STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**01/13/10**	Bill No:	**AB 810**
Tax:	**Sales and Use**	Author:	**Caballero**
Related Bills:	**AB 829 (Caballero)** **AB 1719 (Harkey)** **AB 1812 (Silva)** **AB 2280 (Miller)** **AB 2640 (Arambula)**	Related Bills:	**SB 71 (Padilla)** **SB 699 (Alquist)** **SB 1053 (Runner)** **SBx6 8 (Dutton)** **SBx8 44 (Dutton)**

BILL SUMMARY

Beginning January 1, 2011, this bill would:

- Provide a state sales and use tax exemption at the 5% rate for tangible personal property purchased by a manufacturer or software publisher, or their affiliates, for use as specified, and tangible personal property purchased for use by a contractor for use in the performance of a construction contract for a manufacturer or software publisher, as specified;
- Provide a state sales and use tax exemption at the 6% rate (5% on and after July 1, 2011) for sustainable development equipment investments of tangible personal property purchased by a manufacturer or software publisher or their affiliates for use as specified; and
- Provide a state sales and use tax exemption at the 6% rate (5% on and after July 1, 2011) for tangible personal property purchased by a manufacturer or software publisher for use primarily during the research and development process on qualified research, as defined.

ANALYSIS

CURRENT LAW

Under existing law, as provided by SB 71 (Ch. 10, Padilla, signed by the Governor on March 24, 2010 and effective immediately), certain "projects" may be approved for a state AND local sales and use tax exclusion by the California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA). SB 71 amended Public Resources Code (PRC) Section 26003 and added PRC Section 26011.8 to include within the definition of "project" equipment used to manufacture products that produce energy from alternative sources such as solar, wind, and biomass. SB 71 allows CAEAFTA to authorize a sales and use tax exclusion for purchases of tangible personal property utilized for the design, manufacture, production, or assembly of advanced transportation technologies or alternative source products, components, or systems, which includes renewable energy equipment, combined heat and power equipment, and alternative transportation equipment in California

SB 71 defines renewable and energy to include "solar, biomass, wind, geothermal, hydroelectricity under 30 megawatts, or any other source of energy, the efficient use of which will reduce the use of fossil and nuclear fuels."

Participating parties may apply to the CAEATFA to receive the sales and use tax exclusion. In approving qualifying projects, the law requires that the CAEATFA consider:

- The extent to which the project develops manufacturing facilities, or purchases equipment for manufacturing facilities, located in California.
- The extent to which the anticipated benefit to the state from the project equals or exceeds the projected benefit to the participating party from the sales and use tax exclusion.
- The extent to which the project will create new, permanent jobs in California.
- To the extent feasible, the extent to which the project, or the product produced by the project, results in a reduction of greenhouse gases, a reduction in air or water pollution, an increase in energy efficiency, or a reduction in energy consumption, beyond what is required by any federal or state law or regulation.
- The extent of unemployment in the area in which the project is proposed to be located.
- Any other factors the authority deems appropriate in accordance with this section.

Under SB 71, when the total value of exclusions awarded reaches $100 million annually, the CAEATFA must provide a 20-day notice to the Legislature prior to approving additional projects.

Other business entities engaged in manufacturing, research and development, and software producing activities that either do not qualify for, or do not seek financial assistance through, CAEATFA and who make purchases of equipment and supplies for use in the conduct of their manufacturing and related 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.

The statewide sales and use tax rate (8.25%) 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**	**R & T Code**
4.75% 0.25% 1.00%* 6.00%	State (General Fund)	6051, 6201, 6051.3, 6201.3 6051.7, 6201.7
0.25%	State (Fiscal Recovery Fund)	6051.5, 6201.5
0.50%	Local Revenue Fund	6051.2, 6201.2
0.50%	Local Public Safety Fund	§35 Art XIII St. Constitution
1.00%	Local (0.25% County transportation funds 0.75% City and county operations)	7203.1

* This portion of the state General Fund rate is currently set to expire on July 1, 2011.

PROPOSED LAW

This bill would add Revenue and Taxation Code Section 6376.6 to the Sales and Use Tax Law to provide a partial exemption from the statewide sales and use tax rate operative January 1, 2011 as follows:

- At the 5% rate for tangible personal property purchased by persons engaged in those lines of business described in Codes 3111 to 3399 (manufacturing sector) or 5112 (software publishing) of the North American Industrial Classification System, or their affiliates, for use as specified, and tangible personal property purchased for use by a contractor for use in the performance of a construction contract for a manufacturer or software publisher, as specified.
- At the 6% rate (5% on and after July 1, 2011) for sustainable development equipment investments of tangible personal property purchased by a manufacturer or software publisher or their affiliates for use as specified.
- At the 6% rate (5% on and after July 1, 2011) for tangible personal property purchased for use primarily during the research and development process on qualified research, as defined.

The bill would define “fabricating,” “manufacturing,” “primarily,” “process,” “qualified person,” “qualified research,” “refining,” “sustainable development equipment,” and would describe the tangible personal property intended to be included or excluded from the proposed partial exemption.

