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An Update on California=s MIC and Partial Exemption Statutes

by Chris Micheli

I. INTRODUCTION

The purpose of this article is to provide another annual update on proposals and actual amendments to California=s manufacturing equipment tax incentives, as well as to provide information on tax agency data and the critical sunset date provision. As readers may recall, since the initial statute was enacted and then expanded in 1994, there have been several modifications to the statutes.

In 1995, legislative attempts to amend the statutes were unsuccessful. However, in 1996, the MIC was amended to expand the definitions of Aspecial purpose buildings@ and Asmall business.@ In addition, several technical changes were made. In 1997, only technical changes were made to the MIC statute.

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This year, the MIC was amended to expand the definitions of Aqualified taxpayer@ and Aqualified property.@ While these amendments were made contingent upon the defeat of Proposition 7 on the November 3 statewide ballot, they have now taken effect and are retroactive to January 1, 1998.

II. BACKGROUND ON STATUTES

As most readers are aware, in 1993, California enacted a 6% investment tax credit (herein referred to as the AMIC@) and a partial sales/use tax exemption (equal to 5%) for the purchase of certain property used by manufacturers (California Revenue & Taxation Code [CRTC] '' 17053.49 and 23649 [MIC] and 6377 [partial exemption]).

Basically, the MIC and partial exemption provide tax benefits for certain businesses that acquire, construct or reconstruct certain machinery and equipment primarily used in manufacturing or processing.

For purposes of the MIC and partial exemption, the law provides that a Aqualified taxpayer/person@ is any taxpayer who falls within Standard Industrial Classification (SIC) Codes 2011 to 3999. This is Division D (AManufacturing@) of the SIC Manual. A qualified taxpayer may be an individual, partnership, C or S corporation, limited liability company, trust, or estate.

For purposes of the definition of Aqualified property,@ there are four major requirements to be met in order for property to be eligible for the MIC: It must be (1) tangible personal property, (2) which is depreciable or amortizable under Internal Revenue Code Section 1245(a), (3) which is Aprimarily used@ in the manufacturing process, (4) which is placed in service in California on or after January 1, 1994.

Also available to certain taxpayers is a partial exemption from the sales or use tax that otherwise would be imposed on an item of machinery or equipment. For purchases made after January 1, 1994, but prior to December 31, 1994, the exemption rate equals six percent. For purchases made after December 31, 1994, the exemption rate equals five percent.

In addition, the partial exemption is only available to a Anew trade or business@ (formed or organized after December 31, 1993, or that commenced doing business in California after that date). The partial exemption is only available for the first three years of a business= operation.

Finally, the benefits of the investment tax credit and the sales/use tax exemption will be lost if 100,000 jobs in the manufacturing sector are not created by January 1, 2001, or on January 1 of the earliest year thereafter. The law requires that an annual report be made to the State Legislature by the Employment Development Department showing the total employment in the manufacturing sector (excluding aerospace) in this state.

III. RECENT AMENDMENTS TO THE MIC STATUTE

Only one piece of legislation enacted during the 1998 Legislative Session affects the MIC statute; none affect the partial exemption. AB 2798 (Machado) (Stats. 1998, Ch. 323) expands the MIC by adding SIC Codes 7371 to 7373 to the definition of Aqualified taxpayer.@ Effective for purchases made on or after January 1, 1998, the MIC includes taxpayers engaged in computer programming services, prepackaged software, and computer-integrated systems design.

The credit is available only for purchases of computers and computer peripheral equipment or capitalized labor used to construct the computers and peripherals. To qualify for the credit, this property must be used primarily to develop or manufacture custom or prepackaged software to the special order of the purchaser. These provisions had been contained in AB 1063 (Lempert/Cunneen) and AB 2441 (Campbell).

As a result of the enactment of AB 2798, the following amendments were made to the MIC statute:

' 17053.49/' 23649 (c)(1) amended to be new (b)(4): For purposes of this subdivision, in the case of any qualified taxpayer engaged in those lines of business described in Codes 7371 to 7373, inclusive, of the Standard Industrial Classification (SIC) Manual published by the United States Office of Management and Budget, 1987 edition, Athe first income year beginning on or after January 1, 1998,@ shall be substituted for AJanuary 1, 1994,@ in each place in which it appears.

