STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

DRAFT

Date Amended:	**05/24/11**	Bill No:	**Assembly Bill 303**
Tax Program:	**Sales and Use Tax**	Author:	**Knight**
Sponsor:	**Author**	Code Sections:	**RTC 6377**
Related Bills:	**AB 204 (Halderman)** **AB 218 (Wieckowski)** **AB 979 (Silva)** **AB 1057 (Olsen)** **SB 47 (Alquist)** **SB 395 (Dutton)**	Effective Date:	**Upon enactment, but operative 90 days following 1st calendar quarter**

BILL SUMMARY

This bill would reinstate the state sales and use tax exemption (General Fund only) for purchases of qualifying tangible personal property by new trades or businesses engaged in manufacturing.

Summary of Amendments

Since the previous analysis, this bill was amended to (1) add a delayed operative date, (2) make BOE-suggested technical amendments, and (3) and add coauthors.

ANALYSIS

CURRENT LAW

Under current law, business entities engaged in manufacturing that make purchases of equipment and supplies for use in the conduct of their manufacturing activities are required to pay tax on their purchases to the same extent as any other person either engaged in business in California or not so engaged. Current law does not provide special tax treatment for purchases of equipment used by these entities in their manufacturing activities.

Beginning July 1, 2011, the statewide sales and use tax rate (7.25%) imposed on taxable sales and purchases of tangible personal property is made up of the following components (additional transactions and use taxes (also known as district taxes) are levied by various local jurisdictions and are not reflected in this chart):

Rate	Jurisdiction	Purpose/Authority
5.00%	State (General Fund)	State general purposes (Revenue and Taxation Code (RTC) Sections 6051, 6051.3, 6201, and 6201.3)
0.25%	State (Fiscal Recovery Fund)	Repayment of the Economic Recovery Bonds (RTC Sections 6051.5 and 6201.5, operative 7/1/04)
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)

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.

Rate	Jurisdiction	Purpose/Authority
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
7.25%	Total Statewide Rate	

The 1% General Fund tax under Sections 6051.7 and 6201.7 will expire on 6/30/11, after the effective date of this bill.

PROPOSED LAW

This bill would add RTC Section 6377 to the Sales and Use Tax Law to provide a partial exemption (General Fund only) from the sales and use tax rate of 5% for the following purchases made by a "qualified person":

- Tangible personal property to be used 50 percent or more in any stage of 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.
- Tangible personal property to be used 50 percent or more in research and development.
- Tangible personal property to be used 50 percent or more in maintaining, repairing, measuring, or testing any qualifying equipment.
- Tangible personal property purchased for use by a contractor, as specified, for use in the performance of a construction contract for the qualified persons who will use the property 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.

This bill would define "qualified person" as any new trade or business, as specified, that is primarily engaged in manufacturing activities, as described in Codes 31 to 33, inclusive, in the 2007 edition of the North American Industry Classification System (NAICS). In addition, this bill would specify that a "qualified person" has not conducted business activities in a new trade or business for three or more years.

"Fabricating," "manufacturing," "primarily," "process," "processing," "refining," "research and development," and "useful life," are defined and the tangible personal property intended to be included or excluded from the proposed partial exemption are described.

The proposed exemption would not include (1) any tangible personal property that is used primarily in administration, general management, or marketing, (2) consumables with a useful life of less than one year, except for fuels used in the manufacturing process, and (3) furniture, inventory, equipment used in the extraction process or equipment used to store finished products that have completed the manufacturing process.

The proposed exemption shall <u>not</u> apply to any taxes levied pursuant to Sections 6501.2 and 6201.2 (Fiscal Recovery Fund), 6051.5 and 6201.5 (Local Revenue Fund), and pursuant to Section 35 of Article XIII of the California Constitution (Local Public Safety Fund). In addition, the bill specifies that the exemption shall <u>not</u> apply to any tax levied by a county, city, or district pursuant to the Bradley-Burns Uniform Local Sales and Use Tax Law or the Transactions and Use Tax Law (also known as district taxes).

