California State Senate

COMMITTEE
ON
BUDGET AND FISCAL REVIEW

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Agenda

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AB 93 – Economic Development Reform

SENATE COMMITTEE ON BUDGET AND FISCAL REVIEW
Mark Leno, Chair

Bill No:	**AB 93**
Author:	**Committee on Budget**
As Amended:	**June 21, 2013**
Consultant:	**Mark Ibele**
Fiscal:	**Yes**
Hearing Date:	**June 24, 2013**

Subject: This is the Economic Development budget trailer bill for 2013-14. The proposed statutory changes are related to the Governor's Budget proposal to address budgetary aspects of one of the state's largest and fastest growing tax expenditure programs, and provide additional tax incentive programs to encourage economic development. It contains various changes related to the Budget Bill for 2013-14.

Summary: This bill makes substantial changes to the state tax system, relating to the personal income tax (PIT), corporation tax (CT), and sales and use tax (SUT). The bill would result in phasing-out and ending certain tax provisions relating to taxpayers located in Enterprise Zones (EZs) and similar tax incentive areas, ending the current New Jobs Credit tax incentive program, and instituting two major tax programs—a SUT exemption for equipment and similar purchases, and a hiring tax credit under the PIT and CT for employment in specified geographic areas. The bill would also provide for allocating income tax credits through the Governor's Office of Business and Economic Development (GO-Biz) to assist in retaining existing and attracting new business activity in the state.

Background: The state imposes a tax on the sale and use of tangible personal property, a tax on personal income, and a corporation tax based on income. For each tax, there are various special tax expenditure programs designed to encourage or reward particular economic activities. The state's taxes and tax expenditure programs affected by this bill are outlined below:

1. **Sales and Use Tax**. California's sales and use tax law imposes the sales tax on the sale of tangible personal property in the state and the use tax on the storage, use, or other consumption of tangible personal property in the state, except where a specific exemption is provided. Generally, the SUT applies to the purchase or use of tangible personal property, such as equipment, that is used to manufacture, produce or process tangible personal property. Thus, the tax is generally imposed on equipment used in manufacturing and research and development. The tax is not applied to sales of tangible personal property when it is physically incorporated in a manufactured item that will be sold. The current statewide SUT rate is 7.25 percent and includes rates for the state General Fund, various special funds, and local governments. In addition, local governments may impose voter-approved add-on rates. An allocated exclusion from this tax is provided by the California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA) for purchases of tangible personal property for approved manufacturing projects. The Board of Equalization (BOE) administers the SUT.

2. **Enterprise Zone Programs.** California levies the PIT on all California-sourced income. The PIT is paid by all California residents and nonresidents who receive income from sources in the state, unless such income is specifically excluded from taxation. The state also imposes the CT based on all income derived from or attributable to California, and levies the SUT on the sale of use of tangible personal property in the state.

The Department of Housing and Community Development (HCD) may designate certain geographic areas as EZs, thus providing access to tax incentives for businesses that conduct activities in these zones. Cities and counties may apply to HCD for zone designation based on unemployment rates, residents' participation in subsidized meal programs, median resident income, recent experience with plant closures, and certain other socio-economic characteristics. Statutory authority allows for the creation by HCD of up to 42 zones, each for a 15-year period. Currently, the state has 40 designated zones; two zones were allowed to expire in 2012. EZs are widespread throughout the state and result in potential tax benefits for virtually all types of industries. With exceptions for certain tax programs, these tax incentives are generally available for certain other designated geographic areas, comprising Local Area Military Base Recovery Areas, Targeted Tax Areas, Manufacturing Enhancement Areas, and the Los Angeles Revitalization Zone. These later areas constitute a minor portion of the geographically-based tax incentive program.

