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STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date:	**Chapter 70**	Bill:	**Senate Bill 90**
Tax Program:	**Sales and Use**	Author:	**Galgiani**
		Code Section:	**RTC 6377.1**
Related Bills:	**AB 93 (Comm. on Budget)** **AB 653 (Perez, V.)** **AB 1326 (Gorell)** **SB 235 (Wyland)** **SB 376 (Correa)** **SB 412 (Knight)**	Effective Date:	**Upon enactment, but operative July 1, 2014**

BILL SUMMARY

Among other things, beginning July 1, 2014, and until July 1, 2022, this bill provides manufacturers, biotechnology and other physical, engineering, and life science researchers and developers a 4.1875% sales and use tax exemption for their purchases of qualifying tangible personal property.

ANALYSIS

CURRENT LAW

Except where the law provides a specific exemption or exclusion, California's Sales and Use Tax Law[1] imposes the sales tax on all retailers for the privilege of selling tangible personal property at retail in this state or the use tax on the storage, use, or other consumption in this state of tangible personal property purchased from a retailer.

Generally, sales or use tax applies to the sale or purchase of tangible personal property to persons who use the property to manufacture, produce or process tangible personal property. A manufacturer's taxable purchases include machines, tools, furniture, forklifts, generators, and office equipment. A software publisher's taxable purchases include computer equipment, such as servers, routers, switches, power units, network devices, hard drives, processors, memory modules, and other computer hardware and components. An electric power generating facility's taxable purchases include transformers, alternators, generators, transmitters, turbines and solar panels. A biotechnology researcher's taxable purchases include various lab tools, workstations, monitors, and analyzers.

Conversely, tax does not apply to sales of tangible personal property when the purchasers physically incorporate that property into the manufactured article to be sold. For example, no tax applies to a manufacturer's raw material purchases when, prior to making a taxable use, they become an ingredient or component part of the manufactured article to be resold.

[1] Part 1 of Division 2 (commencing with Section 6001) of the Revenue and Taxation Code (RTC).

California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA). Existing law[2] contains a specific sales and use tax exclusion[3] for tangible personal property purchased for certain approved manufacturing projects. In 2010, legislation[4] authorized the CAEATFA to approve sales and use tax exclusions for tangible personal property utilized for the design, manufacture, production, or assembly of advanced transportation technologies or alternative energy source products, components or systems. In 2012, legislation[5] was enacted to authorize CAEATFA to approve sales and use tax exclusions related to advanced manufacturing projects until July 1, 2016. The law[6] provides a $100 million cap for these exclusions.

CAEATFA's approval of these exclusions is based on whether the project results in a net benefit to the State, with consideration to both fiscal and environmental benefits.

California's sales and use tax rates. Effective January 1, 2013, California imposes a statewide 7.5% sales and use tax on tangible personal property sales and purchases. The table below shows California's various sales and use tax rate components (the table excludes voter-approved city and county district taxes):

Rate	Jurisdiction	Purpose/Authority
3.9375%	State (General Fund)	State general purposes (Revenue and Taxation Code (RTC) Sections 6051, 6051.3, 6201, and 6201.3)
1.0625%	Local Revenue Fund 2011	Realignment of local public safety services (RTC Sections 6051.15 and 6201.15)
0.25%	State (Fiscal Recovery Fund)	Repayment of the Economic Recovery Bonds (RTC Sections 6051.5 and 6201.5)
0.25%	State (Education Protection Account)	Schools and community college funding (Section 36, Article XIII, State Constitution) (until 01/01/17)
0.50%	State (Local Revenue Fund)	Local governments to fund health and welfare programs (RTC Sections 6051.2 and 6201.2)
0.50%	State (Local Public Safety Fund)	Local governments to fund public safety services (Section 35, Article XIII, State Constitution)
1.00%	Local (City/County) 0.75% City and County 0.25% County	City and county general operations (RTC Section 7203.1, operative 7/1/04); Dedicated to county transportation purposes
7.50%	Total Statewide Rate	

[2] RTC Section 6010.8.
[3] An "exclusion" means the transfer of the property is neither a "sale" nor a "purchase" and is therefore excluded from the application of the sales and use tax. An "exemption" involves a retail sale that, absent an exemption in law, would otherwise be subject to the tax.
[4] SB 71 (Ch. 10, Stats. 2010, effective March 24, 2010).
[5] SB 1128 (Ch. 677, Stats. 2011, effective January 1, 2013).
[6] Public Resources Code Section 26011.8.

