

Date of Hearing: April 23, 2013

ASSEMBLY COMMITTEE ON JOBS, ECONOMIC DEVELOPMENT AND THE ECONOMY

Jose Medina, Chair

AB 653 (V. Manuel Pérez) – As Amended: April 16, 2013

SUBJECT: State government.

SUMMARY: Establishes the California Innovation and Jobs Act, which increases the maximum value of the research and development credit (R&D Credit), eliminates state sales tax on manufacturing equipment, authorizes a new tax credit for private investments in postsecondary institutions, and codifies the California Innovation Hub (iHub) Program. Specifically, this bill:

- 1) Makes findings and declarations including, but not limited to, California's economy has declined over the past decade from being the sixth largest to the ninth largest economy in the world, the state has continued to experience budget deficits since the "dot com" economic bubble burst in 2000, and the solution to California's decline is not to simply cut budgets and raise taxes. The answer, this bill states, is in developing a long-term economic plan that envisions the state as becoming a better partner to attract private sector capital in order to spur economic growth and create jobs.
- 2) Codifies and expands the iHub Program at the Governor's Office of Business and Economic Development (GO-Biz) for the purpose of designating regional iHubs to support collaborations and coordinate federal, state and local innovation-supporting resources.
  - a) Establishes proposal criteria for applicants to the iHub Program that includes a statement of purpose, business plan, and list of goals and expectations for job development and business creation; a statement of cooperation listing each entity involved with the partnership and a description of their role; and an explanation of the industry focus and geographic boundaries of the proposed iHub.
  - b) Requires iHubs to include at least: one major university or research center; one economic development organization; and four of the following including: a business support organization; An educational consortium; a venture capital network including angel investors; a business foundation, science foundation, laboratory research institution, federal laboratory, or research and development facility; a municipal economic division or department; and/or a federal government partner such as a national laboratory.
  - c) Specifies that iHubs may, among other things:
    - i) Provide counseling and technical assistance in business planning, management, financing, and marketing;
    - ii) Provide advice on starting a business and accessing financing opportunities;
    - iii) Conduct business workshops, seminars, and conferences with local partners; and
    - iv) Facilitate partnerships between start-ups and research institutions with venture capitalists and financial institutions.
  - d) Requires GO-Biz to collaborate with the Department of General Services to identify unoccupied and underutilized state-owned or leased property that could be used by the iHub Program for the purpose of establishing proof of concept centers, incubators, and demonstration sites. The value of

the free use of state-controlled property can be used in lieu of a cash match to increase the likelihood of qualifying for federal funding.

- 3) Exempts the gross receipts on the sales of specified equipment from specified state and local taxes, beginning on January 1, 2014.
  - a) Specifies that this exemption applies to manufacturers, software publishers, biotechnology R&D, and electric power generation facilities (not including hydroelectric, fossil fuel, nuclear).
  - b) Provides that the equipment be used primarily in the manufacturing, processing, refining, fabricating, or recycling of tangible personal property including:
    - i) Machinery and equipment including components and contrivances such as belts and shafts;
    - ii) All equipment or devices used to operate, control, regulate, or maintain machinery;
    - iii) Tangible personal property used in pollution control that meets or exceeds standards established by the state or any local or regional government agency within the state;
    - iv) Special purpose buildings and foundations used as an integral part of the manufacturing, processing, refining, or fabricating process, that constitute a research or storage facility used in the manufacturing process. This does not include warehousing; and
    - v) Tangible personal property used in recycling.
  - c) Requires the retailer to furnish the purchaser with the exemption certificate, as specified;
  - d) Requires that the equipment remain in California and used for an allowable purpose for at least one year in order to maintain the tax exemption. If these requirements are not met, the purchaser owes the taxes, plus interest.
  - e) Authorizes the exemption to apply to leases which are classified as a "continuing sale" or a "continuing purchase."
  - f) Requires the Board of Equalization (BOE) to establish a process for qualified persons interested in obtaining an exemption certificate to electronically apply for and obtain a certificate, once BOE has the appropriate information technology capability.
- 4) Increases the value of the qualified and basic R&D Credit:
  - a) Under the Personal Income Tax Law (PIT), incrementally increases the credit percentage applied to qualified research expenses in excess of the base amount from 15% to 30% over the five-year period beginning with taxable year 2014 and ending with taxable year 2018;
  - b) Under the Corporate Tax Law (CT), incrementally increases the credit percentage applied to qualified research expenses in excess of the base amount from 15% to 40% over the five year period beginning with taxable year 2014 and ending with taxable year 2018; and
  - c) Under the CT, incrementally increases the credit percentage applied to basic research payments from the current 24% to 40% at a rate of 5% for four years and 1% in the fifth year over the five taxable years 2014 through 2018.
- 5) Authorizes a credit under both the PIT and the CT against net taxes worth 25% of the qualified contribution by a business entity to a postsecondary educational institution.
  - a) Requires the contribution be used for curriculum or research leading to job opportunities in the private sector or consultation services associated with the establishment of curriculum or research leading to job opportunities in the private sector;