Taxpayers with business activities located in an EZ can claim various tax incentives through both the PIT and CT. The available tax incentive programs include tax credits for hiring certain qualified individuals, sales taxes paid on equipment purchases, and net interest deductions for banks making loans to an EZ business. In addition, EZ businesses may benefit from accelerated depreciation of equipment and the carry-over of 100 percent of business losses to future tax years. The specific programs are:

a. **EZ Hiring Credit.** The largest EZ-related incentive is the hiring credit. California law provides a credit to taxpayers that employ qualified employees in an EZ during the taxable year equal to: (1) 50 percent of qualified wages in the first year of employment; (2) 40 percent of qualified wages in the second year of employment; (3) 30 percent of qualified wages in the third year of employment; (4) 20 percent of qualified wages in the fourth year of employment; and, (5) 10 percent of qualified wages in the fifth year of employment. In general, qualified wages means wages that do not exceed 150 percent of the minimum wage. Such wages must be paid to a qualified employee who works at least 90 percent of the time on activities directly related to the business located in an EZ and whose services must be at least 50 percent performed within the boundaries of an EZ. Qualified employees include economically disadvantaged individuals, dislocated workers, disabled individuals, ex-offenders, recipients of certain federal or state aid, members of a federally-recognized Indian tribes, or residents of a defined "targeted employment area" (TEA), where more than 50 percent of the residents are low- and moderate-income. To qualify for the hiring credit, the taxpayer must obtain a certification, or voucher, indicating that the employee meets the eligibility criteria specified above. Taxpayers are required to retain a copy of this voucher and provide it upon request to the Franchise Tax Board (FTB), the state agency charged with administering the CT and the PIT.

b. **Sales or Use Tax Credit.** Taxpayers engaged in a trade or business within an EZ may take a credit equal to the SUT paid during the taxable year in connection with the purchase of qualified property. Qualified property includes specified machinery and machinery parts, data processing and communications equipment, and motion picture manufacturing equipment central to production and postproduction. The total cost of qualified property permitted for purposes of claiming this credit may not exceed $1 million for PIT filers and $20 million for CT filers. Moreover, the qualified property must be used by the taxpayer exclusively in an EZ.

c. **Net Interest Deduction.** California law provides for the deduction of net interest income on loans made to a trade or business located solely within an EZ. For purposes of the EZ net interest deduction, a qualified taxpayer (creditor) is defined as an entity that loans funds on or after the designation date of the EZ to a qualified business (debtor) and receives interest payments thereon. The taxpayer (creditor) does not have to be located in the EZ to take advantage of the net interest deduction; only the debtor needs to operate within the EZ.

d. **Accelerated Depreciation.** Existing law allows EZ taxpayers to treat 40 percent of the cost of specified property as an expense not chargeable to the taxpayer's capital account. Any such cost may be allowed as a deduction for the taxable year in which the taxpayer places the property in service. Such property must be for exclusive use in a trade or business conducted within an EZ.

e. **Employee Tax Credit.** Existing law allows a PIT or CT credit equal to five percent of qualified wages, as defined, received by a qualified EZ employee during the taxable year. However, for each dollar of income received by the employee in excess of qualified wages, the credit is reduced by nine cents.

3. **New Jobs Credit.** Under the PIT and the CT, a tax credit of up to $3,000 for each additional full-time employee hired is available to small businesses with 20 or fewer employees, beginning January 1, 2009. The credit is prorated on an annual full-time equivalent basis for employees employed less than a full year. To qualify, each qualified full-time hourly employee must be paid wages for not less than an average of 35 hours per week and each qualified full-time employee that is a salaried employee must be paid compensation during the year for full-time employment.

   Generally, an employer may not claim the credit for those employees who are certified as a qualified employee in an EZ or similar incentive area, or for an employee whose wages are included in calculating any other credit allowed. In addition, there must be a net increase in qualified full-time employees compared to the number of full-time employees employed in the preceding taxable year. For taxpayers who first commence doing business in California during the taxable year, the number of qualified full-time employees considered employed in the preceding year would be generally be zero, unless certain special rules apply.

   The credit is an allocated credit and the total amount of credit available to be claimed by all taxpayers is capped at $400 million. The credit must be claimed on a timely filed original return received by the FTB on or before a cut-off date specified by the FTB.

4. **Governor's Office of Business and Economic Development.** The Governor's Office of Business and Economic Development (GO-Biz) was created to serve as a single point of contact for economic development and job creation efforts. The office offers a range of services to businesses including: business attraction, retention and expansion services; site location selection; permit assistance; regulatory filing and approval assistance; small business assistance; international trade development; and assistance with state government. Under the Governor's Reorganization Plan No. 2 (GRP 2), the Infrastructure Development Bank, the California Film Commission, the Office of Tourism, and the Small Business Loan Guarantee Program will be transitioned from the Business, Transportation and Housing Agency (BT&H) to GO-Biz, effective July 1, 2013.