' 17053.49 / ' 23649 new (c)(1): For purposes of this section, Aqualified taxpayer@ means any taxpayer engaged in those lines of business described in Codes 2011 to 3999, inclusive, or Codes 7371 to 7373, inclusive, of the Standard Industrial Classification (SIC) Manual published by the United States Office of Management and Budget, 1987 edition.

' 17053.49 / ' 23649 new (d)(2): Computers and computer peripheral equipment, as defined in Section 168(i)(2)(B) of the Internal Revenue Code, that is tangible personal property as defined in Section 1245(a) of the Internal Revenue Code for use by a qualified taxpayer in those lines of business described in SIC Codes 7371 to 7373, inclusive, of the SIC Manual, 1987 edition, that is primarily used to develop or manufacture prepackaged software or custom software prepared to the special order of the purchaser who uses the program to produce and sell or license copies of the program as prepackaged software.

' 17053.49 / ' 23649 amended (d)(3): The value of any capitalized labor costs that are directly allocable to the construction or modification of property described in paragraph (1) or (2).

' 17053.49 / ' 23649 new (f)(6): For purposes of this subdivision, in the case of any qualified taxpayer engaged in those lines of business described in Codes 7371 to 7373, inclusive, of the Standard Industrial Classification (SIC) Manual published by the United States Office of Management and Budget, 1987 edition, Athe first income year beginning on or after January 1, 1998,@ shall be substituted for AJanuary 1, 1994,@ in each place in which it appears. In addition, Athe effective date of this paragraph@ shall be substituted for Athe effective date of this clause@ and Afourth calendar quarter of 1998@ shall be substituted for Afourth calendar quarter of 1994.@

' 17053.49 / ' 23649 new (k): The amendments made by the act adding this subdivision shall be operative for income years beginning on or after January 1, 1998.

IV. UPDATE SIC REFERENCES?

Readers may recall that, in 1997, AB 1040 (Assembly Revenue & Taxation Committee) (Stats 1997, Ch. 605) set forth legislative intent that the MIC statute should be amended when the North American Industry Classification System (NAICS) is established. The NAICS Manual has now been released.

The language of AB 1040 states: AIt is the intent of the Legislature to replace the code section references to the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition, that are contained in the Revenue and Taxation Code with code section references to the North American Industry Classification System (NAICS), expected to be published in 1997. Publication of NAICS is not to be construed to impair the ability of any taxpayer to rely on a SIC classification for the purposes of determining eligibility for the manufacturers investment tax credit.@

There may be a legislative effort in 1999 to change the SIC Manual references to those contained in the NAICS Manual. Taxpayers should monitor legislative efforts in this regard and ascertain their NAICS Code.

V. 1998 LEGISLATION AFFECTING THE MIC STATUTE

During this second year of the 1997-98 California Legislative Session, there were several efforts to enhance the MIC and partial exemption statutes, particularly to expand the benefits to other industries. The following bills were considered by the California Legislature this year:

AB 1062 (Battin) would have increased the amount of the MIC from 6% to 8%. Later it was amended to expand the MIC and partial exemption to post-production activities. Failed passage in the Assembly Appropriations Committee, but amended into AB 2798, which was enacted.

AB 1063 (Lempert/Cunneen) would have expanded the partial exemption and MIC to include computer software businesses. Failed passage in the Senate Appropriations Committee, but amended into AB 2798, which was enacted.

AB 1976 (Campbell) would have made the MIC refundable. The excess credit would be applied first to all other amounts due, then the remaining excess credit would be refunded on a pro-rata basis over the next three years. Failed passage in the Assembly Appropriations Committee.

AB 2441 (Campbell) would have expanded the MIC to include computer programming and software businesses. Failed passage in Assembly Appropriations Committee, but amended into AB 2798, which was enacted.

VI. PROPOSED AMENDMENTS TO SBE REGULATION

Readers should be aware that the staff of the SBE has published proposed amendments to Regulation 1525.2 [Title 18, Division 2, Chapter 4 of the California Code of Regulation], which implements the partial exemption for start-up manufacturers. A hearing on the proposal is scheduled before the Board in early December. If approved at that time, the amendments will take effect upon formal approval by the Office of Administrative Law.