PROPOSED LAW

Beginning July 1, 2014, and until July 1, 2022, this bill provides a 4.1875% sales and use tax exemption for a "qualified person's" purchases of:

- Qualified tangible personal property to be used primarily in manufacturing, processing, refining, fabricating, or recycling of property (i.e., machinery, equipment, parts, belts, shafts, computers, software, pollution control equipment, buildings and foundations), as specified.
- Qualified tangible personal property to be used primarily to maintain, repair, measure, or test any qualified tangible personal property.
- Qualified tangible personal property purchased by a contractor, as specified, for use in the performance of a qualified person's construction contract. The qualified person must use the property, however, as an integral part of any manufacturing, processing, refining, fabricating, or recycling process or as a research or storage facility in connection with the manufacturing process.
- Qualified tangible personal property to be used primarily in research and development (R&D).

The bill excludes from the "qualified person" definition, an apportioning trade or business that is required to apportion its business income pursuant to specified provisions. This includes business activity relating to the production, refining, or processing of oil, natural gas, or mineral ore.

The bill also limits the allowable exemption to $200 million in qualifying purchases each calendar year by each qualified person or by all qualified persons required or authorized to be included in a combined report under the Corporation Tax Law.[7]

The bill defines "fabricating," "manufacturing," "primarily," "process," "processing," "refining," "research and development," and "useful life." The bill also specifies the tangible personal property included or excluded from the proposed partial exemption.

The proposed partial exemption excludes:

- Consumables with less than a one year useful life,
- Furniture, inventory, equipment used in the extraction process or equipment used to store finished products that have completed the manufacturing process, and
- Tangible personal property primarily used in administration, general management, or marketing.

The bill excludes from the exemption, any city, county, or district tax levied pursuant to the Bradley-Burns Uniform Local Sales and Use Tax Law or the Transactions and Use Tax Law. It also excludes the 1.0625% Local Revenue Fund 2011, 0.5% Local Revenue Fund, the 0.5% Local Public Safety Fund, and the 0.25% Fiscal Recovery Fund components. The proposed exemption includes the two remaining state sales and use tax components.[8]

The bill contains additional provisions outside the BOE's purview, and are not discussed in this analysis.

[7] Revenue and Taxation Code Section 25101 or 25101.15.
[8] 3.9375% General Fund, 0.25% Education Protection Account.

BACKGROUND

For a ten-year period ending December 31, 2003, the law provided new manufacturers with a state General Fund sales and use tax exemption on their purchases of specified manufacturing equipment. Also, the law provided manufacturers income and corporation tax credits (MIC) of 6% for similar equipment placed in service in California. Similar to the exemption proposed in this bill, the partial exemption and credit related to equipment used primarily for manufacturing, refining, processing, fabricating or recycling. New manufacturers could claim the partial exemption or the MIC. However, existing manufacturers could only claim the MIC.

This partial exemption and MIC contained a conditional sunset date. The law required these provisions to sunset when manufacturing employment,[9] less aerospace employment, failed to exceed January 1, 1994, manufacturing employment by more than 100,000. On January 1, 2003, the employment figures were less than the 1994 number by over 10,000. Therefore, the partial exemption and MIC sunset at the end of 2003.

Legislative History. Since then, numerous bills have been introduced to reinstate, expand, or modify the exemption and/or MIC, but all failed to pass. Bills introduced during the last two Legislative sessions that exempted similar purchases from sales and use tax include:

Bill No.	Session	Author	Proposed Exemption
ABx1 40	2011-12	Allen	3.9375% exemption for new businesses and 3% for existing businesses engaged in manufacturing, software production, biotechnology research and development, and renewable power generation facilities.
AB 103	2011-12	Budget Committee	5% exemption for new manufacturers and software producers, and 1% for existing manufacturers and software producers.
AB 218	2011-12	Wieckowski	5.25% exemption for manufacturers and software producers.
AB 303	2011-12	Knight	5% exemption for new manufacturers.
AB 979	2011-12	Silva	5% exemption for manufacturers and software producers and affiliates.
AB 1057	2011-12	Olsen	5% exemption for manufacturing, research and development, and air pollution mitigation by manufacturers and affiliates.
SB 116	2011-12	Dutton	Same as ABx1 40 above.
SB 395	2011-12	Dutton	5% exemption for manufacturing and software production.
AB 1911	2011-12	Donnelly	3.9375% exemption for manufacturing and software production.