Proposed Law: The proposed law institutes several new tax programs that will result in tax reductions for certain purchases of tangible personal property and for increasing employment in specific designated areas. In addition, the law would provide for the allocation of tax credits in exchange for investments and employment in California. The law would also result in the elimination of EZ and related area tax incentives and the New Jobs Credit.

1. **Sales and Use Tax Exemption.** The proposed law would allow for an exemption from the state portion of the SUT, beginning January 1, 2014 and before January 1, 2019, for certain purchases by qualified purchasers that are used in designated activities. The exemption would be limited annually to the first $200 million of otherwise eligible purchases by a qualified purchaser. Qualified purchasers that would be eligible for the SUT exemption are identified by designated codes of the North American Industry Classification System (NAICS), but excluding extractive industries:

    a. NAICS Codes 3111 through 3399 include all establishments primarily engaged in manufacturing activities. This encompasses manufacturers in the aerospace sector, textiles, pharmaceuticals, printing, food and others.

    b. NAICS Code 54171 includes establishments primarily engaged in conducting biotechnology research and experimental development. This encompasses industries using microorganisms and cellular and bio-molecular processes to develop or alter materials.

    c. NAICS Code 541712 includes establishments primarily engaged in conducting research and experimental development in the physical, engineering and life sciences. This encompasses activities in agriculture, electronics, environmental biology, botany, computers, chemistry, food, fisheries, forest, geology, health, mathematics, medicine, oceanography, pharmacy, physics, veterinary and other allied fields.

    Qualified tangible personal property must be used at least 50 percent of the time by the qualified purchaser in any stage of manufacturing, processing, refining, fabricating, or recycling of tangible personal property; for purposes of research and development; to maintain, repair, measure, or test tangible personal property; and, if purchased by a contractor, used as an integral part of the manufacturing, processing, refining, fabricating, or recycling process, or as a research and storage facility for use in connection with those processes.

    Qualified tangible personal property eligible for the exemptions would include: machinery and equipment, including component parts such as belts, shafts, moving parts and operating structures; equipment or devices used or required to operate and control machinery such as computers, data processing equipment, software; pollution control equipment that meets state and federal standards; and special purpose buildings used as an integral part of manufacturing, processing, refining, fabricating or recycling process, not including storage. Eligible property must have a useful life in excess of one year and excludes items such as furniture, equipment used for extraction or storage, or property used for administration, management or marketing.

    The SUT exemption would be provided if the purchaser furnishes a seller with an exemption certificate, which would be kept by the seller and furnished to the BOE upon request. Qualifying purchases that are removed from the state, or used for unqualified activities, within one year of the purchase would be subject to a 'claw-back' equal to the value of the SUT exemption. The purchaser of the property would be liable for the payment of the sales or use tax that would otherwise have been collected from the seller absent the provision of the exemption.

2. **Hiring Credit.** The proposed legislation would initiate a new hiring tax credit under the PIT and CT, from January 1, 2014 to January 1, 2019, for additional hiring of employees in defined geographic areas of the state. The hiring credit would be available in the geographic areas largely covered by the existing EZs (except certain census tracts with low unemployment), two recently expired EZs located in Antelope Valley and Watsonville, and in designated census tracts that have a civilian unemployment rate and a poverty rate in the top 25 percent of all census tracts in the state. The credit percentages for all hiring credits are 35 percent per year for five years for wages between 150 percent and 350 percent of the minimum wage (currently between $12 and $28 per hour). The credit is available for full-time employees who perform at least 50 percent of their activities in the designated areas. Generally, (except for small businesses that claim the credit), the following apply: (1) taxpayers from a temporary agency, retailer, restaurant or drinking establishment, as defined by the NAICS codes are prohibited from receiving the hiring credit; and (2) taxpayers that move into an EZ are required to provide an "offer of transfer" to its employees with comparable compensation. Important features of the Hiring Credit include the following:

   a. **Employee Characteristics.** Employees would have to meet one of the following characteristics: (1) have been previously unemployed for six months; (2) received the Earned Income Tax Credit (EITC); or (3) have served in the United States Military.

   b. **Net New Jobs.** The bill requires that in order to qualify for any credit, the taxpayer must have experienced an increase in total jobs throughout the state from one year to the next. Taxpayers are only allowed the credit for the number of new jobs provided in the state. For example, if a company shows it has hired 100 employees statewide, the company may receive total credits for up to 100 employees. Alternatively, if a taxpayer hires 50 new employees in one area but laid-off 25 employees in another part of the state, the taxpayer would only be eligible for credits for 25 qualified employees.

