

Effective After January 1, 2000 Assumed Enactment After June 30, 1999 (In Millions)		
1999-0	2000-1	2001-2
Neg. Loss *	Minor Loss **	(\$1)

\* Less than \$250,000

\*\* Less than \$500,000

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

Tax Revenue Discussion

This estimate assumes that the area designated under this bill would not be subject to the same expiration date as the underlying zone to which it is attached and, thus, would have a 15-year life.

Revenue losses under the Personal Income Tax Law and the Bank and Corporation Tax Law largely would depend on the number of businesses that would purchase qualified property subject to the sales tax, the amount of wages paid to qualifying employees, and the state tax liabilities of employers claiming tax benefits.

For the 1996 tax year, the total revenue loss for the 37 existing zones was \$39 million (average impact of \$1 million per zone).

The potential exists for significant businesses to locate in the extension into McClellan Air Force Base. Consequently, the average revenue loss of \$1 million per area per year has been used. It is not known when development will begin. It is anticipated that revenue losses most likely would be below the average in the first years after the zone is expanded. Allowance is made in future years for businesses that might start up.

BOARD POSITION

Pending.

Attachment A  
SB 1272  
As Introduced February 26, 1999

ENTERPRISE ZONE TAX INCENTIVES

**Sales or Use Tax Credit**

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 enterprise zone. The amount of the credit is limited to the tax attributable to enterprise zone income. Qualified property is defined as follows:

- Machinery and machinery parts used for:
  - manufacturing, processing, assembling, or fabricating;
  - producing renewable energy resources; or
  - air or water pollution control mechanisms.
- Data processing and communication equipment.
- Certain motion picture manufacturing equipment.

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

**Hiring Credit**

A business located in an enterprise zone may reduce tax by a percentage of wages paid to qualified employees. A qualified employee must be hired after the area is designated as an enterprise zone and meet certain other criteria. At least 90% of the qualified employee's work must be directly related to a trade or business located in the enterprise zone and at least 50% must be performed inside the enterprise zone. The business may claim up to 50% of the wages paid to a qualified employee as a credit against tax imposed on enterprise zone income. The credit is based on the lesser of the actual hourly wage paid or 150% of the current minimum hourly wage (under special circumstances for the Long Beach enterprise zone, the maximum is 202% 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.

**Business Expense Deduction**

A business located in an enterprise zone may elect to deduct as a business expense a specified amount of the cost of qualified property purchased for exclusive use in the enterprise zone. The deduction is allowed in the taxable or income year in which the taxpayer places the qualified property in service. The basis of the property must be reduced by the amount of the deduction. The maximum deduction for all qualified property is the lesser of 40% of the cost or the following:

If the property was placed in service:

Months after designation	Maximum deduction
0 to 24	\$40,000
25 to 48	30,000
48 and over	20,000

### **Net Operating Loss Deduction**

A business located in an enterprise zone may elect to carry over 100% of the enterprise zone net operating losses (NOLs) to deduct from enterprise zone income of future years. The election must be made on the original return for the year of the loss. The NOL carryover is determined by computing the business loss that results from business activity in the enterprise zone.

### **Net Interest Deduction**

A deduction from income is allowed for the amount of net interest earned on loans made to a trade or business located in an enterprise zone. Net interest is defined as the full amount of the interest less any direct expenses (e.g., commission paid) incurred in making the loan. The loan must be used solely for business activities within the enterprise zone and the lender may not have equity or other ownership interest in the enterprise zone trade or business.

### **Employee Wage Credit**

Certain disadvantaged individuals are allowed a credit for wages received from an enterprise zone business. Public employees are not eligible for the credit. The amount of the credit is 5% of "qualified wages," defined as wages subject to federal unemployment insurance. For each dollar of income received by the taxpayer in excess of qualified wages, the credit is reduced by nine cents. The credit is not refundable and cannot be carried forward. The amount of the credit is limited to the amount of tax that would be imposed on income from employment in the enterprise zone, computed as though that income represented the taxpayer's entire taxable income.

### **Apportioning**

For businesses operating inside and outside an enterprise zone, the amount of credit or net operating loss deduction that may be claimed is limited by the amount of tax on income attributable to the enterprise zone. 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). This income is further apportioned to the enterprise zone using a two-factor formula based on the property and payroll of the business.