As a tax levy, the provisions of the bill would become effective immediately upon enactment, but would become operative on the first day of the first calendar quarter commencing more than 90 days after the bill is enacted. The provisions would remain in effect until January 1, 2017, and as of that date be repealed.

BACKGROUND

For a ten-year period ending December 31, 2003, the law provided a partial (General Fund only) sales and use tax exemption for purchases of equipment and machinery by new manufacturers, and income and corporation tax credits for existing manufacturers' investments (MIC) in equipment. Manufacturers were defined in terms of specific federal "Standard Industrial Classification" (SIC) codes. The exemption provided a state tax portion exemption for sales and purchases of qualifying property, and the income tax credit was equal to 6% of the amount paid for qualified property placed in service in California. Qualified property was identical to the property described in this bill - depreciable equipment used primarily for manufacturing, refining, processing, fabricating or recycling; for research and development; for maintenance, repair, measurement or testing of qualified property; and for pollution control meeting state or federal standards. Qualified property also included tangible personal property purchased by a contractor, as specified, for use in the performance of a construction contract for the qualified person who would use that property as an integral part of the manufacturing process, as described. Certain special purpose buildings were included as "qualified property" as this bill proposes. New manufacturers could either receive the benefit of the exemption or claim the income tax credit. However, existing manufacturers could only receive the benefit of the income tax credit.

This sales and use tax exemption and income tax credit had a conditional sunset date. They were to sunset in any year following a year when manufacturing employment (as determined by the Employment Development Department) did not exceed January 1, 1994 manufacturing employment by more than 100,000. On January 1, 2003, manufacturing employment (less aerospace) did not exceed the 1994 employment number by more than 100,000 (it was less than the 1994 number by over 10,000), and therefore the MIC and partial sales tax exemption sunsetted at the end of 2003.

Legislative History. Since the expiration of the partial exemption of manufacturing equipment, numerous bills have been introduced to either reinstate or to expand or modify the exemption, but failed to pass. A sample of bills introduced during the last three Legislative Sessions include the following:

Bill No.	Session	Author	Proposed Exemption
AB 810 and AB 829	2009-10	Caballero	Qualifying tangible personal property, including sustainable development equipment investments, by persons engaged in manufacturing, research and development, and software publishing
AB 1719	2009-10	Harkey	Reinstate the original exemption for qualifying tangible personal property by new trades or businesses engaged in manufacturing
AB 1812	2009-10	Silva	Qualified tangible personal property by persons engaged in manufacturing and software production
AB 2280	2009-10	Miller	Equipment by manufacturers engaged in manufacturing activities

Bill No.	Session	Author	Proposed Exemption
SB 1053	2009-10	Runner	Qualifying tangible personal property by persons engaged in manufacturing and software publishing and their affiliates
SBx6 18	2009-10	Steinberg & Alquist	Qualifying tangible personal property by persons engaged in specific manufacturing and software production activities
SBx6 8 and SBx6 44	2009-10	Dutton	Qualifying tangible personal property by manufacturers and software publishers and affiliates engaged in manufacturing activities or research and development
AB 1152	2007-08	Niello	Qualifying tangible personal property by persons engaged in manufacturing and software production
AB 1206	2007-08	Smyth	Machinery and equipment used in research and development activities
AB 1681	2007-08	Houston	Qualified tangible personal property for use by qualified persons engaged in manufacturing, telecommunications, and electrical generation activities
AB 344	2005-06	Villines	Qualifying tangible personal property by qualified persons primarily engaged in manufacturing, telecommunications and electrical generation activities. Would apply to 25% of the sales or purchases for 2006, 50% for 2007, and 100% thereafter.
AB 1580	2005-06	Torrico	Qualifying tangible personal property by qualified persons primarily engaged manufacturing, construction contracting, software production, telecommunications, cable distribution, scientific research and development services, and wholesale distribution of recyclable materials
SB 552	2005-06	Alquist	Materials, supplies, machinery and equipment used by entities engaged in manufacturing, research and development, telecommunications, software production, and printing, and for semiconductor, biotechnology and pharmaceuticals clean rooms and equipment. Includes optional Bradley-Burns local and district tax exemption
SB 1291	2005-06	Alquist	Materials, supplies, machinery and equipment used by entities engaged in manufacturing, research and development, software production, and newspaper printing, and for semiconductor, biotechnology and pharmaceutical clean rooms and equipment

COMMENTS

1. **Sponsor and Purpose.** The author is sponsoring this bill in an effort to create jobs and encourage employers to invest in their businesses. According to the author's office, this measure will give employers an incentive to buy new equipment to invest in research and development for their businesses, and thereby create more jobs to stimulate and assist California's economy.