   c. **Small Business Provisions.** The bill requires that 25 percent of the hiring credits be reserved for small business, defined as businesses with annual gross receipts of under $2.0 million. Small business must comply with all requirements except the offer of transfer and the industry limitations noted above.

   d. **Credit Administration.** Taxpayers may only qualify for the credit if it is on the original filed timely return with the FTB; no credit may be claimed on an amended return. Taxpayers, with qualified employees that meet the net new jobs test, must reserve a credit with the FTB. The credit is then claimed on an original filed timely return. The proposed statute requires the FTB to compile a list of the hiring credit vouchers claimed and number of new jobs created for each taxable year.

3. **Governor's Office of Business and Economic Development.** The bill establishes the California Competes Tax Credit Committee (CCTCC), consisting of the State Treasurer, Director of Finance, the Director of GO-Biz, and a representative of the Senate and Assembly. The CCTCC would approve or reject written agreements for the allocation of California Competes tax credits under the PIT and the CT after the receipt of fully executed written agreements between the taxpayer and GO-Biz. Under the program, up

to $30.0 million would be allocated in 2013-14, $150.0 million in 2014-15 and $200.0 million from 2015-16 through 2018-19. The amounts actually allocated would be subject to restrictions based on the total value of SUT exemptions and Hiring Credits claimed relative to the amount of $750.0 million. Twenty-five percent of the credits would be reserved for small businesses and priority would be given to projects proposed for location in areas of high unemployment or poverty.

The agreement to award credits would take into consideration, but not limited to: the number of jobs created; the compensation paid to employees; amount of investment by the taxpayer in the state; amount of unemployment in the area; other incentive available to the taxpayer in this state and other states; duration of the project; overall economic impact of the project; strategic importance of the project; opportunity for future expansion in the state by the taxpayer; and the extent to which state benefits exceed state costs. In the event that a taxpayer fails to perform under the written agreement, the credit would be subject to recapture. The bill also requires GO-Biz to provide information to FTB regarding the effectiveness of the credits as measured by job creation, additional investment and other metrics.

4. **Enterprise Zone Programs.** Under the proposed legislation, programs related to tax incentives for activities in EZs and similar areas, would generally no longer be effective beginning January 1, 2014. However, with respect to the EZ hiring credit, for employees employed by the qualified taxpayer prior to January 1, 2014, the wages paid with respect to those employees would continue to qualify for the credit for any remainder of the five-year period. In addition, credits claimed, or earned, under the EZ program and carried-over from prior years, could continue to be applied to tax liabilities for up to five years, or through December 2019.

5. **New Jobs Credit.** Under the proposed statute, the 2009 New Jobs Credit would cease to be operative for taxable years beginning on or after January 1, 2014 and repealed.

6. **Appropriation.** An appropriation to the Department of Finance and the CCTCC is provided for the costs of administering the provisions of this act. The allocation of funds under this appropriation would be effective 30 days after the notification by the Director of Finance to the Joint Legislative Budget Committee (JLBC).

Proposed Amendments: *Proposed committee amendments to AB 93 are the following:*

1. ***Legislative Intent.*** *The legislative intent language amendment would indicate that the Legislature finds and declares the goal of California's economic development policy should be designed to: create good jobs with middle class wages and benefits; target for assistance individuals with barriers to employment; and, encourage businesses to invest and create jobs in California.*

2. ***Targeted Employment Areas.*** *There are three categories of employees eligible for the hiring credit: (1) individuals who have been unemployed for six months; (2) veterans unemployed at discharge; and (3) EITC recipients. The amendment would allow for the expedited processing of credit reservation requests from a qualified taxpayer who submits a tentative tax credit reservation request for an eligible employee (under of the three eligibility categories) who also happens to reside in a TEA.*

3. ***Legislative Reporting.*** *The proposed amendment would require the following program evaluations be provided to the JLBC annually. The reports would include discrepancies between initial estimates and actual credit or exemption usage under the programs and*

identify options for program changes in the event usage is below expectations. The evaluations presented to the JLBC would be provided by: FTB for the Hiring Credit; BOE for the SUT exemption; and GO-Biz for the California Competes credits.