- b) Requires that the curriculum be in an area where there is substantial potential for the future employment of students as a result of the contribution; and
  - c) Allows for the carry forward of the credit until the value of the credit is exhausted.
- 6) Specifies that the Economic Development Fund is continuously appropriated.
  - 7) Provides no reimbursement for loss of local sales tax.
  - 8) Specifies that provisions of the bill are severable.
  - 9) Includes an urgency clause.

EXISTING LAW

- 1) Establishes GO-Biz within the Governor's Office for the purpose of serving as the lead state entity for economic strategy and marketing of California on issues relating to business development, private sector investment and economic growth. GO-Biz also serves as the administrative oversight for the California Business Investment Service and the Office of the Small Business Advocate.
- 2) Imposes a sales tax on retailers for the opportunity to sell tangible personal property, absent a specific exemption.
- 3) Imposes a use tax on the storage, use, or consumption of tangible personal property purchased from any retailer.
- 4) Allows a credit against the taxes imposed under the PIT and the CT for increasing research expenses over a base amount. The credit allowed under the PIT and the CT is equal to 15% of the excess qualified research expenses over the base year amount for the taxable year and, under the CT, 24% for payments to qualified research organizations for basic research. Qualified research expenses must be related to research conducted in California and include amounts paid or incurred for wages and supplies in the conduct of qualified research as well as contract research expenses. Qualified research expenses also include payments made to qualified organizations (including educational institutions and certain scientific research organizations) for basic research.
- 5) Provides for an alternative research credit calculation under the PIT and the CT. A taxpayer may elect to compute the research credit using the alternative incremental credit calculation. The alternative incremental credit is equal to the sum of three tiers of the qualified research expenses in excess of a base amount; each tier calculated using an increasing percentage. The first tier is 1.49% of the total qualified research expenses for the taxable year that exceeds 1% but not more than 1.5% of the average annual gross receipts; the second tier is 1.98% of the total qualified research expenses for the taxable year that exceeds 1.5% but not 2% of the average annual gross receipts; tier three is 2.48% of the total qualified research expenses for the taxable year that exceeds 2% of the average annual gross receipts.

FISCAL EFFECT: Unknown

COMMENTS:

- 1) Framing the Policy Issue: This measure proposes the addition and enhancement of existing business incentives. These incentives are designed to foster California's long-term economic growth in

innovation-based industries. Historically, this has been an area in which California has enjoyed a comparative advantage, not only relative to other states but also to other regions of the world. In the last decade, however, other states, such as Massachusetts, and other countries, such as Singapore, have begun to implement more targeted economic development activities to attract innovation-based industries.

These changes are a cause for concern and suggest that California cannot be passive or assume that what was true in 1990 will continue to be true in the 21<sup>st</sup> century. This bill proposes a significant and comprehensive economic development agenda to affirmatively focus the states activities into attracting and growing innovation-based businesses. This analysis includes information on the development of the bill, the drivers and challenges of the California economy, background on GO-Biz and related legislation. Suggested amendments are included in comment 7.

