STATE OF CALIFORNIA
Franchise Tax Board

Bill Analysis

Author: O'Donnell

Sponsor:

Bill Number: AB 2227

Related Bills: See Legislative History

Introduced: February 15, 2022

SUBJECT

Intermodal Equipment Manufacturing Tax Credit

SUMMARY

This bill would, under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL), create a tax credit for purchases of certain tangible personal property by certain manufacturing businesses.

RECOMMENDATION

No position.

SUMMARY OF AMENDMENTS

Not applicable.

REASON FOR THE BILL

The reason for this bill is to promote investment for manufacturing in California.

ANALYSIS

For each taxable year beginning on or after January 1, 2022, and before January 1, 2032, this bill would allow a credit to a qualified taxpayer for 6 percent of the amount paid or incurred during the taxable year for qualified personal tangible property up to $5,000,000.

The bill would define "qualified taxpayer" as any taxpayer that, on and after January 1, 2022, is primarily engaged in a qualified business located in the state.

The bill would define "qualified business" as a business that is or does all of the following:

- Described in the "Manufacturing" Sector Codes (31 to 33, inclusive) of the North American Industry Classification System (NAICS) published by the United States Office of Management and Budget (OMB), 2017 edition.
- Engaged in the manufacturing of intermodal equipment or fabrication of the components of intermodal equipment.
- Completes all activities relating to the manufacturing of intermodal equipment or fabrication of the components of intermodal equipment in California.

This bill would define "primarily" as 50 percent or more of the time.

This bill would define "qualified personal tangible property" as property that is any of the following:

- Machinery and equipment, including component parts and contrivances such as belts, shafts, moving parts, and operating structures.
- Equipment or devices used or required to operate, control, regulate, or maintain the machinery, including, but not limited to, computers, data processing equipment, computer software, together with all repair and replacement parts with a useful life of one or more years. The above equipment and devices could be purchased either separately or in conjunction with a complete machine and regardless of whether the machine or component parts are assembled by the qualified person or another party.
- Tangible personal property (TPP) used in pollution control that meets standards established by the state or any local or regional governmental agency within this state.
- Special purpose buildings and foundations used as an integral part of the manufacturing, processing, refining, fabricating, or recycling process, or that constitute a research or storage facility used during manufacturing, processing, refining, fabricating, or recycling process, but not buildings used solely for warehousing purposes after completion of those processes.

This bill would specifically exclude the following from the definition of "qualified tangible personal property:"

- Consumables with a useful life of less than one year;
- Furniture, inventory, and equipment used in the extraction process;
- Equipment used to store finished products that have completed the manufacturing, processing, refining, fabricating, or recycling process; and
- TPP that is used primarily in administration, general management, or marketing.

If TPP is treated as having a "useful life" of one or more years for state income or franchise tax purposes or is deducted under Section 17201, 17255, or 24356, it would be deemed to have "useful life" of one or more years for purposes of this credit. If TPP is treated as having a "useful life" of less than one year for state income or franchise tax purposes, it would be deemed to have "useful life" of less than one year for purposes of this credit.

This bill would define "manufacturing" as the activity of converting or conditioning TPP 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 TPP that result in a greater service life or greater functionality than that of the original property.

This bill would define "fabricating" as activity to make, build, create, produce, or assemble components for TPP to work in a new or different manner.

"Processing" would be defined as the physical application of the materials and labor necessary to modify or change the characteristics of TPP.

This bill would define the "process" as the period:

- Beginning at the point at which any raw materials are received by the qualified person and introduced into the manufacturing, processing, refining, fabricating, or recycling activity of the qualified person, and
- Ending at the point at which the manufacturing, processing, refining, fabricating, or recycling activity of the qualified person has altered TPP to its completed form, including packaging, if required.

Raw materials would be considered as being introduced into the process when the raw materials are stored on the same premises where the qualified person's manufacturing, processing, refining, fabricating, or recycling activity is conducted. If raw materials are stored outside the premises described above, these raw materials would not be considered as being introduced into the process.

Unused credits may be carried over until exhausted.

This credit, under the PITL and CTL, would be excluded from the $5 million limitation on certain business credits and their carryovers.

Because this bill does not specify otherwise, this credit would not reduce regular tax below tentative minimum tax (TMT).

For purposes of complying with Section 41, the Franchise Tax Board (FTB) would be required to report to the Senate Committee on Budget and Fiscal Review, the Assembly Committee on Budget, the Senate and Assembly Committees on Appropriations, the Senate Committee on Governance and Finance, and the Assembly Committee on Revenue and Taxation the following specified items:

- The number of taxpayers claiming the credit,
- The average credit amount on tax returns claiming the credit, and
- The number of taxpayers claiming the credit in a taxable year that have not claimed the credit for a previous taxable year.

Effective/Operative Date

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2022, and before January 1, 2032.

Federal/State Law

Federal Law

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

In addition, current federal law does not specify a dollar limit on the total amount of all credits that can reduce the tax due.

State Law

State law, under the PITL and CTL, limited the amount of business tax credits that could reduce tax for two tax years, limiting the amount of allowable business tax credits to $5 million for taxable years beginning on or after January 1, 2020, and before January 1, 2023. In addition, the definition of business tax credits specifically excluded certain credits, such as the earned income tax credit, young child tax credit, and household and dependent care. SB 113 (Committee on Budget and Fiscal Review, Chapter 3, Statutes of 2022) was signed by the Governor on February 9, 2022, and among other things, under the PITL and CTL, repealed the business credit limitation for taxable years beginning on or after January 1, 2022.

