California State

Board *of* Equalization

Legislative Bill Analysis

Legislative and Research Division

Assembly Bill 2518 (Gomez)
Date: Introduced
Program: Sales and Use Tax
Sponsor: Author
Code: Revenue and Taxation Code Section 6356.9
Effective: Upon enactment

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Summary: Provides a state (3.9375%) sales and use tax exemption for building and construction supplies, materials, equipment, and machinery purchased by a nonprofit corporation, as specified, for construction of properties sold to low-income families.

Purpose: To provide tax relief to certain nonprofit corporations that build homes to be sold to low-income families.

Fiscal Impact Summary: Annual state General Fund sales and use tax revenue loss of $175,000

Existing 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. Currently, the Sales and Use Tax Law does not provide any exemption or exclusion for sales and purchases of building materials, supplies, equipment, or machinery, to be used for the construction of homes sold to low-income households.

California's sales and use tax rates. Since January 1, 2013, a statewide 7.5% sales and use tax rate applies to tangible personal property sales and purchases. The table shows California's various sales and use tax rate components, including the 1.25% Bradley-Burns Local Tax (the table excludes voter-approved city and county district taxes, which range from 0.1% to 2.5%):

Rate	Jurisdiction	Purpose/Authority
3.9375%	State (General Fund)	State general purposes (RTC Sections 6051, 6051.3, 6201, 6201.3)
0.25%	State (Education Protection Account)	Until 01/01/17, schools and community college funding (Section 36, Article XIII, State Constitution)
0.50%	State (Local Public Safety Fund)	Local governments to fund public safety services (Section 35, Article XIII, State Constitution)
0.50%	State (Local Revenue Fund)	Local governments to fund health and welfare programs (RTC Sections 6051.2 and 6201.2)
1.0625%	Local Revenue Fund 2011	Realignment of local public safety services (RTC Sections 6051.15 and 6201.15)
1.25%	Local (City/County) 1.00% City and County 0.25% County	(RTC Section 7203.1, operative 7/1/04) General city and county operations County transportation purposes
7.50%	**Total Statewide Rate**	

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

Proposed Law: This bill exempts from the state portion (3.9375%) of the sales and use tax rate building and construction supplies, materials, equipment and machinery, including parts, purchased for use by a nonprofit corporation for construction of properties sold to low-income families. A nonprofit corporation must be exempt from paying federal income tax under Internal Revenue Code Section 501(c) (3), and receive a welfare exemption under RTC Section 214.15. A qualifying nonprofit corporation is a corporation organized and operated for the specific and primary purpose of building and rehabilitating single or multifamily residences for sale at cost to low-income families with financing in the form of a zero interest rate loan and without regard to religion, race, national origin, or the sex of the head of household.

The exemption will not apply if, within one year from the date of purchase, the purchaser (1) uses the supplies, materials, equipment, and machinery in a manner not qualifying for the exemption, (2) converts the supplies, materials, equipment, and machinery from an exempt use to a non-qualifying use, or (3) removes the qualifying supplies, materials, equipment, and machinery from California.

The exemption would *not* apply to the 0.25% State Education Protection Account, 0.5% Local Revenue Fund, 0.5% Local Public Safety Fund, 1.0625% Local Revenue Fund 2011, or any tax levied pursuant to the Bradley-Burns Uniform Local Sales and Use Tax Law or the Transactions and Use Tax Law.

As a tax levy, the bill takes effect immediately.