The amendments are intended to permit manufacturers who did not timely prequalify for the exemption, but who would otherwise qualify, to file a claim for refund for qualified purchases self-reported without taking the deduction and submit an application for an exemption certificate to the SBE for review and approval.

The first proposed amendment would amend Subdivision (f)(3)(B) to read (deletions in strikeout; additions in underline):

Failure to file a timely return for an otherwise qualified purchase from a retailer not engaged in business in this state, or failure to attach a completed manufacturer=s declaration to such a timely filed return, <u>does not</u> constitute a waiver of the use tax partial exemption for that purchase ~~and, as a consequence, the partial exemption cannot be claimed on that purchase~~. <u>A person who fails to file a timely return or attach a completed manufacturer=s declaration to a timely return for an otherwise qualified purchase has the burden of establishing that he or she was entitled to claim the partial exemption.</u>

The second proposed amendment would add new Subdivision (f)(3)(C) to read (additions in underline):

<u>A person who self-reported and paid use tax on a qualified purchase from a retailer not engaged in business in this state, and who failed to claim the partial use tax exemption as provided by this regulation may file a claim for refund equal to the amount of the partial exemption that he or she could have claimed pursuant to this regulation. The procedure for such a claim shall be the same as for other claims for refund filed pursuant to Revenue and Taxation code section 6901. A person filing a claim for refund of the partial use tax exemption has the burden of establishing that he or she was entitled to claim the partial exemption with respect to the amount of refund claimed under this part.</u>

These proposed amendments will be considered by the SBE Board at its hearing in early December. At this time, there does not appear to be any objections to the adoption of these amendments.

<u>VII. SBE PROPOSED LEGISLATION</u>

Also of interest was a proposal from SBE staff to repeal CRTC ' 6902.2, which provides an alternative mechanism for receiving the benefits of the MIC. This statute permits a taxpayer to apply for a sales / use tax refund in an equivalent amount to the MIC, rather than taking the MIC. According to SBE staff, the statute Afails to provide meaningful relief to taxpayers beyond the already existing manufacturer=s investment credit.@

Section 6902.2 does not allow a taxpayer to seek a refund of the MIC in excess of the amount of tax liability that could have been offset by the MIC. According to a staff report, the existence of this refund mechanism Ahas created taxpayer confusion. To date, three of the four section 6902.2 claimants have withdrawn their claims for refund based on their inability to obtain a refund in excess of their existing tax liability.@

Finally, the staff argued that Aonly one Section 6902.2 claim for refund has been fully processed since the inception of 6902.2 and no other claims are pending. We believe that the FTB would concur with this proposal since it would have no impact on its current MIC program.@ On November 17, 1998, this legislative proposal was rejected by the 5-member SBE Board.

VIII. UPDATE ON FTB INFORMATION

According to data from the Franchise Tax Board provided to the author on October 27 and 29, 1998, the following is the amount of tax credits claimed by qualified taxpayers under the MIC statute:

FTB MIC RETURNS

1995 Returns (94/95 purchases)	Total Amount of MIC	Average MIC
PIT 4,502	$41,203,148	$9,152
B&C 2,137	$229,291,700	$107,296

1996 Returns	Total Amount of MIC	Average MIC
PIT 4,341	$27,630,000	$6,365
B&C 4,957	$493,081,000	$99,472

Of interest to readers is the substantial growth in the number of corporate taxpayers claiming the MIC and the total amount of credits claimed by those taxpayers. On the corporate side, the number of taxpayers claiming the credit has more than doubled to 4,950. Moreover, the amount of credits earned has more than doubled to $493 million.

Since the MIC=s enactment, the staff have issued only two Chief Counsel rulings on the MIC. These are similar to IRS private letter rulings and are taxpayer specific; they are attached to the taxpayer=s return. They are not made public and cannot be used by any taxpayer other than the one who requested it. There have been seven requests (two more since last year) for Chief Counsel rulings, but only two have been issued to this date.

The first Chief Counsel Ruling analyzes the effect of like-kind exchanges pursuant to IRC ' 1031 as qualified costs for the MIC. The second Chief Counsel Ruling concerns the definition of Amanufacturing@ as its applies to printers.

The FTB staff have also issued one Legal Ruling. They are made public and are similar to IRS Revenue Rulings. These Rulings, which are intended to provide taxpayer guidance in the area covered by the Ruling, are made public after formal adoption by the three-member FTB Board.

