



**STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS**

DRAFT

Date:	02/19/14	Bill No:	<u>Assembly Bill 777</u>
Tax Program:	Property	Author:	Muratsuchi
Sponsor:	SpaceX	Code Section:	RTC 242
Related Bills:		Effective Date:	Operative for the 2014 lien date

BILL SUMMARY

This bill exempts from property tax qualified space flight property, including fuel, until the 2024-25 fiscal year.

Summary of Amendments

Since the previous analysis, this bill was amended to modify the effective period, delete a provision extending the exemption for property placed or used aboard the space flight property, and explicitly state that no inference is to be drawn as to whether space flight property exempted under this bill qualifies as business inventory under the Revenue and Taxation Code or Property Tax Rule 133.

ANALYSIS

CURRENT LAW

Except where the law provides a specific exemption, the property tax applies to all property, both real and personal. The law imposes the property tax on tangible personal property items used in a trade, profession, or business.¹ Currently, there is no specific property tax exemption for space flight property. Such property, however, may qualify under the business inventory exemption if the criteria are met.² The law exempts business inventories, but imposes tax on supplies.

- Supplies are items used in the normal operation of the business and are not intended for sale or lease.
- Business inventory, on the other hand, includes all personal property that is a product or becomes a product that is held for sale or lease. It also includes raw materials and work in progress with respect to such products.
- Business inventory does not include business machinery or equipment unless such property is held for sale or lease in the ordinary course of business.

The Constitution authorizes the Legislature to statutorily exempt any personal property from property tax with a 2/3 vote of each house.³

PROPOSED LAW

This bill exempts from property tax qualified property for use in space flight for lien dates 2014 to 2024, inclusive.⁴ “Space flight” means any flight designed for suborbital, orbital,

¹ RTC §224

² RTC §219, RTC §129, Regulation 133

³ Article XIII, Section 2 of the California Constitution

⁴ These lien dates correspond to the 2014-15 to 2024-25 fiscal years.

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

or interplanetary travel by a space vehicle, satellite, space facility, or space station of any kind.

The exemption is limited to taxpayers that have a primary business purpose in space flight activities. The exemption does not apply to any material that is not intended to be launched into space, but does apply regardless of whether the property will ultimately be returned to California.

“Qualified property” includes:

- Tangible personal property that has space flight capacity. This includes an orbital space facility, space propulsion system, space vehicle, launch vehicle, satellite, or space station of any kind, and any component thereof.
- Tangible personal property, including raw materials, work in process or finished goods, that has, or upon manufacture, assembly, or installation, has space flight capacity.
- Fuel produced, sold, and exclusively used for space flight and not adaptable for use in ordinary vehicles.

The assessor cannot deny the exemption because:

- The space flight launch fails, is postponed, or is cancelled.
- A launch vehicle, or any component thereof, is destroyed.

The exemption goes into immediate effect and applies retroactively to the January 1, 2014 lien date for the 2014-15 fiscal year.

IN GENERAL

Business Personal Property. Personal property used in a trade or business is generally taxable. Annually, the law requires property owners to report their business assets to the assessor on the [business property statement](#),⁵ which can also be [e-filed](#). The self-reported assets and costs are subject to audit⁶. Proposition 13’s value limitations do not apply to personal property, which is valued each lien date at its current fair market value.

The business property statement includes information regarding the supplies, business equipment, and leasehold improvements for each business location in the state. The owner provides information on the statement that is then used to assess and tax property in accordance with the law. The owner reports the acquisition costs of the supplies, business equipment and leasehold improvements that were owned on the lien date at the business location. Business personal property includes all supplies, equipment and leasehold improvements used in the operation of a business. Business inventory and licensed vehicles (except Special Equipment (SE) tagged and other off-road vehicles and equipment) are not taxable personal property and are not reported on the statement.

Generally, the assessor determines the fair market value using the property’s acquisition cost. The assessor multiplies acquisition cost by a price index (an inflation trending factor based on acquisition year) to estimate reproduction cost new. Next, the assessor multiplies reproduction cost new by a percent good factor (from BOE-issued percent good tables) to estimate depreciated reproduction cost (reproduction cost new

⁵ RTC §441 - “Business Personal Property Statement” BOE Form 571-L

⁶ RTC §469

less depreciation). The assessor uses the reproduction cost new less depreciation value as the property's taxable value for the fiscal year. The tax rate applied to the value is the same as the rate on real property; that is 1% plus voter approved indebtedness, which varies by locality.

Business Inventory versus Supplies. The BOE's Assessors' Handbook 504 (AH 504), [Assessment of Personal Property and Fixtures](#), explains it is important to distinguish supplies, which are assessable, from inventory items, which are exempt. In short, business inventory includes all items of personalty that become part of, or are themselves, a product that is held for sale or lease in the ordinary course of business. For an item of property to qualify for the business inventory exemption, the key phrases *ordinary course of business* and *goods intended for sale or lease* must apply.

The AH 504 provides that business inventory generally includes:

- Goods transferred in the rendition of a “**nonprofessional service.**”
- Items incorporated into a product and held for sale in the ordinary course of business.

Supplies include:

- Incidental goods transferred in the rendition of a “**professional service**” unless the goods are regularly billed separately from the service.
- Items consumed in the manufacturing process but not physically incorporated into the product.

