STATE OF CALIFORNIA
Franchise Tax Board

Bill Analysis

Author: Grayson

Sponsor:

Related Bills: See Legislative History

Bill Number: AB 904

Introduced February 17, 2021, and Amended March 18, 2021

SUBJECT

Manufacturers' Machinery and Equipment Investment 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 property by certain manufacturing businesses.

RECOMMENDATION

No position.

SUMMARY OF AMENDMENTS

The March 18, 2021, amendments added a provision to allow this credit under the PITL, made technical changes and eliminated provisions of this bill that would not impact the department's programs and operations.

This is the department's first analysis of the bill.

REASON FOR THE BILL

The reason for this bill is to promote investment for manufacturing businesses.

ANALYSIS

For taxable years beginning on or after January 1, 2021, and before January 1, 2032, this bill would allow a credit to a qualified taxpayer for a percentage of the amount paid or incurred during the taxable year for qualified tangible personal property up to $1,000,000. The credit percentages would be:

- 6 percent for taxpayers employing less than 100 people in a qualified business, and
- 5 percent for taxpayers employing 100 or more people in a qualified business.

The bill would define "qualified taxpayer" as any taxpayer that, on and after January 1, 2020, is primarily engaged in a qualified business.

This bill would define "qualified business" as a business described in the "Manufacturing" Sector Codes (31 to 33, inclusive) of the North American Industry Classification System (NAICS) published by the United Stated Office of Management and Budget (OMB), 2017 edition.

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 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.
    - Buildings used solely for warehousing purposes after completion of those processes are not included.

This bill would specifically exclude the following from the definition of "qualified 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
- Tangible personal property that is used in administration, general management, or marketing.

This bill would define “manufacturing” as 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 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 tangible personal property to work in a new or different manner.

This bill would define “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 tangible personal property to its completed form, including packaging, if required.

Raw materials would be considered 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 were stored outside the above premises, raw materials would not be considered being introduced into the process.

“Processing” would be defined as the physical application of the material and labor necessary to modify or change the characteristics of tangible personal property.

This bill would define “refining” as the process of converting a natural resource to an intermediate or finished product.

This bill would define “useful life” for tangible personal property:

- If tangible personal property is treated as having a “useful life” of one or more years for state income or franchise tax purposes, it would be deemed to have “useful life” of one or more years for purposes of this section; and
- If tangible personal property 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 section.

This bill would provide the following carryover provision for any unused credit:

- For taxpayers, employing less than 100 people in a qualified business, the credit would not be carried over on or after January 1, 2035; and
- For taxpayers, employing more than 100 people in a qualified business, the credit would not be carried over on or after January 1, 2034.

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.

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

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, 2021, 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

Current state law, under the PITL and CTL, limits the amount of business tax credits that may reduce tax for three tax years and states the following:

- Limits the amount of allowable business tax credits that may reduce tax to $5 million for taxable years beginning on or after January 1, 2020, and before January 1, 2023. For taxpayers included in a combined report, this determination is made at the group level.

- The carryforward period for credits subject to the limitation is increased by the number of taxable years the credit was not allowed by operation of this limitation.

For purposes of the PITL credit limitation, the $5 million credit limit applies to "business credits" as defined. In addition to excluding the LIHC, the definition of business credits specifically excludes the credits relating to earned income, young child, household and dependent care, adoption costs, renters, personal exemption, joint custody head of household and for care of dependent parent, senior head of household, and excess contributions of unemployment compensation. Business credits, as limited, are required to be applied against the tax due before the excluded credits.

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) 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:
   - 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 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.

Implementation Considerations

None noted.

Technical Considerations

This bill uses undefined term "personal tangible property." For consistency in terminology, it is recommended to use the phrase "tangible personal property."

In addition, for consistency in terminology, the term "net tax" in subdivision (d) of Section 23650 should be replaced with "tax."

Policy Considerations

This bill would allow a qualified taxpayer to place tangible personal property in service inside or outside of California. If this is contrary to the author's intent, this bill should be amended.

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.

This bill would provide differing tax treatment to taxpayers depending on when they qualify for the credit. For example, if the taxpayer claims the credit in 2031 and carryover stops for a taxable year beginning on or after January 1, 2035, the taxpayer would only have a three-year carryover period. The author may wish to revise carryover language allowing similar carryover period for all qualified taxpayers.

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.

LEGISLATIVE HISTORY

SB 445 (Ashburn, 2009/2010) would have created a tax credit for purchases of certain property used in manufacturing. SB 445 did not pass out of the Senate Committee.

AB 2076 (Dutton, 2003/2004) would have reinstated the previous MIC only for electric services. AB 2076 did not pass out of the Assembly Revenue and Taxation Committee.

AB 1998 (Dutton, 2003/2004) would have reinstated the previous MIC for taxable years beginning on or after January 1, 2005, and extended the MIC to activities related to electric service (power generation, transmission, or distribution). AB 1998 did not pass out of the Assembly Revenue and Taxation Committee.

AB 2070 (Houston, 2003/2004) would have reinstated the previous MIC for taxable years beginning on or after January 1, 2005. AB 2070 did not pass out of the Assembly Revenue and Taxation Committee.

SB 1295 (Morrow, 2003/2004) would have reinstated the previous MIC for taxable years beginning on or after January 1, 2004, and would have increased the rate of credit from 6 percent to 8 percent. SB 1295 did not pass out of the Senate 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.

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 904 as Amended on March 18, 2021.
Assumed Enactment after June 30, 2021

($ in Millions)

Fiscal Year	Revenue
2021-2022	-$550
2022-2023	-$360
2023-2024	-$370

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

To be determined.

ARGUMENTS

To be determined.

LEGISLATIVE CONTACT

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