TAX INCENTIVES FOR ECONOMIC GROWTH: SALES AND USE TAX EXEMPTION AND EXCLUSION: CALIFORNIA COMPETES TAX CREDIT

Hearing Goal

The goal of this hearing is to educate Committee Members on the current implementation of California's two Sales and Use Tax (SUT) incentives: a partial SUT exemption for purchases and leases of certain manufacturing and research and development (R&D) equipment and the SUT exclusion program administered by the California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA). This hearing will also focus on the application process established by the Governor's Office of Business and Economic Development (GO-Biz) in administering the California Competes Tax Credit (CCTC).

Background

California provides several tax incentives designed to encourage socially beneficial behavior, such as an increase in low-income housing, research and development activity, and overall economic activity. A major policy concern when enacting a tax incentive program is the possibility of rewarding behavior that would have occurred in the absence of the subsidy, known as "deadweight loss". The possibility of rewarding, instead of incentivizing, behavior has become an accepted reality for almost all tax incentive programs. The Legislature has attempted to address this problem by creating tax incentives programs that require potential beneficiaries to go through a rigorous application process to ensure, on a case-by-case basis, that the state receives the desired benefit. The prime examples of such programs are the SUT exclusion administered by the CAEATFA and the CCTC administered by the GO-Biz. Both programs have established a lengthy application process to ensure the efficient use of state resources by requiring each applicant to demonstrate a benefit to the state before an award may be granted.

SUT Exclusion under CAEATFA

The California Alternative Energy Source Financing Authority was established in 1980, with an authorization of $200 million in revenue bonds to finance projects utilizing alternative or renewable energy sources, such as wind, solar, cogeneration and geothermal. In 1994, the authority was renamed the "California Alternative Energy and Advanced Transportation Financing Authority" and its charge was expanded to include the financing of "advanced transportation" technologies.

Generally, CAEATFA is authorized to provide financial assistance to approved projects via the issuance of bonds, loans, loan guarantees, and credit enhancements. CAEATFA is also allowed to provide a SUT exclusion for certain specified projects. The first SUT exclusion was granted to Tesla in 2009. Shortly thereafter, SB 71 (Padilla), Chapter 10, Statutes of 2010, expanded the SUT exclusion to apply to purchases of equipment used for the design, manufacture, production, or assembly of "advanced transportation technologies" and "alternative source" products, components, or systems. Alternative source products include cogeneration technology; energy conservation; and solar, biomass, wind, geothermal, specified hydro-electric, or any other energy efficient technologies that reduce the use of fossil and nuclear fuels. In 2012, SB 1128 (Padilla), Chapter 677, Statutes of 2012, added "advanced manufacturing" to the list of eligible projects. Consequently, the SUT exclusion program was enlarged to include "advanced manufacturing" projects. SB 1128 also placed a $100 million cap on the amount of the SUT exclusion that may be awarded in a calendar year. Finally, in 2015, AB 199 (Eggman), Chapter 768, Statutes of 2015, further modified the SUT exclusion program to include manufacturing projects that either process or utilize "recycled feedstock." The expanded program is due to sunset on January 1, 2021.

Before a SUT exclusion may be awarded, CAEATFA is required to determine the eligibility of an individual project based on a number of factors relating to the reduction in greenhouse gases and the creation of manufacturing jobs. Specifically, when evaluating an application, CAEATFA must consider the extent to which the project develops manufacturing facilities located in California; the extent to which the project will create new, permanent jobs in California; the extent to which the project results in a reduction of greenhouse gases; the unemployment rate in the area in which the project will be located; and any other factors that CAEATFA deems appropriate in accordance with this program, among other criteria.

Most important among the factors is the requirement that applicants demonstrate a "net benefit" to the state. Known as the "net benefits" test, this test quantifies the fiscal and environmental benefits of the proposed project to ensure that the state receives a benefit beyond the cost of the SUT exclusion and is one of the most important factors that CAEATFA considers when awarding the exclusion. In this manner, the test attempts to addresses the dead-weight problem found within every subsidy. Projects approved for the exclusion receive a full exemption from the state and local portions of the SUT. The full SUT rate ranges from 7.5% to 10.0%, with a statewide average of 8.42%.

