

GOVERNOR'S 2013 ECONOMIC DEVELOPMENT PLAN

Sales Tax Exemption for Manufacturing Equipment – Repeal of Enterprise Zones

POLICY BRIEF | SEPTEMBER 12, 2013

Background

California law authorizes the establishment of Geographically-Targeted Economic Development Areas (G-TEDAs) to stimulate financial activity and job growth in economically depressed areas of the state. G-TEDAs, authorized through the end of 2013, consist of enterprise zones¹, Local Agency Military Base Recovery Areas (LAMBRAs)², Manufacturing Enhancement Areas (MEAs)³, and the Tulare Targeted Tax Area (TTA)⁴ – each of which imposes different qualification requirements, but is similar with regard to the types of tax incentives offered. Enterprise zones comprise the majority of G-TEDAs, by far, and G-TEDAs often are collectively referred to as EZs.

California's EZ program, established in 1984 and expanded in the 1990s, provides several tax incentives to businesses and employers located in economically distressed areas. The incentives include hiring credits, sales and use tax credits, accelerated depreciation, a longer carry-forward period for net operating losses, and interest deductions for lenders. The hiring credit is the most utilized EZ tax incentive.

With the state budget in turmoil over the past few years due to an economic downturn, lawmakers looked for ways to address expenditures and increase revenue. In 2011-12, Governor Jerry Brown proposed to repeal all EZ tax incentives, citing suggestions from the Legislative Analyst's Office that the EZ programs be restructured or repealed. After a lengthy political fight between supporters of the programs – who contend that the programs increase

investment and retain jobs that otherwise would be lost – and critics who question the effectiveness of the tax incentives, the proposal was tabled.

EZs again were the hot topic in 2013, when Governor Brown proposed to repeal the EZ program and replace it with three tax incentives. Lawmakers were divided about the proposal. Those with EZs in their districts tended to oppose the proposal, citing the job and economic growth generated by the EZs in their areas. Those supporting the proposal cited news reports that strip clubs and nightclubs had benefitted from EZ credits, and insisted that a sales tax exemption included in the governor's proposal would promote economic activity statewide.

Negotiations between the proponents and opponents continued and a plan that repeals all EZs, but provides a statewide sales and use tax exemption, and also allows some former EZs to qualify for a new hiring tax credit was approved. This replacement package, commonly known as the "governor's economic development plan," became law when the governor signed AB 93 (Ch. 69, St. 2013); and SB 90 (Ch. 70, St. 2013). SB 100 and AB 106, both clean-up measures, were passed by the Legislature on September 12 but were not yet signed into law at this writing.

This policy brief summarizes the significant provisions of the governor's plan as outlined in the four measures, and includes a one-page quick-reference table (see page 8). This document is not intended to provide legal tax advice for purposes of determining eligibility.



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Significant Provisions

The plan includes: a statewide sales and use tax exemption for manufacturing and research-and-development (R&D) equipment; a tax credit for hiring eligible employees in specified areas of the state; and an investment tax credit to be administered by the Governor's Office of Business and Economic Development (GO-Biz). The plan also repeals all EZ programs on January 1, 2014. The significant eligibility requirements and exclusions for each of the three new tax incentives are described below.

Sales and Use Tax Exemption

Existing law imposes a sales tax or use tax on the sale or use of specified tangible personal property. The new tax incentive establishes a partial sales and use tax exemption statewide for the pur-

chase of qualified equipment that is used for manufacturing or research and development by eligible persons, subject to the following criteria:

Operative Dates and Tax Rates

A partial sales and use tax exemption – equivalent to 4.1875 percent – is available statewide for purchases of qualified equipment from July 1, 2014 through June 30, 2022. Qualified equipment is subject to the remainder of the sales and use tax rate, which is equivalent to 3.3125 percent, plus up to an additional 2 percent local add-on tax.