In addition, previous 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) TPP defined in Section 1245(a) of the Internal Revenue Code (IRC), used in a qualified SIC code activity, and used primarily for:
   - Manufacturing, processing, refining, fabricating, or recycling of property, Research and development,
   - Maintenance, repair, measurement, or testing of otherwise qualified property, or
   - 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 are facilities used for warehousing purposes and equipment used to store finished products, after completion of the manufacturing process, including TPP 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.

Implementation Considerations

Department staff has identified the following implementation considerations for purposes of a high-level discussion; additional considerations may be identified as the bill moves through the legislative process. Department staff is available to work with the author’s office to resolve these and other considerations that may be identified.

This bill would allow a qualified taxpayer an annual credit of 6 percent of the amount paid or incurred during taxable year for qualified TPP up to $5,000,000 for 10 years. It is unclear whether the $5 million cap applies to the credit amount itself or the amount paid or incurred for qualified TPP.

This bill uses the undefined terms “consumables”, “special purpose building” and “intermodal equipment.” The absence of a definition to clarify the term could lead to disputes between taxpayers and the department. For clarity, it is recommended that the bill be amended to define the term.

While this bill contains Section 41 performance measures, it does not specify the frequency of the FTB reporting requirements. If the author intends the FTB to report annually, it is recommended that SEC. 5 of the bill be amended to clarify that the report shall begin in 2025, between April and July based on data availability, and annually thereafter, until two years after the sunset date.

Technical Considerations

For consistency of terminology, the following changes are recommended:

- This bill uses the term “personal tangible property” and “tangible personal property” interchangeably. The phrase “tangible personal property” should be consistently used throughout the bill.
- References to "qualified person" should be changed to "qualified taxpayer".

SB 113 (Committee on Budget and Fiscal Review, Chapter 3, Statutes of 2022 was recently enacted on February 9, 2022, and among other things, repealed the business credit limitation for taxable years beginning on or after January 1, 2022. As a result, the business credit limitation no longer applies for taxable years beginning on or after January 1, 2022, and SEC. 1, amending RTC section 17039.3, and SEC. 3, amending RTC section 23036.3, can be removed from the bill.

Policy Considerations

This bill would allow for an unlimited carryover period. Consequently, the department would be required to retain the carryover on the tax forms indefinitely. Credits are generally enacted with a limited carryover period because experience shows credits typically are exhausted within eight years of being earned.

The bill, as drafted, does not allow the credit to reduce Alternative Minimum Tax (AMT) or built-in gains tax for S corporations. If this is not the author’s intent, this bill should be amended.

This bill would allow the credit in the taxable year in which the equipment is purchased, which may be earlier than the taxable year in which the equipment is actually "placed in service" (i.e., used). Most credits involving the acquisition of an item of property provide that the credit be claimed in the same taxable year that the "placed in service date" occurs. For example, a taxpayer could within the same taxable year purchase the equipment, claim the credit, and remove the equipment from this state, or sell the equipment to a third party. The author may wish to amend the language by requiring the taxpayer to use the TPP for a specific length of time in this state or require the taxpayer to recapture all or some portion of the credit amount.

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. For example, under this bill a taxpayer could deduct the expenses for the costs of construction, reconstruction, or leasing and be allowed this credit. 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.

LEGISLATIVE HISTORY

AB 904 (Grayson, 2021/2022) would have created a tax credit for purchases of certain property by certain manufacturing businesses. AB 904 did not pass out of the Assembly Revenue and Taxation Committee.

SB 676 (Alquist, Chapter 751, Statutes of 1994) made clarifying changes to the MIC and added provisions allowing the credit for leased property, but only to the lessee.

SB 671 (Alquist, Chapter 881, Statutes of 1993) enacted the MIC.

SB 445 (Ashburn, 2009/2010), AB 1998 (Dutton, 2003/2004), AB 2070 (Houston, 2003/2004), AB 2076 (Dutton, 2003/2004), and SB 1295 (Morrow, 2003/2004), each, among other things, would have reinstated the MIC. None of these bills passed out of the committee process.

PROGRAM BACKGROUND

None noted.

FISCAL IMPACT

This bill would impact the department's systems, resulting in programming and processing revisions. The department's costs to implement this bill have yet to be determined. As the bill continues to move through the legislative process, costs will be identified.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 2227 as Introduced on February 15, 2022
Assumed Enactment after June 30, 2022

($ in Millions)

Fiscal Year	Revenue
2022-2023	-$330
2023-2024	-$310
2024-2025	-$330

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

LEGAL IMPACT

None noted.

APPOINTMENTS

None noted.

SUPPORT/OPPOSITION

Support

According to the March 18, 2022, Assembly Revenue and Taxation Committee analysis registered support for AB 2227 includes: California Trucking Association, California Association of Port Authorities, Pacific Merchant Shipping Association, and California Chamber of Commerce.

Opposition

None noted.

ARGUMENTS

Proponents

According to the March 18, 2022, Assembly Revenue and Taxation Committee analysis the California Trucking Association supports the bill and notes, in part, the following:

> The historic congestion at California's Ports has exposed the dire need to invest in supply chain infrastructure at all levels. AB 2227 helps meet a specific demand that is currently lacking in that infrastructure. AB 2227 creates an important incentive to spur the manufacturing of intermodal equipment, in particular truck chassis, which are currently in very short supply. Without adequate available chassis, truckers and goods movement companies are unable to ease the congestion at ports. Without an available chassis, containers are left to stack up and impede port operations.
>
> Getting more chassis available to use by California's truckers will lead to the more efficient and timely movement of goods to and from the state's ports. AB 2227 will prompt needed growth in the manufacturing of chassis within California, all while supporting good California jobs.

Opponents

None noted.

LEGISLATIVE CONTACT

FTBLegislativeServices@ftb.ca.gov