Once the exclusion has been granted, applicants are allowed three years to use the award but can request extensions from the CAEATFA Board. Amounts awarded in previous years, but not yet utilized, may not be recaptured by the CAEATFA. In November 2015, CAEATFA suspended acceptance of new applications due to the proposed program revisions and the development of the regulations to implement AB 199. Currently, $25 million of the 2016 annual amount remains unallocated.

Partial SUT Exemption for Purchases of Manufacturing and R&D Equipment

In 2013, Governor Brown signed AB 93 (Committee on Budget) Chapter 69, Statutes of 2013, which reformed California's economic development policies. The new law eliminated enterprise zones and other geographically targeted economic development areas and, instead, created three new tax benefits: (1) a temporary tax credit for wages paid by taxpayers to qualified employees within former enterprise zones, and other areas that suffer from high levels of poverty and unemployment; (2) a temporary SUT exemption on purchases of manufacturing equipment made by qualified taxpayers, capped at $200 million annually per taxpayer; and (3) the CCTC program. Existing law seeks to limit the total annual amount of these three tax incentives to $750 million.

With the passage of AB 93, sales and leases of certain manufacturing and R&D equipment may now qualify for the temporary SUT partial exemption. The partial exemption rate is currently set at 4.1875%, which means that sales of qualifying property sold to a qualified person are taxed at a rate of 3.3125% (7.50% current statewide tax rate minus 4.1875% partial exemption rate), plus any applicable district taxes. The exemption is available for purchases made until July 1, 2022.

To qualify for this exemption, a taxpayer must be a "qualified person," must purchase "qualified property," and must use the property in a qualified manner, as required. Qualified property does not include furniture, inventory or equipment used in the extraction process, or equipment used to store finished products. Nor does qualified property include property used primarily in administration, general management, or marketing. Furthermore, consumables with a useful life of less than one year are not eligible for the exemption.

The program is generally self-certified, with little oversight from the State Board of Equalization (BOE). The program was created in such a way as to allow the partial SUT exemption to be taken immediately without complicated forms and procedures. However, only the first $200 million of annual purchases by a qualified person are eligible for this exemption. In contrast, the CAEATFA SUT exclusion program does not limit the amount of qualifying purchases even though the overall annual award amount is capped at $100 million.

Unlike CAEATFA's SUT exclusion, the partial SUT exemption does not necessarily attempt to encourage or incentivize beneficial behavior. Instead, the partial SUT exemption attempts to reduce the distortion from the imposition of a tax on a tax, otherwise known as "pyramiding". When manufacturers pay a SUT on tangible personal property, the tax is incorporated into the cost of a consumer product, often leading to double taxation. Ideally, taxes should only be levied once because pyramiding may cause consumers to favor goods and services provided by a single company instead of those that require multiple production steps.

CCTC Program Administered by GO-Biz

The CCTC program is administered by GO-Biz. While the CCTC program is scheduled to sunset on January 1, 2025, GO-Biz is only authorized to award this credit to qualified taxpayers until Fiscal Year (FY) 2018-19, up to an annually capped amount. The amount is capped at $30 million for FY 2013-14; $150 million for FY 2014-15; and $200 million for FYs 2015-16, 2016-17, and 2017-18, plus certain statutorily prescribed adjustments.

The CCTC is an income tax credit available to businesses considering relocation to, or expansion in, California. Twenty-five percent of the annual amount is reserved for small businesses, and no more than 20% of the aggregate amount may be allocated to any one applicant per fiscal year. All in all, the CCTC program was designed to retain businesses in California, as well as encourage businesses to move to California or expand their current in-state operations. Taxpayers must commit to create a certain number of jobs, make a specified investment in California, and enter into a Tax Credit Agreement with GO-Biz. The award and the agreement must be approved by the CCTC Committee. The agreement to award credits takes into consideration the number of jobs created, the compensation paid to employees, the amount of investment by the taxpayer in California, the amount of unemployment or poverty in the area according to the U.S. census, the overall economic impact of the project, and the extent to which state benefits exceed state costs, among other criteria. GO-Biz, unlike CAEATFA, has authority to recapture the credit award if the applicant has not achieved contractual milestones as outlined in the agreement.