Eligible Taxpayers

Taxpayers engaged at least 50 percent of the time in industries enumerated in the following North American Industry Classification System (NAICS) codes are eligible for the exemption:⁵

TAXPAYERS ELIGIBLE FOR SALES TAX AND USE TAX EXEMPTION ON MANUFACTURING AND RESEARCH-AND-DEVELOPMENT EQUIPMENT

Under the economic development plan, taxpayers engaged in the following North American Industry Classification System categories are eligible for the sales/use tax exemption for manufacturing and research-and-development equipment (NAICS codes are in parentheses):

- Apparel Manufacturing (315)
- Beverage and Tobacco Product Manufacturing (312)
- Biotechnology Research and Development (541711)
- Chemical Manufacturing (325)
- Computer and Electronic Product Manufacturing (334)
- Electrical Equipment, Appliance, and Component Manufacturing (335)
- Fabricated Metal Product Manufacturing (332)
- Food Manufacturing (311)
- Furniture/Related Product Manufacturing (337)
- Leather/Allied Product Manufacturing (316)
- Machinery Manufacturing (333)
- Miscellaneous Manufacturing (339)
- Nonmetallic Mineral Product Manufacturing (327)
- Paper Manufacturing (322)
- Petroleum/Coal Products Manufacturing (324)
- Physical, Engineering, and Life Sciences Research and Development (541712)
- Plastics/Rubber Products Manufacturing (326)
- Primary Metal Manufacturing (331)
- Printing and Related Support Activities (323)
- Textile Mills (313)
- Textile Product Mills (314)
- Transportation Equipment Manufacturing (336)
- Wood Product Manufacturing (321)

SALES AND USE TAX EXEMPTION

- Codes 3111 through 3399 – dealing with manufacturing of food, textiles, clothing, chemicals, plastics, wood, cement, metals, component parts, etc.
- Codes 541711 or 541712 – dealing with research and development of bio-tech, and the physical, engineering and life sciences.

Businesses required to apportion business income under the three-factor formula (i.e., taxpayers engaged in the extractive and agricultural industries, or banking and financial activities) are ineligible for the sales and use tax exemption.

Qualifying Equipment

Eligible equipment includes tangible personal property that primarily will be used for/by:

- Manufacturing, processing, refining, fabricating, or recycling.
- Research and development.
- Maintaining, repairing, measuring or testing equipment that is used in manufacturing, processing, refining, fabricating, recycling, or research and development.
- A contractor for the construction of a project that will be used for manufacturing, processing, refining, fabricating, recycling, or research and development.

Qualifying equipment also includes component parts; computers and software necessary to operate or control machinery; pollution-control equipment; and special-purpose buildings and foundations, as specified.

Implementing legislation broadly describes equipment eligible for exemption; however, eligibility likely will be defined by case law and regulations.

Limit on Exemption

The total amount of purchases that may be ex-

empt is capped at \$200 million per taxpayer per year. For taxpayers required to be included in a combined report pursuant to Revenue and Taxation Code Section 25101, or authorized to be included in a combined report pursuant to Revenue and Tax Code Section 25101.15, the exemption is capped at \$200 million in purchases per combined report.

Recapture Provision

Exempt equipment is subject to sales/use tax recapture if, within a year of purchase, the equipment is:

- Removed from California;
- Converted to a non-qualifying use; or
- Used in a non-qualifying manner.

Certificate Process

Taxpayers seeking the exemption must complete an exemption certificate prescribed by the State Board of Equalization, and must provide this certificate to the retailer. It is unclear whether the same process is applicable to taxpayers seeking a use tax exemption.

Hiring Tax Credit

The governor's economic development plan provides a tax credit for the hiring of eligible full-time employees within specified areas of the state. This hiring credit replaces the former EZ hiring credit and the small business hiring credit that was enacted in January 2009. The qualification criteria include:

Operative Dates

The tax credit is available for taxable years beginning on or after January 1, 2014, and before January 1, 2021.

Eligible Employers

Taxpayers engaged in a trade or business within targeted areas of the state are eligible for the credit, except for employers who:

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- Provide seasonal or temporary help.
- Provide retail services.
- Are engaged in food services.
- Are engaged as a sexually oriented business.⁶
- Are listed in NAICS Codes 713210, 721120 or 722410 – dealing with casinos, casino hotels, and drinking establishments.