- 2) Legislative Hearing and Research Contributed to Bill: The Innovation and Jobs Creation Act was developed in response to testimony and research from an August 2012 hearing of the Assembly Committee on Jobs, Economic Development and the Economy, (JEDE) chaired by the author of AB 653. One of the key hearing findings was the growing importance of publicly advancing a coordinated economic revitalization blueprint.

The hearing was held jointly with the Assembly Select Committees on High Technology, chaired by Assemblymember Paul Fong, and the Assembly Select Committee on Government Efficiently, Technology, and Innovation, chaired by Assemblymember Buchanan. Central to the Member's deliberations was the importance of how California must retain its competitive edge and historic position as a "first mover" among nations. Key recommendations from the hearing include:

1. Enhancing the state's R&D capacity;
2. Incentivizing businesses to invest in our higher education system;
3. Creating an equal playing field for manufacturing; and
4. Supporting industrial innovation through government reforms.

Follow-up to the hearing also resulted in the establishment of a nonprofit sponsored "Innovation State" web-platform to help Members of the Legislature and the public keep abreast of innovation issues, connect with business and industry leaders, and to facilitate a high-level statewide dialogue on California's innovation future.

- 3) Drivers in California's Future Economy: For decades, California has been known as a place where innovation and creativity flourishes. A 2007 study on California's global competitiveness identified eight key dominant and emerging industry clusters including high-tech manufacturing, biotech and clean technologies. In 2011, California remained the number one state in the U.S. for attracting foreign direct investment and venture capital (51% of total dollars). Over 931,000 Californians are employed in high tech jobs, and biotech continues to be a dominant industry sector in both Northern and Southern California providing \$115 billion in annual revenues and employing 267,271 individuals.

While research shows that the state is uniquely positioned to be a preferred global partner in the areas of innovation, science, and technology, the state also needs to adapt to the reality of a growing talent pool in other countries and the global redistribution of manufacturing abroad. Emerging economies around the world are striving to become leaders in innovation and not merely "copycat" economies of the U.S.

Although these dynamics may pose challenges to current leading technology centers, for California they offer new opportunities for collaboration and cooperation. With its diverse population and access to world-class research universities and national laboratories, the state is a highly prized academic and research partnership. As early as 2004, the state had bi-national research initiatives with Canada and Iceland on renewable energy and other technologies. The University of California at San Diego has a multi-year manufacturing initiative with Mexico, supporting economic growth on both sides of the border. AB 653 proposes to take the state's commitment to innovation and technology-based industries to another level by formally codifying the state's iHub Program, enhancing and creating innovation inducing tax provisions, and having the state directly engage in the testing and demonstration of new products, services and processes.

- 4) Challenges to California's Competitiveness: A consensus of research recognizes that innovation-based industries are primary drivers of economic competitiveness in today's global economy. California is a leader in many cutting-edge industries and home to many world-leading businesses; however, California's business climate is a cause of concern.

JEDE tracks a variety of surveys, indexes, and reports that assess California's business climate, and the general consensus is that California's biggest weakness in attracting and retaining businesses is that California is a high cost state. Business climate indexes that focus on taxes and costs consistently score California poorly. California has the 2<sup>nd</sup> highest income tax burden in the nation, and the 11<sup>th</sup> highest sales tax burden. Relative to the cost of doing business, California has the 8<sup>th</sup> highest average retail cost of electricity. Even among high cost states, California have challenges as seen by the state's ranking as 16<sup>th</sup> in the nation relative educational attainment of residents age 25 or older. Other state rankings: Massachusetts (1<sup>st</sup>) and New York (9<sup>th</sup>).