The Ruling concerns design and engineering costs. It addresses whether capitalized labor costs for engineering and design sourecs may be Aqualified costs@ for the MIC.

IX. UPDATE ON SBE INFORMATION

According to data provided by the State Board of Equalization to the author on October 28 and November 13, 1998, the following is the amount of tax exemptions claimed by qualified persons under the partial exemption statute:

SBE PARTIAL EXEMPTION RETURNS

YEAR	TOTAL PURCHASES CLAIMED	TAX AFFECTED (TAX SAVINGS)
1994	$58,607,020	$2,930,351
YEAR	TOTAL PURCHASES CLAIMED	TAX AFFECTED (TAX SAVINGS)
1995	$90,476,929	$4,523,846
YEAR	TOTAL PURCHASES CLAIMED	TAX AFFECTED (TAX SAVINGS)
1996	$151,724,061	$7,586,203
YEAR	TOTAL PURCHASES CLAIMED	TAX AFFECTED (TAX SAVINGS)
1997	$213,993,006	$10,699,650
YEAR	TOTAL PURCHASES CLAIMED	TAX AFFECTED (TAX SAVINGS)
1998 (thru 6/30)	$48,674,662	$2,433,733

The above chart is most interesting when examined in light of the SBE=s original revenue estimate that was issued in 1993 upon adoption of SB 671, the implementing legislation. According to SBE staff, the estimated tax savings were $9 million on an annual basis.

The information provided above is based upon amounts claimed on sales/use tax returns attributable to the exemption. These figures represent significant differences in the amounts previously provided to the author by SBE staff for the years 1994 through 1996. These differences are attributable to the way the SBE is now accounting for the amounts claimed.

Previously, the SBE used amounts shown on exemption certificates that taxpayers submitted when prequalifying for the exemption. However, these amounts were considerably understated when staff compared the amounts claimed on sales/use tax returns with the amounts that had been declared on the exemption certificates. As a result, the figures set forth above are the precise figures taken directly from the returns.

Regarding the partial exemption and prequalifications completed by the SBE, staff have provided the following information (the exemption requests are still only processed in Sacramento):

- Total number of requests for prequalification received by SBE: 1,687
- Total number of prequalification certificates issued (granted by SBE): 1,331 (with an additional 14 requests that have not been processed)

YEAR	APPROVED PREQUALIFICATIONS
1994	181
1995	263
1996	312
1997	303
1998 (thru 10/30)	259
TOTAL:	1,318
Revoked Exemptions:	13

Also of interest is that SBE staff have received approximately 50 requests (about 10 more since last year) for legal opinions under Regulations 1525.2 and 1525.3. They have issued a response to each requestor.

X. UPDATE ON THE SUNSET CLAUSE

Finally, of interest to readers is the current number of new jobs created under the MIC and partial exemption since their effective date of January 1, 1994. As you will recall, at least 100,000 new manufacturing jobs (not including aerospace jobs) must be created by January 1, 2001, or else the MIC and partial exemption statutes will expire (remember that the laws can expire on any January 1 thereafter if a net 100,000 jobs is not maintained).

Below is a chart listing data supplied by the California Employment Development Department to the author on October 20, 1998 (as required to be reported on an annual basis to the California Legislature in compliance with Revenue and Taxation Code Sections 6377, 17053.49 and 23649) detailing the annual average statewide employment in manufacturing (minus the aerospace industry):

YEAR	ANNUAL AVERAGE OF MANUFACTURING JOBS	NET CHANGE SINCE 1/1/94
1994	1,587,000	N/A
1995	1,625,000	+38,000
1996	1,686,600	+99,600
1997	1,746,100	+159,100

As you can see from this data, just over 159,000 new jobs have been created in the manufacturing sector since January 1, 1994. There are just over two years until the first sunset date could take effect if at least 100,000 jobs are not maintained.

XI. CONCLUSION

While there were again several attempts to expand the tax incentives contained in the manufacturers' investment tax credit and partial exemption statutes, only one of these proposals was successful this year. After three successive attempts, the software industry was able to expand the MIC to include these businesses.

Undoubtedly, there will be additional efforts next year and in the future to expand the MIC and partial exemption to other industries, as well as to enhance the current benefits.