Eligible Areas of the State

The tax credit is available for hires in targeted areas of the state, which include:

- Former enterprise zones, including recently expired zones in Antelope Valley

and Watsonville.

- Former LAMBRAs.
- “Designated census tracts,” which represent the highest quartile for both civilian unemployment and poverty statistics, as determined by the California Department of Finance based on data from the five-year American Community Survey.

Qualified Hires

Hires qualifying for the credit include:

- Workers who previously were unemployed for six months or more immediately preceding employment with the qualified taxpayer;

TAXPAYERS INELIGIBLE FOR THE HIRING CREDIT

Under the economic development plan, employers in the following North American Industry Classification System codes are ineligible for the hiring tax credit (NAICS codes are in parentheses).

ADMINISTRATIVE SUPPORT

- Temporary Help Services (Including help supply services, model supply services, labor contractors, temporary staffing services, manpower tools.) (561320)

ACCOMMODATION AND FOOD SERVICES

- Cafeterias, Grill Buffets, and Buffets (722514)
- Casino Hotels (721120)
- Drinking Places – Alcoholic Beverages (722410)
- Full-Service Restaurants (722511)
- Limited-Service Restaurants (722513)
- Snack and Nonalcoholic Beverage Bars (722515)

ARTS, ENTERTAINMENT, AND RECREATION

- Casinos (713210)
- Theater Companies/Dinner Theaters (711110)

RETAIL TRADE

- Building Material, Garden Equipment, and Supplies Dealers (444)
- Clothing and Accessory Stores (448)
- Electronics and Appliance Stores (443)
- Food and Beverage Stores (445)
- Furniture and Home Furnishing Stores (442)
- Gasoline Stations (447)
- General Merchandise Stores (452)
- Health and Personal Care Stores (446)
- Miscellaneous Store Retailers (453)
- Motor Vehicle Parts Dealers (441)
- Nonstore Retailers (454)
- Sporting Goods, Hobby, Musical Instrument, and Book Stores (451)

HIRING TAX CREDIT

- Veterans who separated from the U.S. armed forces within the 12 months prior to being hired;
- People who received the federal Earned Income Tax Credit in the previous taxable year;
- Ex-felons; or
- Recipients of benefits from the California Work Opportunity and Responsibility to Kids (CalWORKs) program, or general assistance.

Wage Requirements

Eligible employee wages must be at least 150 percent, but not more than 350 percent, of minimum wage. Under the current \$8 an hour minimum wage, this equates to a minimum of \$12 an hour, up to \$28 per hour.

In five “designated pilot areas” to be determined by GO-Biz, employee wages may be at least \$10 per hour. The “designated pilot areas” are limited to areas within former enterprise zones, LAMBRAs, and “designated census tracts.”

Net Job Increase Requirement

The credit is applicable to employers with a calculated net increase in jobs, determined on an annual full-time equivalent basis by subtracting the number of employees employed in the base year from the number of employees employed in the current taxable year.

Credit Amount

The total allowable credit is calculated based on 35 percent of qualified wages and the net increase in employees relative to the total number of employees. Any unused credit may be carried forward for five years.

Credit Reservation and Filing

Taxpayers must first reserve the credit with the Franchise Tax Board within a specified time period, and

must claim the credit on a timely filed, original return.

Recapture Provision

The tax credit will be recaptured if a qualified hire who was counted toward the credit is terminated by the taxpayer during the first 36 months of employment, unless that termination was:

- Voluntary on the part of the employee;
- Due to the employee becoming disabled and unable to perform the services of employment, as specified;
- Due to employee misconduct, as specified;
- Due to a substantial reduction in the employer’s trade or business operations;
- Replaced by another qualified hire, so as to create a net increase in employees and hours of employment; or
- Due to seasonal employment, and the qualified employee is rehired on a seasonal basis.

GO-Biz Investment Tax Credit

The governor’s economic development plan also authorizes a tax credit intended to encourage investment in the state, and prioritized for investment in areas with high unemployment or poverty.

Businesses will compete with each other from a pool of available tax credits whose size will be determined annually, and generally will be based on the state’s estimate of the amount of unused sales and use tax exemption and hiring tax credit, and its projection of how much may be allocated from the GO-Biz investment credit, such that the sum of all three tax incentives claimed does not exceed \$750 million a year.