Approximately $223 million in CCTC has been awarded to taxpayers thus far, which translates into commitments of creating 42,000 new jobs and $10.2 billion in additional investments. According to GO-Biz, the average return on investment is $46, calculated by dividing the total amount of committed investments by the total amount of tax credits awarded.

Minimizing the "Deadweight Loss"

Both the CCTC program and the SUT exclusion under CAEATFA attempt to ensure, by utilizing the "net benefits" test, that the tax benefits are not provided for work that would have occurred in the absence of the incentive. Although useful, the test may be inadequate in ensuring that the completed project provides all the benefits promised during the initial application process. Projects may not move forward as originally stated, timelines may change, and projections may fall short. As such, a project may not actually provide a net benefit to the state once completed; and, even if it does provide a benefit, that benefit may be smaller than originally anticipated. In order to ensure that projects move forward as approved, the CCTC program requires that all applicants enter into Tax Credit Agreements with GO-Biz. The agreements establish timelines for the project and goals that must be met and provide for the recapture of the credits if goals are not met within a specified period of time. In contrast, CAEATFA has no equivalent mechanism, nor is CAEATFA able to recapture the SUT exclusion amounts granted but not utilized. Although no loss in revenue occurs, the lack of a recapture provision prevents other projects from utilizing the SUT exclusion program.

The Interaction of the SUT Exclusion and SUT Exemption

To a large degree, the CAEATFA SUT program overlaps with the partial SUT exemption for manufacturing and R&D equipment. Thus, unless a project includes a purchase of manufacturing or R&D equipment worth more than $200 million, the purchase may qualify for the partial SUT exemption, which requires no application or allocation. However, the partial

SUT exemption provides tax relief only for the state portion of the SUT, as discussed above. When the partial SUT exemption was enacted, the BOE estimated that General Fund revenue would decrease annually by more than $600 million ($637 million in FY 2014-15 and $681 million in FY 2015-16). However, the most recent data demonstrates that the exemption is underutilized. The total exemption amount claimed in FY 2014-15 was $91.2 million; in the first four months of FY 2015-16, the amount was only $77.2 million. The underutilization problem may be due to certain complexities of the program. It may be attributed to the conditional nature of the SUT exemption, where only a certain type of property and purchasers qualify for the exemption. It may be argued that the partial nature of the exemption, where some amount of SUT still needs to be collected by the vendor, also contributes to the underutilization problem.

Meanwhile, the CAEATFA exclusion program has been oversubscribed. Although the program has no per purchaser limit, it is subject to the overall annual cap of $100 million. The demand for the grants has increased in recent years, mostly due to continued economic recovery and the expansion of the program. According to CAEATFA, a very diverse group of applicants are applying for the same funds. In the absence of legislative intent, it is unclear which types of projects should receive priority. Without an increase in the annual cap, it is anticipated that the CAEATFA program will likely be oversubscribed in 2016 and 2017.

The CAEATFA program had been in place for many years prior to the enactment of the partial SUT exemption. It is unknown whether the underutilization of one program has contributed to the oversubscription for the other program or whether there is any connection between the two programs. However, in light of the underutilization of the partial SUT exemption and oversubscription of the CAEATFA program, the Legislature may consider simplifying the partial SUT exemption program, restructuring the CAEATFA program to prioritize certain projects, allowing recapture of allocated funds and rollover of unallocated funds, and authorizing CAEATFA to exempt only the local portion of the SUT in the case of projects that otherwise meet the eligibility requirements for the partial SUT exemption.