Commentary:

1. **Effect of the bill.** This bill creates a state (General Fund only) exemption for sales and purchases of building and construction supplies, materials, equipment, machinery, and related parts sold to a nonprofit corporation. The nonprofit corporation must be exempt from federal income taxation and receive the welfare exemption. The items purchased must be used for construction of properties that are sold to low-income families. The exemption applies to items that are consumed or used by the nonprofit corporation to construct the low-income housing and items that are physically incorporated into the housing.
2. **"Low-income families" is not defined.** "Lower income" households are defined in both federal and state law. A definition of "low-income" should be added to the bill to eliminate any ambiguity and avoid any unanticipated revenue losses.
3. **Nonprofit corporation defined.** A nonprofit corporation must be exempt from paying federal income tax under Internal Revenue Code Section 501 (c)(3), and must receive the welfare exemption under RTC Section 214.15. A qualifying nonprofit corporation under Section 214.15 is a corporation whose primary purpose is to build or rehabilitate single or multifamily residences to be sold at cost to low-income families, with a zero interest rate loan and without regard to religion, race, national origin, or the sex of the head of household. According to the California Department of Housing and Community Development and the California Housing Finance Agency, there are only a few nonprofit organizations that construct housing for sale to low-income families with zero percent financing. The Habitat for Humanity program constructs, builds, and rehabilitates homes for sale to low-income families and provides long-term, zero percent financing.
4. **Qualifying nonprofit corporation is entitled to the exemption.** The exemption applies only to the qualifying nonprofit corporation. If a qualifying nonprofit corporation hires a contractor to construct a low-income housing project, the qualifying nonprofit corporation must directly purchase all the materials, supplies, and equipment that the contractor uses in order to qualify for the exemption. The contractor's purchases for the project are subject to tax.
5. **Items eligible for the exemption are broad.** Eligible items include materials, supplies, equipment and machinery, and parts that are used or consumed in, or incorporated into, the construction of low-income housing. These exempt items may include flooring, lumber, paint, stucco, tile, windows, furnaces, ceiling fans, lighting fixtures, tools, dishwashers, electric and gas stoves, electric generators, bulldozers, backhoe loaders, cranes, and more. Equipment also may include pick-up trucks and tractors.

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.

The proposed exemption, as currently drafted, would apply to building and construction supplies, equipment, and machinery that are used by the nonprofit corporation to construct the housing, as well as items that are actually incorporated into the housing. If the intent of the bill is to limit the exemption to the items incorporated into the housing, then the language should clarify this. In addition, the bill should clarify whether computers and office supplies used in administration or management activities also qualify for the exemption.

6. **Non-qualifying uses of items.** The proposed exemption will not apply if, within one year from the date of purchase, the nonprofit corporation uses the building supplies, equipment, and machinery in a manner not qualifying for the exemption, converts the building supplies, equipment, and machinery from an exempt use to a non-qualifying use, or removes the qualifying building supplies, equipment, and machinery from California. Similar sales and use tax exemptions specify that the qualifying items must be used *primarily* in the qualifying activity. These exemptions define "primarily" as 50 percent or more of the time. To administer this exemption consistent with similar sales and use tax exemptions, BOE staff recommends that the term "primarily" be added to the bill. BOE staff will work with the author's office to address this concern.

7. **Exemption applies to rehabilitated homes.** The bill uses the term 'construction' of properties. However, the welfare exemption states that a qualifying nonprofit corporation's primary purpose is to "build" and rehabilitate residences for sale to low-income families. According to the author's office, the term *construction* is intended to apply to newly constructed *and* rehabilitated homes. For clarity, 'rehabilitated homes' should be added to the language to clarify those projects are also included in the proposed exemption.

8. **Partial exemptions complicate administration.** Currently, most sales and use tax exemptions are applied to the total applicable sales and use tax. However, several partial exemptions exist in which only the state tax portion (5.25%) of the sales and use tax rate is exempted, such as the farm equipment and teleproduction equipment exemptions. These partial exemptions are difficult for both retailers and the BOE, and complicate return preparation and processing. Moreover, errors attributable to these partial exemptions occur frequently. This results in additional return processing workload for the BOE.