   At the April 4, 2011 Assembly Revenue and Taxation Committee hearing, the author cited the following findings from a report prepared by the Milken Institute:

   > "Exempting manufacturing equipment from the 5 percent sales tax results in an average of 50,000 new jobs per year over the next 10 years, of which 14,000 are created in the manufacturing sector. With a 5 percent reduction, state revenues

from higher economic activity increases by $624 million by the fifth year, offsetting the loss of $510 million in tax revenues that would have been collected by the state, resulting in a net revenue gain of $114 million."

This report, put out by the Milken Institute in June 2002, *Economic Impact Of A Sales Tax Reduction On Manufacturing Equipment*, examined the impact of a sales tax reduction of 5 percent on the purchases of manufacturing and telecommunications equipment. http://www.milkeninstitute.org/pdf/CMTA-Rev.pdf. The findings indicated that enacting a 5 percent sales tax reduction would lead to higher capital formation, promote greater job and income growth, and after an initial loss, ultimately increase tax receipts in California.

In addition, the report pointed out the following arguments in support of eliminating the 5 percent tax on manufacturing equipment:

- Exempting manufacturing equipment would contribute to reducing the cost disadvantages that California's manufacturing producers face with other western states and other countries. Higher capital investment improves the productivity of California's manufacturing work force.
- Providing a full or partial reduction from the 5 percent sales tax on the purchase of manufacturing and telecommunications equipment may initially be more costly for the state, but it eventually creates more jobs and higher income, more than offsetting the lost tax revenue due to the reduction.
- From a public policy perspective, the creation of additional manufacturing jobs will propel more workers and families into middle-class status in California. Additionally, most manufacturing jobs provide benefits such as health care coverage.
- Lastly, because manufacturers are increasingly locating more of their development activities within their production facilities, some of these incremental manufacturing jobs will be in research and development.

2. **The May 23, 2011 amendments** address technical issues raised in the BOE's previous analysis. The amendments (1) make the provisions become operative on the first day of the first calendar quarter commencing more than 90 days after the bill is enacted, (2) add a definition of "useful life," and (3) add coauthors.

3. **Similar to previous manufacturing exemption, this proposed partial exemption would apply to new businesses only.** A "qualified person" would include a person that started a new trade or business (described in the NAICS codes 31 to 33) in this state on or after the effective date of this bill. In addition, the proposed exemption would be available only during the first three years of the new business's existence.

4. **Technical issue.** Subdivision (c) would require a purchaser to furnish an exemption certificate to the retailer and the retailer to subsequently furnish the BOE with a copy of the exemption certificate (this provision was in the former Section 6377). This provision will require the BOE to store copies of each exemption certificate taken by a retailer, which is a cumbersome process for BOE staff. To address this concern, staff suggests that the bill be amended to require the retailer to retain a copy of each exemption certificate and make it available to the BOE for examination upon request. Staff will assist the author's office in drafting this proposed amendment.

5. **Partial exemptions complicate administration of the tax.** Currently, most sales and use tax exemptions apply to the total applicable sales and use tax. However, there are currently five partial exemptions in California law, where only the state tax portion (6.25% (5.25 beginning July 1, 2011): General Fund (6%) and Fiscal Recovery Fund (0.25%)) of the state and local sales and use tax rate is exempted. These five partial tax exemptions include: (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 are difficult for both retailers and the BOE. They complicate return preparation and return processing. And errors on returns attributable to these partial exemptions occur frequently, which result in additional return processing workload for the BOE.