[9] As determined by the Employment Development Department.

Bill No.	Session	Author	Proposed Exemption
AB 1972	2011-12	Huber	Full exemption for manufacturing, software production, biotechnology research and development, and renewable power generation facilities.
SB 686	2011-12	Padilla	Full exemption for biotechnology manufacturing and research and development activities.
AB 810 and AB 829	2009-10	Caballero	5% exemption for qualifying tangible personal property, and 6% exemption for sustainable development equipment investments by manufacturing and software production.
AB 1719	2009-10	Harkey	6% exemption for manufacturing.
AB 1812	2009-10	Silva	6% exemption for manufacturing and software production.
AB 2280	2009-10	Miller	Full exemption for manufacturing.
SB 1053	2009-10	Runner	6% exemption for manufacturing and software publishing and their affiliates.
SBx6 18	2009-10	Steinberg & Alquist	6% exemption for specific manufacturing and software production activities.
SBx6 8 & SBx6 44	2009-10	Dutton	6% exemption for manufacturers and software publishers and affiliates.

COMMENTS

1. **Sponsor and Purpose.** This is part of Governor Brown's 2013-14 Budget revision plan to revamp the state's enterprise zone and hiring credit programs to encourage manufacturing investment and increase employment in high-poverty areas. This bill supersedes AB 93, also Governor Brown's 2013-13 Budget revision measure.

2. **The bill references various NAICS codes to describe qualifying taxpayers.**

   NAICS codes 3111 to 3399 include all establishments primarily engaged in manufacturing activities. This includes manufacturers in the aerospace sector, textiles, pharmaceuticals, printing, food, and more.

   NAICS code 541711 includes establishments primarily engaged in conducting biotechnology research and experimental development. This involves the study of the use of microorganisms and cellular and biomolecular processes to develop or alter living or non-living materials. This biotechnology R&D may result in new biotechnology processes or in new or genetically-altered product prototypes that various industries may reproduce or utilize.

   NAICS code 541712 includes establishments primarily engaged in conducting research and experimental development (except biotechnology research and experimental development) in the physical, engineering, and life sciences, such as agriculture, electronics, environmental, biology, botany, computers, chemistry, food, fisheries, forests, geology, health, mathematics, medicine, oceanography, pharmacy, physics, veterinary and other allied subjects.

3. **Partial exemptions complicate administration of the tax.** Currently, most sales and use tax exemptions apply to the total applicable sales and use tax. However,

California law contains a partial exemption for sales of gas (at a 5.25% rate) and five partial exemptions at a 5.5%[10] rate, as follows:

(1) Farm equipment and machinery,

(2) Diesel fuel used for farming and food processing,

(3) Teleproduction and postproduction equipment,

(4) Timber harvesting equipment and machinery, and

(5) Racehorse breeding stock.

These partial tax exemptions complicate retailers' return preparation and return processing. Return errors occur frequently with claimed partial exemptions. Accordingly, the BOE's return processing workload increases.

Also, this bill proposes a new 4.1875% exemption rate. This requires a sales and use tax return revision with a new, separate return computation. If enacted, some retailers may be required to segregate the 4.1875% exempt sales, the 5.50% exempt sales, fully exempted sales (e.g., a resale sale or interstate commerce sale), and fully taxable sales. This adds a new level of complexity, and potentially increases tax reporting errors. Accordingly, the BOE's tax administrative functions and retailers' reporting obligations become more complicated.