4. ***Severability.*** *The bill amendments would provide a severability clause that would allow for the continued operation of other provisions of the statute in the event that the establishment of the GO-Biz California Competes credit is found to be an unlawful delegation of legislative authority. In addition, the bill amendments contain language that would preclude the operation of the SUT exemption and the Hiring Credit in the event the repeal of the EZ program and the New Jobs Credit are overturned and instead remain operative.*

5. ***Sales and Use Tax Exemption Delay.*** *The proposed amendments would delay the implementation of the sales and use tax exemption for equipment related to manufacturing and research and development for six months. Under the amendments, the exemption would be available beginning July 1, 2014.*

6. ***Technical Amendments.*** *Legislative Counsel has identified certain technical changes that relate to cross-references, typographical errors, and inadvertent minor inconsistencies that will be clarified through the amendments.*

Fiscal Effect: The bill contains measures that would result in revenue increases and decreases. Revenue decreases would result under the proposal from the sales and use tax exemption, tax credits for additional hiring created, and tax incentives provided by GO-Biz. Increases in revenues would stem from the repeal of certain tax credits and other tax incentives related to the enterprise zones and similar tax incentive areas, and cessation of the 2009 New Jobs Credit. The table below indicates the revenue impacts of isolated components of the proposal and the total impact of the measure over the next four years:

Revenue Impacts (In Millions $)

Tax Provision	2013-14	2014-15	2015-16	2016-17
Sales and Use Tax Exemption	-236	-486	-521	-531
Hiring Credit	-7	-34	-70	-110
GO-Biz Incentives	0	-32	-83	-134
Enterprise Zone Repeal	95	375	635	805
New Jobs Credit Repeal	75	0	0	0
Total	**-73**	**-177**	**-39**	**30**

Estimates from the Board of Equalization (BOE) and the Franchise Tax Board (FTB) provide the basis for the revenue estimates shown the table. The Department of Finance (DOF) then made additional adjustments in these estimates to account for specific policy design aspects of the proposal, assumptions regarding behavioral shifts, and anticipated future actions.

In particular, the BOE provided base estimates of the revenue loss due to sales and use tax exemptions which do not account for certain adjustments required to incorporate behavioral changes, interactions with other programs, and limitations on the availability of the exemption. DOF's most significant adjustment to the BOE estimates is a downward adjustment resulting from the $200 million per-firm limitation. A review of California data indicates that, while few firms exceed the $200 million threshold, those that do contribute a disproportionate share of capital purchases—almost 22 percent of equipment purchases are attributable to purchases in excess of $200 million by firms with more than $200 million in purchases. This adjustment results in a reduction in the revenue loss from this component.

Similarly, the FTB provided base estimates for the elimination of EZ credits and those for similar zones. FTB's estimates did not account for anticipated revenue impacts of regulatory decisions by the Administration, through audit procedures or other administrative steps that would, as a matter of course, work to reduce the impact of the EZ tax incentive programs. Not accounting for these anticipated actions would tend to overstate the positive revenue implications in the bill attributable to ending EZ tax incentive programs. Thus, the DOF adjustment results in a reduction in the revenue gain associated with the proposal.

DOF's revenue impact projections are based on available California data and account for historical patterns of equipment purchases for various firms. The available state-level data used is based on a reasonable period from which to sample. While there will always be variations from estimated revenues due to changing circumstances and events for which forecasting tools cannot account, the revenue estimates seem reasonable.

Support: NA

Opposed: NA

Comments: From an economic perspective, the core of the proposed policy changes would represent an improvement in overall state tax policy. The SUT exemption, although limited to particular industries, would represent a fundamental policy improvement by addressing the phenomenon of 'tax pyramiding'—that is, when inputs to production are taxed as well as the outputs. While this aspect of the proposal represents good tax policy, broad application would result in significant revenue loses; however, this possibility is dealt with by targeting the exemption to particular industries. Regarding the EZ programs, the general intent of the PIT and CT tax incentives in the EZ program is to generate, in designated areas, economic activity—such as additional investment and employment—that would otherwise not occur. However, the effectiveness of the EZ program in this regard has been the subject of substantial criticism. A broad body of economic and tax research indicates that the program offers a poor return on the state's sizable investment, largely as a consequence of the ineffectiveness and inefficiencies inherent in tax incentive programs of this type. On balance, the proposal represents a significant step forward for state policy, while still retaining certain incentive benefits for disadvantaged areas of the state.