A recent survey of manufacturers illuminates several of the deficiencies of California's business climate. Of the 18% of manufacturers that considered expanding in California in 2011, only 2.2% chose California. This compares poorly with other major states such as Ohio (12% consideration rate, capturing 11.3% of national manufacturer expansion/relocations), Texas (11% consideration rate, capturing 6.9% expansions/relocations), and North Carolina (10% consideration rate, capturing 7.2% expansions/relocations). The reasons most commonly cited for not expanding in California were the costly regulatory environment, high taxes, high labor costs, and insufficient incentives and credits.

According to the sponsor, the California Hispanic Chambers of Commerce, AB 653 is strategically designed to address these challenges. Leading the strategy is the 40% credit on increases in California research, which the sponsor expects could increase state R&D investments by an additional \$5.2 billion. The iHub Program will further drive regional collaboration and commercialization of new products. Access to these new technologies will give California manufactures an advantage, as will the sales tax exclusion on manufacturing related equipment. Being one of the few states that still charge sales tax on manufacturing equipment is generally identified as a competitive disadvantage to the state.

In order to support advanced manufacturing and other innovation-based businesses, the bill proposes a 40% credit to encourage businesses to contribute to development of relevant curricula and training programs at post-secondary institutions. A 2011 report by McKinsey & Company reported that over the next decade, the U.S. will face a shortfall of approximately 1.9 million technical and analytical workers. This education institution credit is designed to provide a ready supply of trained technicians during the R&D phase, high-skill manufacturing personnel and trained employees to support small and medium size businesses within the supply chain.

- 5) Costly Package: AB 653 enhances two and creates a new business incentive related to innovation based industries. The exact cost of these incentives has yet to be estimated by the Franchise Tax Board and the Board of Equalization. Unfortunately when these estimates are completed there will be no dynamic analysis of what the incentives might bring to California nor the impact of not responding to the changing global economy will mean to California workers, businesses and tax base.
- 6) Governor's Office of Business and Economic Development: In April 2010, the Governor's Office of Economic Development was established to provide a One-Stop-Shop for serving the needs of businesses and economic developers. While initially established through Executive Order S-01-10, the office was later codified and renamed as the Governor's Office of Business and Economic Development (GO-Biz), in AB 29, Chapter 475, Statutes of 2010. In 2012, GO-Biz directly assisted 5,308 companies, resulting in the creation and/or retention of 9,050 jobs and \$1.45 billion in investments.

Among other programs, GO-Biz provides permit and other technical assistance for new and expanding businesses, as well as administering the iHUB Program in partnership with the statewide network of 12 regional economic development partnerships. The iHub Program is designed to improve the state's national and global competitiveness by stimulating regional collaborations around specific innovation-based industry clusters. Key assets and partners of the initiative include technology incubators, research parks, universities, federal laboratories, economic development organizations, business groups, and venture capitalists.

In 2012, the Governor initiated, and the Legislature approved, a comprehensive reorganization of the state's administrative structure. Key changes included the dismantling of the Business, Transportation and Housing Agency (BTH) and further consolidating GO-Biz' position as the state's lead in economic development. Effective July 1, 2013, GO-Biz will have administrative authority for more economic development related programs and services including the Small Business Loan Guarantee Program and the Infrastructure and Economic Development Bank. AB 653 codifies an existing program at GO-Biz.

- 7) Technical Issues: Putting forth a comprehensive innovation package can be challenging from a technical standpoint. Below are a list of issues that the author may wish to address to clarify its purposes and ensure its successful implementation.
  - a) iHUB: AB 653 includes language substantively similar to AB 250 (Holden and V. Manuel Pérez). When AB 250 passed the JEDE committee on April 9, 2013, the committee approved a series of amendments, which include the following:
    - i) Authorize joint applications;
    - ii) Revise the definition of iHubs to more accurately capture all the expected innovation partners including private sector firms and industries, academic institutions, economic development organizations, and local governments;
    - iii) Set a 5-year term of the designation and a mechanism for the de-designation of an iHub;
    - iv) Specify that iHubs are designated through an memorandum of understand that includes the goals and performance standards set out in the application;
    - v) Allow for more than one iHub in a region to the extent that industry focuses are different;
    - vi) Require GO-Biz to annually aggregate outcomes from the iHubs; and
    - vii) Identify two additional technical assistance stakeholders - Small Business Development Centers and the microenterprise development organizations.