Operative Dates

The tax credit is available for taxable years beginning on or after January 1, 2014, and before January 1, 2025.

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Negotiation of Investment Agreements

Taxpayers and GO-Biz representatives will negotiate the terms and conditions of investment in a formal written agreement that will be subject to final approval by a new California Competes Tax Credit Committee.

Credit Allocation Amount

GO-Biz will allocate the investment credit for fiscal years 2013-14 through 2017-18. The credit amount that will be allocated to each taxpayer is unspecified, and will be determined by the Committee based on 11 factors:

- Number of jobs retained or created;
- Wages and benefits provided to employees;
- Amount of in-state investment;
- Level of unemployment in the area;
- Other California incentives available to the taxpayer;
- Out-of-state incentives available to the taxpayer;
- Duration of investment;
- Overall economic impact to the state from the investment;
- Strategic importance of taxpayer's investment in the state or region;
- Opportunity for future growth of taxpayer's investment in the state; and
- Extent to which the anticipated benefit to the state exceeds the amount of the credit.

The amount of credit that is allowed to be claimed in a taxable year is to be set forth in the written agreement. Unused credits may be carried

forward for six years.

Recapture Provision

The tax credit will be recaptured in whole or in part if a business fails to fulfill provisions of the agreement. Any recapture is to be treated as a mathematical error appearing on a return, and added to the taxpayer's liability in the taxable year in which the recapture is determined.

Disclosure of Taxpayer Information

Taxpayers receiving a tax credit from GO-Biz will have specified information disclosed to the public on the GO-Biz website, including: the name of the business, amount of investment, number of jobs created, and the amount of tax credit recaptured in cases where the state rules that there has been a breach of agreement.

Small Business Carve-Out

Twenty-five percent of available credits will be set aside for small businesses, defined as those with less than \$2 million in gross receipts during the previous taxable year.

Repeal of Enterprise Zones and Small Business Hiring Credit

In addition to implementing three new tax incentives, the plan repeals EZs and the small business hiring credit that was enacted in 2009.

Repeal of G-TEDA Designations

Authorized designations for all G-TEDAs – including enterprise zones, MEAs, TTAs and LAMBRAs, are repealed January 1, 2014.

EZ Tax Incentive Repeal and Carryforward

The G-TEDA sales and use tax credit and hiring credit also are repealed January 1, 2014, but a 10-year carryover is allowed, commencing with the first taxable year beginning on or after January 1, 2014.

The credit carryover may be used only against

REPEAL OF ENTERPRISE ZONES

the net tax that would have been imposed on the income attributable to activities within the respective former EZ program.

The G-TEDA net operating loss deduction, net interest deduction and the accelerated capital depreciation deduction also are repealed beginning with the January 1, 2014, taxable year.

Vouchering Extension/Hiring Deadline

Local agencies are authorized to continue accepting applications and issuing certifications for qualified hires in EZs until January 1, 2015. This helps to ensure that taxpayers making qualified hires prior to January 1, 2014, would be eligible to claim the EZ hiring credit.

However, hires in enterprise zones and LAMBRAs made on or after January 1, 2014, are explicitly ineligible for the EZ hiring credit, regardless of whether the taxpayer files on a fiscal- or calendar-year basis.

Time Period for Qualified Equipment to Be Placed in Service

Taxpayers are allowed one year to place qualified equipment purchases into service after repeal of the EZ sales and use tax credit. Specifically, qualified equipment that is purchased prior to the January 1, 2014, repeal date by taxpayers located in enterprise zones and TTAs is allowed a sales and use tax credit if the equipment is placed into service prior to January 1, 2015.

Repeal of Small Business Hiring Credit

The current small business hiring tax credit under Revenue and Taxation Code Sections 17053.80 and 23623 is inoperative for taxable years beginning on or after January 1, 2014.

Severability Clause

A provision is included in the main implementing measure (AB 93) to allow for the continued operation of other provisions of the bill in the event that some portions are found by the courts to be illegal.