Related legislation. Similar bills have been introduced this year:

- **AB 93 (Committee on Budget)** – contains a partial sales and use tax exemption similar to this bill, except that the partial exemption applies to all qualified persons for five years, and for qualified persons who purchase the qualified tangible personal property for use in specified zones, the partial exemption would apply for an additional two years.
- **AB 486 (Mullin, et al.)** – provides manufacturers, software publishers, biotechnology and other physical, engineering, and life science researchers and developers, and their affiliates, a 5.25% sales and use tax exemption for their purchases of qualifying tangible personal property.
- **AB 653 (V. Perez)** – provides manufacturers, software publishers, biotechnology research entities, and renewable power generator facilities, and their affiliates a state and local exemption for their qualifying tangible personal property purchases.
- **AB 1326 (Gorell)** – provides unmanned aerial vehicle manufacturers a state and local exemption for their qualifying tangible personal property purchases.
- **SB 235 (Wyland)** – provides manufacturers and their affiliates a 3.9375% exemption for their qualifying tangible personal property purchases.
- **SB 376 (Correa)** – beginning January 1, 2017 to January 1, 2022, provides manufacturers, software publishers, and their affiliates a 6.25% exemption for their qualifying tangible personal property purchases.
- **SB 412 (Knight)** – provides aerospace products and parts manufacturers a 3.9375% exemption for their qualifying tangible personal property purchases.

[10] 3.9375% General Fund, 1.0625% Local Revenue Fund 2011, 0.25% Fiscal Recovery Fund, and 0.25% Education Protection Account.

COST ESTIMATE

Non-absorbable costs will be incurred to reprogram for the partial exemption, revise and process returns, notify retailers, audit claimed exemptions, and answer inquiries from taxpayers and the general public. These costs are estimated to be for 2013-14 $421,000, for 2014-15, $824,000, and for 2015-16 and ongoing, $787,000.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

NAICS 31-33 (Manufacturing). The United States Census Bureau's *Annual Survey of Manufacturers* (ASM) reports California manufacturing capital expenditures data (machines and equipment, buildings, fuels). In fiscal year (FY) 2010-11, California manufacturers' capital expenditures amounted to an estimated $11 billion. We assume this amount includes manufacturers' research and development-related capital expenditures. This bill does not exempt fuel purchases.

NAICS 541711 (Biotechnology R&D). Based on ACES data and 2007 *Economic Census* data, we estimated that capital expenditures by establishments in California primarily engaged in biotechnology research and experimental development amounted to $0.48 billion in FY 2010-11.

NAICS 541712 (Physical, Engineering & Life Sciences R&D). Based on ACES data and 2007 *Economic Census* data, we estimated that in FY 2010-11, California establishments primarily engaged in physical, engineering and life sciences R&D amounted to $0.51 billion.

Capital Expenditures. Based on the Census data, total capital expenditures in FY 2010-11 amounted to an estimated $13.4 billion (NAICS 31-33, $11 billion + NAICS 5112, $1.4 billion, NAICS 541711, $0.48 billion, NAICS 541712, $0.51 billion).

The partial sales and use tax exemption becomes operative July 1, 2014. To forecast expenditures from the 2010-11 data described previously, we used a national economic forecasting firm's (IHS Global Insight) most recent business equipment investment forecast. The estimated expenditures are as follows:

Capital Expenditures - California
(*in billions)*

	FY 2014-15	FY 2015-16
NAICS 31-33	$13.87	$14.83
NAICS 541711	$0.65	$0.70
NAICS 541712	$0.69	$0.73
	$15.21	$16.26

REVENUE SUMMARY

The annual revenue loss from exempting from the 4.1875% sales and use tax for qualifying purchases used in manufacturing (NAICS 31-33), biotechnology R&D (NAICS 541711) and physical, engineering & life sciences R&D (NAICS 541712) amounts to:

Sales & Use Tax Loss
(In Millions)

	FY 2014-15	FY 2015-16
State General Fund 3.9375%	$599	$640
Education Protection 0.25%	$38	$41
Estimated Loss 4.1875%	$637	$681

Qualifying Remarks. The revenue estimate is overstated to the extent that it does not account for manufacturing-related sales and use tax exclusions authorized by CAEATFA. The 2009 legislation has resulted in sales and use tax revenue losses of approximately $37 million in 2010, $4.7 million in 2011, and $8.7 million in 2012. We have no information on exclusions related to advanced manufacturing purchases authorized by the 2012 legislation. However, the law caps the allowable sales and use tax exclusions for both programs at $100 million annually.

The revenue estimate is also overstated to the extent that it does not account for a qualified person's purchases of qualified tangible personal property that exceed two hundred million dollars ($200,000,000) in any calendar year. These purchases would not qualify for the partial exemption. However, we do not have information as to the amount of purchases that will not qualify for the exemption because of this limitation.

This revenue estimate does not account for any changes in economic activity that may or may not result from enactment of the proposed law.

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