STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

DRAFT

Date:	**05/14/13**	Bill No:	**Senate Bill 412**
Tax Program:	**Sales and Use Tax**	Author:	**Knight**
Sponsor:	**Author**	Code Sections:	**RTC 6377.2**
Related Bills:	**SB 19 (Knight)** **SB 235 (Wyland)** **SB 376 (Correa)** **AB 486 (Mullin)** **AB 653 (V. Perez)**	Effective Date:	**Upon enactment but operative 01/01/14**

BILL SUMMARY

This bill provides aerospace product and part manufacturers a 3.9375% sales and use tax exemption for their purchases of qualifying tangible personal property, until January 1, 2019.

Summary of Amendments

Since the previous analysis, this bill was amended to require the Legislative Analyst's Office (LAO) to report on the exemption's effect on aerospace and related industries' employment, as specified.

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.

Conversely, tax does not apply to sales of tangible personal property when the purchaser physically incorporates 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.

PROPOSED LAW

Beginning January 1, 2014 and before January 1, 2019, this bill provides a 3.9375% state sales and use tax exemption for a "qualified person's" purchases of:

- Tangible personal property to be used 50% or more in aerospace products and parts manufacturing,

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

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 BOE's formal position.

- Tangible personal property purchased for use by a contractor, as specified, 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 process or as a facility for use in connection with the manufacturing process.

This bill defines "qualified person" as either:

- A person who is primarily engaged in aerospace product and part manufacturing described in the 2012 edition of North American Industry Classification System (NAICS), Code 3364, or
- A qualified person's affiliate, if the affiliate is a member of that person's unitary group, as specified.

The bill defines "manufacturing," "primarily," and "process." The bill also specifies which tangible personal property the proposed exemption includes or excludes.

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 also requires the LAO, by January 1, 2018, to report on the exemption's effect on employment in aerospace and related industries, using data, including, but not limited to, the data produced by the Employment Development Department (EDD) Labor Market Information Division.

BACKGROUND

For a ten-year period ending December 31, 2003, the law provided all new manufacturers (including aerospace) 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 percent for purchases of similar equipment placed in service in California. Similar to this bill's proposed exemption, 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,[2] less aerospace employment, did not 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. The partial exemption and MIC therefore sunset at the end of 2003.

[2] As determined by the EDD.

COMMENTS

1. **Sponsor and Purpose.** According to the author's office, Senator Knight, as the sponsor, introduced this bill to create a sales and use tax exemption for manufacturing equipment specific to aerospace, sending a strong signal to investors around the United States that California is serious about maintaining the vital aerospace industry in this state.

2. **The May 14, 2013 amendments** require the LAO to report on the exemption's employment effect, as specified. The **April 18, 2013 amendments** added "tangible personal" before property, and clarified that a qualified person is one that is *primarily* engaged in aerospace product and part manufacturing.

3. **NAICS Code 3364 includes aircraft, missile, and space vehicle manufacturers, and others.** Specifically, this code describes establishments primarily engaged in one or more of the following: (1) complete aircraft, missile, or space vehicle manufacture; (2) aerospace engine, propulsion units, auxiliary equipment or parts manufacture; (3) aerospace product prototype development; (4) aircraft conversion; and (5) complete aircraft or propulsion systems overhaul and rebuild.

4. **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 five partial exemptions, currently at a 5.50%[3] rate:

   (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 3.9375% 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 exempt 3.9375% sales, the exempt 5.50% sales, fully exempted sales (e.g., sale to the US government 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 complex.

5. **Related legislation.** Senator Knight also introduced SB 19 to exempt from sales and use tax equipment and materials purchased for use in the construction or improvement of specified facilities at commercial space launch sites.

   Other bills introduced this year related to exempting from sales and use tax manufacturing equipment purchases include:

   - **SB 235 (Wyland)** – provides manufacturers and their affiliates a 3.9375% exemption for their qualifying tangible personal property purchases.

[3] 3.9375% General Fund, 1.0625% Local Revenue Fund 2011, 0.25% Fiscal Recovery Fund, and 0.25% Education Protection Account.

- **SB 376 (Correa)** – beginning January 1, 2017, provides manufacturers, software publishers, and their affiliates a 6.25% exemption for their qualifying tangible personal property.
- **AB 486 (Mullin)** – provides manufacturers, software producers, and biotechnology and other research entities, and their affiliates a 5.25% exemption for their qualifying tangible personal property purchases.
- **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.

COST ESTIMATE

An estimate is pending to determine costs to program the computer system, notify retailers, audit claimed exemptions, and respond to inquiries from taxpayers and the general public.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

The U.S. Census Bureau's *2007 Economic Census* shows capital equipment spending of $441.4 million in California for NAICS industry code 3364.[4] This is the latest California data available for this industry. Another Census survey shows California capital equipment spending for NAICS Industry 336, Transportation Equipment, for 2007 and 2011.[5] This is a broader industry, as it includes cars and aerospace products. Since "Transportation Equipment" includes aerospace, we believe aerospace growth can be approximated. Research staff used this industry's California Census data to calculate the 2007 to 2011 growth factor. For the 2011 estimate, we applied this factor to the 2007 California aerospace equipment purchases. We followed a similar procedure to forecast the 2011 estimate into the future. To do this, we used *Global Insight*[6] data to calculate 2011 to 2016 growth factors. The specific *Global Insight* data we used related to aircraft investment, the industrial sector most closely related to aerospace.

For Industry 3364, California fuel purchase data is unavailable. Census data are available for total materials costs, which include fuels. In 2007, California's Industry 3364's total materials costs equaled $7.747 billion.

The U.S. Bureau of Economic Analysis (BEA) tracks national fuel and total material costs for Industry 336.[7] The 2011 national data show that fuel purchases accounts for 0.15 percent of total materials purchases. We assume this percentage is the same for Industry 3364 in both the U.S. and California. We also used *Global Insight* forecast data to project future costs.

[4] U.S. Census Bureau, *2007 Economic Census,* "Manufacturing: Geographic Area Series: Industry Statistics for the States."
[5] U.S. Census Bureau, *Annual Survey of Manufacturers*.
[6] An economic forecasting firm.
[7] U.S. Bureau of Economic Analysis website, "1998-2011 KLEMS Intermediate Use Estimates: Detailed Estimates of Energy, Materials, and Purchased Services Used by Industries," http://www.bea.gov/industry/more.htm .

REVENUE SUMMARY

Based on these assumptions and calculations, the estimated state General Fund (3.9375%) revenue loss from exempting sales of tangible personal property for California Industry 3364 is:

- FY 2013-14: $12.5 million ($317 million X 3.9375%). (6 months)
- FY 2014-15: $25.9 million ($658 million X 3.9375%).
- FY 2015-16: $27.5 million ($697 million X 3.9375%).

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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