   This measure proposes a 5% exemption (General Fund only), which would create a new exemption category (since current law does not have any partial exemptions other than a 6.25% exemption, which effective July 1, 2011 is reduced to 5.25%). This would require a revision to the sales and use tax return and result in a new, separate computation on the return. Some retailers would have to segregate in their records sales subject to the 5% exemption (proposed by this bill), 5.25% exemption, sales with a full exemption (such as a sale for resale or a sale in interstate commerce), and sales that are fully taxable. This bill would add a new level of complexity, which would create a corresponding increase in errors in reporting the tax to the BOE. This increase in errors would further complicate the BOE's administration of the sales and use tax law and complicate reporting obligations of retailers.

6. **Related legislation.** Similar bills have been introduced this year:

   - AB 204 (Halderman) would provide a partial (General Fund only) sales and use tax exemption for purchases of equipment by a biomass energy facility, as defined, for use in its biomass energy production activities.
   - AB 218 (Wieckowski), among its provisions, would provide a partial (General Fund and Fiscal Recovery Fund only) sales and use tax exemption for purchases of certain tangible personal property by qualified persons engaged in manufacturing and software production, as specified and defined. This bill would intend to use revenue generated from the estate tax, which this bill would create, to supplant the reduction of General Fund revenue as a result of the exemption. Its enactment, however, would require voter approval at the next statewide General Election.
   - AB 979 (Silva) would provide a partial (General Fund only) sales and use tax exemption, beginning January 1, 2012, on tangible personal property purchased for use in manufacturing activities by manufacturers and software publishers and affiliates.
   - AB 1057 (Olsen) would provide a partial (General Fund only) sales and use tax exemption, beginning January 1, 2014 and before January 1, 2020, on tangible personal property purchased for use in manufacturing activities, research and development, and air pollution mitigation by manufacturers and affiliates.
   - SB 47 (Alquist) would provide a partial (General Fund and Fiscal Recovery Fund) sales and use tax exemption for purchases of qualifying tangible personal property used by entities engaged in manufacturing, research and development,

newspaper printing, and software production, and for semiconductor, biotechnology and pharmaceutical clean rooms and equipment.

- SB 395 (Dutton) would provide a partial (General Fund only) sales and use tax exemption for purchases of qualifying tangible personal property by persons engaged in manufacturing and software production, as specified and defined.

COST ESTIMATE

Because of the *new* partial exemption, the BOE would incur administrative costs attributable to programming, return revisions, and return processing. In addition, the BOE would incur costs to notify affected retailers, prepare a special publication and exemption certificate, audit claimed exemptions, and answer inquires from the public and taxpayers. An estimate of these costs is pending.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

The U.S. Census Bureau's *Annual Survey of Manufactures* (ASM) reported NAICS 31-33 capital expenditures data (machine and equipment, buildings, fuels) for California. In FY 2008-09, capital expenditures by California manufacturers amounted to an estimated $18.5 billion. Using the most recent forecast of business equipment investment of IHS Global Insight, a national economic forecasting firm, we estimated expenditures as follows:

California Expenditures (in billions)		
FY 2011-12	FY 2012-13	FY 2013-14

Exemption Impact - New Businesses Only. As previously stated, this bill would only provide an exemption to new trade or businesses (in business for three years or less) described in the NAICS codes 31 to 33. To give us an idea as to what the qualifying expenditure would be, we looked at recent Bureau of Labor Statistics (BLS) U.S manufacturing data related to percentage of manufacturing job gains from new manufacturing establishments. It was estimated that the qualifying expenditure would amount to 0.3%. This would result in expenditures as follows:

New Businesses Expenditures Estimate (in millions)		
FY 2011-12	FY 2012-13	FY 2013-14

REVENUE SUMMARY

The revenue impact from exempting tangible personal property purchased by new manufacturing businesses (in business for three years or less) from the state sales and use tax is as follows:

General Fund Revenue Loss
(in millions)

	FY 2011-12	FY 2012-13	FY 2013-14
General Fund (5%)	$3.6	$3.8	$4.1

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