ENDNOTES

1. Targeted to economically distressed areas in the state. The 42 enterprise zones, designated for 15-year terms by the state's Department of Housing and Community Development (HCD), offer tax incentives such as hiring credits, a sales tax credit on machinery purchases, and net operating loss carryforwards. Interest deductions for lenders are allowed in enterprise zones, but not in other G-TEDAs.
2. Targeted to former military bases that were closed as part of the federal Defense Base Closure and Realignment Act process. A maximum of eight LAMBRAs may be designated by HCD for a term of eight years. Tax incentives are similar to those offered in EZs.
3. Targeted to impoverished areas along the California-Mexico border. A maximum of two MEAs may be designated by HCD for 14 years. Tax incentives include hiring credits and streamlined regulatory and permitting requirements.
4. Established within Tulare County for a 15-year term, this targeted tax area is administered by HCD and offers incentives similar to those offered in enterprise zones.
5. NAICS code industry descriptions can be found at <http://www.census.gov/cgi-bin/sssd/naics/naicsrch?chart=2012>.
6. A "sexually oriented business" includes a nightclub, bar, restaurant, or similar commercial enterprise that provides for an audience of two or more individuals live "nude entertainment" (as defined) or performances where the nudity is a function of planned and intentional everyday business operations.

About CalTax

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Sales Tax Exemption for Manufacturing Equipment – Repeal of Enterprise Zones

SALES/USE TAX EXEMPTION*	HIRING CREDIT*	GO-BIZ TAX CREDIT
<ul style="list-style-type: none">Statewide partial exemption for manufacturing and R&D equipment, including equipment used to construct manufacturing equipment.Partial exemption equal to 4.1875 percent of the state sales tax. Local sales taxes would apply.Capped at \$200 million in equipment purchases per taxpayer or combined reporting group.Eligible industries include NAICS industries in Codes 3111 through 3399, and 541711 or 541712.Extractive and agricultural industries, and banking and financial activities are ineligible for exemption.Taxpayers must complete exemption certificate per instructions from State Board of Equalization, and provide certificate to the retailer. <p>Operative from 7/1/2014 - 6/30/2022.</p>	<ul style="list-style-type: none">Applicable to "economic development areas" (former enterprise zones and former local agency military base recovery areas), and designated areas of high unemployment/poverty.Credit applies only to net increase in jobs calculation, not for replacement of current employees; must be claimed on original timely filed return.Eligible hires: six-month unemployed workers; veterans discharged within 12 months prior to hire; persons receiving the federal Earned Income Tax Credit; ex-felons; and recipients of CalWORKs or general assistance.Ineligibles: temporary help; retail workers; restaurants; nightclubs and strip clubs; casinos; and drinking establishments.Based on the current \$8 per hour minimum wage, eligible employee wages must be at least \$12 per hour, except for hires in five "designated pilot areas" determined by GO-Biz, which may be at least \$10 per hour.Credit equal to 35 percent of wages, amount of allowable credit calculated based on qualified wages and net increase in employees. <p>Operative for taxable years beginning 1/1/2014 and before 1/1/2021.</p>	<ul style="list-style-type: none">Credit prioritized for investment in areas of high unemployment/poverty.Businesses will compete with each other from a pool of available tax credits.Competitive criteria includes: number of jobs retained or created; amount of in-state investment; level of unemployment in area; benefit to state; etc.GO-Biz will negotiate agreements with businesses, and will allocate the credits for fiscal years 2013-14 through 2017-18, but taxpayers may claim credit until taxable year 2024, per terms of written agreement.Tax credit will be recaptured if business fails to fulfill agreement.Allocation of credit subject to final approval by a new California Competes Tax Credit Committee.GO-Biz will post on website: business name; amount of investment; number of jobs created; amount of credit recaptured for breach of agreement, etc.25 percent of annual funding carved out for small businesses (defined as those with less than \$2 million in gross receipts). <p>Operative for taxable years beginning 1/1/2014 and before 1/1/2025.</p>

*Existing EZ sales and use tax and hiring tax credits are repealed 1/1/2014. Unused credits have 10-year carryover, commencing with the first taxable year beginning on or after 1/1/2014.