The AH 504 notes that many services are difficult to classify as a professional or nonprofessional service but provides the following criteria to help assessors make the determination:

Professional Services: A "profession" is a vocation where the labor and skill is predominantly mental or intellectual, rather than physical or manual. A profession requires knowledge of an advanced type in a given field of science or learning gained by a prolonged course of specialized instruction and study.

Property Tax Rule 133 lists as examples medicine, law, architecture, or accountancy.

Nonprofessional Services: A "nonprofessional service" is generally defined as a vocation requiring skill of a manual or mechanical nature. Courts tend to classify a nonprofessional service as a business as opposed to a profession. Examples noted include barbers, carpenters, and plumbers.

Property Tax Rule 133 lists as examples dry cleaners, beauty shop operators, and swimming pool service companies.

COMMENTS

1. **Sponsor and Purpose.** According to the author, this bill “ensures that California’s brilliant space technology innovators stay in business by nurturing a productive business climate for the state’s aerospace sector.” The sponsor, Space Exploration Technologies (SpaceX), designs, manufactures and launches rockets and spacecraft.
2. **The February 19, 2014 amendments** (1) update the fiscal years to which the proposed exception applies since the bill was not enacted in 2013, (2) delete a provision exempting items placed or used aboard qualified property, and (3) expressly provide that no inference is to be drawn from the creation of the exemption

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

with respect to whether space flight property qualifies as business inventory under related Revenue and Taxation Code or the Property Tax Rule provisions. **The August 26, 2013 amendments** changed the effective date from January 1, 2007 to January 1, 2013, limited the exemption to those taxpayers that have a primary business purpose in space flight activities, and required taxpayers to provide evidence to support exemption eligibility upon the assessor's request. **The May 21, 2013 amendments** added sunset provisions to make the exemption temporary.

3. **The Legislature may tax or exempt personal property in its discretion.** Because space flight property is classified as personal property, the Legislature legally may exempt it, provided they do so by a two-thirds vote of both houses. Section 2 of Article XIII of the California Constitution provides that the Legislature, two-thirds of the membership of each house concurring, may classify personal property for differential taxation or for exemption.
4. **The exemption is retroactive to the January 1, 2014 lien date upon which the 2014-15 tax bill will be based.** A public purpose statement supporting retroactivity notes the bill promotes businesses within the state that consistently expand and provide secure employment in a much needed industry.
5. **Related BOE Legal Opinion and Possible BOE Rulemaking Process to amend Property Tax Rule 133 "Business Inventory."** On December 24, 2013, the BOEs legal department issued an advisory, non-binding [legal opinion](#) that the business inventory exemption applies to space flight property fabricated and used to transport satellites and cargo to locations in outer space if the owner relinquishes ultimate control at launch. The opinion [recommended that Rule 133 be amended](#) to specifically address space flight property governed by the Arms Control Export Act and the International Traffic in Arms Regulation (See footnote 2). On February 6, 2014, an interested parties meeting was held to discuss this rule change. On February 25, 2014, the Members of the BOE will [discuss](#) whether to initiate the rule making process related to this subject matter.
6. **Differences between this bill and the possible rule changes.** The BOE-rule change under consideration is narrower in scope than this bill. Specifically, the rule applies only to business inventory and does not apply to reusable spaceflight property. The exemption under this bill exempts all qualified space flight property whether inventory or not, and whether reusable or not. Furthermore, this bill also proposes to exempt fuel.
7. **The issue giving rise to this bill.** As previously noted, business inventories are exempt, while supplies are taxable. The sponsor indicates that two of its propulsion systems – rockets used for space travel - were classified as "supplies" resulting in an unexpected property tax bill. [The county indicates that it classified the property, not as supplies, but as machinery and equipment which is also taxable.] The sponsor believes its rockets should be classified as inventory and thus exempt from tax. Under existing law, the question is unsettled. For the years this exemption is in effect, this bill would make it unnecessary to determine whether propulsion systems are (1) business machinery and equipment, (2) business inventory, or (3) supplies.
8. **Whether space flight property qualifies as exempt business inventory is currently being applied.** Assessment appeals are pending in Los Angeles County. The county argues that the property in dispute is not eligible for the business inventory exclusion because it is machinery and equipment used to provide a service (space transportation) and the space launch equipment is not sold. The

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

county also contends that RTC Section 129 specifically provides that “business inventories” does not include machinery and equipment not ordinarily sold. Furthermore, the county notes that goods transferred in connection with professional services are not eligible for the inventory exemption. The issue has not yet been decided by the local appeals board as the issue has not been set for hearing.

9. **This bill does not allow for refunds of any prior tax years paid.** This bill would exempt qualified property commencing with the January 1, 2014 lien date. In contrast, rule changes are declaratory of existing law, and property expressly exempt under a rule change allow affected property owners to claim a tax refund for any years open under the statute of limitations for property tax refunds (typically four years from the date paid.)

COST ESTIMATE

The BOE’s cost to update publications is absorbable.

REVENUE ESTIMATE

According to county assessors, this bill results in an annual property tax revenue loss of at least \$1.1 million.

Analysis prepared by:	Rose Marie Kinnee	916-445-6579	02/24/14
Contact:	Michele Pielsticker	916-322-2376	
Is			0777ab021914rmk.doc

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