9. **The bill is effective immediately.** The proposed exemption takes effect immediately, which provides the BOE with no lead time to notify retailers. In order for retailers to properly claim a sales tax exemption under this bill, retailers must accept in good faith an exemption certification from a nonprofit corporation that certifies that the corporation's purchases qualify for the exemption. The bill should provide a minimum, 90-day lead time to allow the BOE to notify and educate retailers of sales tax responsibilities associated with this new exemption.

Administrative Costs: BOE will incur administrative costs to notify affected retailers, modify tax returns, program for the exemption's partial rate, prepare a special publication, audit claimed exemptions, and answer inquiries from taxpayers and the general public. A cost estimate is pending.

Revenue Impact:

Background, Methodology, and Assumptions. Identifying the value of construction supplies, materials, equipment, and machinery purchased by nonprofit corporations for construction of properties that are sold to low income families is challenging. BOE staff estimated these values by making assumptions and combining data from the following sources:

1) The U.S. Census Bureau, *Economic Census,* "Construction: Geographic Area Series: Detailed Statistics for the State [California]: 2012"
2) Construction Industry Research Board (CIRB), *California Construction Review,* "2015 Semi-Annual Data by Month-Residential Detail" (Subscription).
3) California Department of Housing and Community Development.

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4) California Housing Finance Agency

5) Discussions with industry representatives

The latest annual data available from the California Department of Housing and Community Development indicates that 5,543 new housing units were built under various loan and grant programs by both for profit and nonprofit firms.[2] These include both single family units and multifamily units. The *Program Directory* descriptions emphasize rental housing programs since few low income households would be able to purchase new single family homes. The California Housing Finance Agency (CHFA) staff provided internal documents indicating that less than 50 of these units were likely to qualify as low-income new single family homes. The criterion for this bill is that loans are zero interest, whereas the loans in the CHFA inventory are low interest loans. Staff believes it is reasonable to assume numbers of zero interest loans (and homes qualifying) are similar in general magnitude to numbers of low interest loans.

This bill may include materials for rehabilitation of existing homes in addition to materials for newly constructed homes. Staff received data from industry representatives on the numbers of new homes constructed and the numbers of rehabilitated homes. After reviewing this data, staff concluded that about 100 “new home equivalents” in materials costs for new and rehabilitated homes would likely qualify under this bill. For revenue estimation purposes, staff will assume 100 homes qualify under the bill’s provisions.

Using the CIRB data, staff calculated average permit value per dwelling unit for 432 cities and counties issuing permits in the first half of 2015. Staff averaged the permit values using the lowest five percent of single family home permit. This method was used in lieu of an average value for all permits to match low income households to low income home permits as closely as possible by providing sufficient numbers of permits to be representative of low income homes. The average permit value of these homes was $144,396 per unit in 2015. For some perspective of reasonableness, this estimated average for low income homes is less than half the average for all homes, and below the average per unit for multifamily dwelling units, such as apartments.

According to the Census Bureau data, materials, components and supplies account for an average of about 30% of the value of construction, which is also the value of these permits. Therefore, the average value of materials, components and supplies is 30% of $144,396, or $43,760 per unit. Census data also indicate that capital equipment spending by the home building construction industry was $15.9 million in 2012, or an average of $577 per home permit issued in 2012. Thus, exempt materials, components, supplies, and capital equipment under this bill would be the sum of $43,760 + $577, or $44,337 per home. With 100 units qualifying, total sales would be about $4.4 million ($44,337 x 100 = $4,433,700). At a state rate of 3.9375%, revenues associated with these sales would be about $175,000.

Revenue Summary. The annual General Fund revenue loss for this bill is $175,000.

Qualifying Remarks. The BOE Research and Statistics Section made estimates of the value of taxable sales qualifying under this bill using professional judgment on assumptions and the most accurate information available at the time these estimates were made. Staff is continuing to research low income home construction, and may modify these estimates if better information becomes available.

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

[2] *Financial Assistance Program Directory*, Department of Housing and Community Development, June 2012, http://www.hcd.ca.gov/financial-assistance/program_directory_june%202012.pdf