- b) *Sales Tax Exemption*: Providing a sales tax exemption on manufacturing equipment is consistently identified as a top priority among economic developers. Below are amendment suggestions:
    - i) Remove the local sales tax component in order to allow local communities have the option of waiving the local portion of sales tax;
    - ii) Remove the limitation on pollution control equipment or clarify that the limitation only applies if the manufacturer is purchasing a self-contained piece of equipment; and
    - iii) Require the taxpayer to notify the BOE that the equipment is being taken out of California or its use no longer meets the requirements of the exemption.
  
  - c) *Postsecondary Education Credit*: There is a worldwide shortage of medium and high skilled workers making a trained workforce a key competitive advantage.
    - i) Define a postsecondary education facility to only include accredited institutions including career technology;
    - ii) Limit the carry forward to 10 years;
    - iii) Require the postsecondary education facility to issue the taxpayer a tax credit certificate and to annually report to the FTB the names and taxpayer IDs of qualified contributors;
    - iv) Require the postsecondary education facility to maintain the records of the certificates;
- 8) Related Legislation: Below is a list of related legislation.
- a) *AB 250 (Holden and V. Manuel Pérez) California Innovation Hub Program*: This bill codifies and expands the California Innovation Hub (iHub) Program at the Governor's Office of Business and Economic Development (GO-Biz) for the purpose of stimulating economic development and job creation through the coordination of federal, state and local innovation-supporting resources. Status: Pending in the Assembly Committee on Appropriations.
  
  - b) *AB 699 (Portantino and V. Manuel Pérez) State Economic and Innovation Strategy*: This bill would have updated the requirements for the development of a State Economic Development Strategy, especially in the areas of technology and innovation, and requires it be submitted to the Legislature by May 1, 2010. Status: Held in Assembly Appropriations Committee in 2009.
  
  - c) *AB 744 (John A. Pérez) Office of Intellectual Property*: This bill required the Department of General Services to assist state agencies in the management and development of intellectual property that was developed by state employees or with state funding. Among other duties, the department is required to develop a database of state-owned intellectual property starting January 1, 2015. Status: Signed by the Governor, Chapter 463, Statutes of 2012.
  
  - d) *AB 894 (V. Manuel Pérez) California Manufacturing Competitiveness Act of 2011*: This bill would have established a loan and loan guarantee program to enable the state to draw down federal dollars to support the retooling and expansion of manufacturing in California. Status: Vetoed by the Governor, 2011
  
  - e) *AB 2506 (V. Manuel Pérez) California Innovation and Jobs Act*: This bill would have increased the state R&D credit from 15% to 40%, eliminated sales tax on manufacturing equipment, authorized a new tax credit for private investments in postsecondary institutions, required state agencies to submit regulatory actions to the Legislature 60 days prior to submitting those actions to the Office of the Administrative Law, and authorized the creation of regional innovation boards. Status: Held in the Assembly Committee on Business, Professions, and Consumer Protection in 2012.

- f) AB 2711 (Portantino, Arambula, Price and Salas) State Technology and Innovation Strategy: This bill would have required the Secretary of the Business, Transportation and Housing Agency to develop a comprehensive state technology and innovation strategy to guide future state expenditures and activities. Status: Held under submission in the Assembly Committee on Appropriations in 2008.
- 9) Double Referral: This measure has been double referred by the Assembly Committee on Rules to two policy committees. Should AB 653 pass JEDE, it will be referred to the Assembly Committee on Revenue and Taxation for further policy review.

REGISTERED SUPPORT / OPPOSITION:

Support

California Hispanic Chamber of Commerce (sponsor)  
BIOCOM

Opposition

None received

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