The bill would become operative January 1, 2011.

BACKGROUND

For a ten-year period ending December 31, 2003, the law provided a state 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 similar 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. Certain special purpose buildings were included as "qualified property" as this bill proposes.

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.

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 few Legislative Sessions include the following:

Bill No.	Session	Author	Proposed Exemption
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.** This bill is sponsored by the California Manufacturers and Technology Association (CMTA). According to the author's office, the bill is intended to create jobs, encourage investment, and to enable California to be at the forefront of research and development as well as manufacturing of new green technologies and climate change solutions.

2. **Partial exemptions complicate administration.** Currently, most sales and use tax exemptions apply to the total applicable sales and use tax. However, there are currently a few partial exemptions in California law, where only the state tax portion (6.25%) of the state and local sales and use tax rate is exempted, such as sales and purchases of teleproduction equipment and farm equipment. These partial exemptions are difficult for both retailers and the Board. 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 Board.

   This measure proposes a 5% and a 6% exemption, which would add two new exemption categories (since current law does not have any partial exemptions other than a 6.25% exemption). 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, 6% exemption, sales with a complete 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 Board. This increase in errors would further complicate the Board's administration of the sales and use tax law and complicate reporting obligations of retailers.

3. **Technical issue.** The proposed definitions for the types of property included and excluded from the proposed exemption include items having a useful life of one year or more (or less than one year). – see page 5, lines 10 and 24. In order to minimize potential audit disputes, the bill should contain some mechanism for determining the useful life. Perhaps some reference to the provision in the California income tax laws for depreciating assets should be incorporated into the bill.

4. **Related measures.** Last year's AB 829 (Caballero) and SB 699 (Alquist) contained similar provisions that would have provided a partial sales and use tax exemption, beginning on January 1, 2013, on tangible personal property, including sustainable development equipment investments purchased by persons engaged in manufacturing, research and development, software publishing, and their affiliates, as specified. AB 829 died in the Assembly Appropriations Committee, while SB 699 died in the Senate Revenue and Taxation Committee.

   Similar bills have been introduced this year:

   - AB 1719 (Harkey) would provide until January 1, 2017 a partial sales and use tax exemption (General Fund only) for purchases of qualifying tangible personal property by new trades or businesses engaged in manufacturing, as specified.
   - AB 1812 (Silva), SB 1053 (Runner), SBx6 8 and SBx8 44 (Dutton) would provide a partial sales and use tax exemption for tangible personal property purchased for use in manufacturing activities by manufacturers and software publishers and affiliates.
   - AB 2280 (Miller) would provide a sales and use tax exemption on equipment purchased by any manufacturer for use in its manufacturing business in California.
   - AB 2525 (Blumenfield) would provide a state (General Fund only) sales and use tax exemption for purchases of qualifying tangible personal property by persons engaged in the manufacture of clean energy technology and engaged in manufacturing and software production, as specified and defined.

COST ESTIMATE

The Board would incur costs to administer this measure. These costs would be attributable to, among other things, identifying and notifying qualifying entities, auditing claimed amounts, revising sales tax returns, reviewing returns with claimed exemptions, and programming. An estimate of these costs is pending.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

The *2008 Annual Survey of Manufactures* (ASM), a Census publication, reported manufacturing expenditures or purchases for California of $22 billion. As a result of the recession, we estimate total expenditures or purchases subject to the proposed exemption to be $19.6 billion in 2011 and $20.4 billion in 2012.

The ASM also reported U.S. figures related to structures and equipment expenditures by software publishers. To estimate for California, we used the 12% population ratio of California to the U.S. The amount subject to the proposed exemption would amount to $ 0.6 billion. We estimated total expenditures or purchases subject to the proposed exemption in this category to be $0.7 billion in 2011 and 2012.

The ASM requires all manufacturers to report all production machinery. Sustainable development equipment and research and development equipment are part of production machinery and equipment and their expenditures are part of machine and equipment capital expenditures reported by manufacturers. Unfortunately, given that these expenditures are not specifically broken out, it is difficult to determine the amounts related to sustainable development and research and development expenditures.

Revenue Summary

Effective April 1, 2009, the state sales and use tax rate increased by 1% to 6%. The 1% increase will expire on June 30, 2011; and as a result, the state sales and use tax rate will revert to 5%. Given that this bill would apply to purchases made on or after January 1, 2011, manufacturers would be entitled to a 6% exemption on sustainable development equipment and research development equipment expenditures for the first half of 2011.

<u>Calendar Year 2011</u>

The revenue loss from exempting tangible personal property purchased by manufacturers and software publishers from the state sales and use tax (5%) amounts to $1.0 billion ($20.3 billion x 5% = $1.0 billion).

The revenue estimate does not reflect the 6% state sales and tax exemption for sustainable development and research development equipment related expenditures by manufacturers in the first half of 2011. However, we believe these amounts are de minimis, especially in light of SB 71 and CAEAFTA's ability to approve similar purchases that would be excluded from the state and local sales and use tax.

<u>Calendar Year 2012</u>

The revenue loss from exempting tangible personal property purchased by manufacturers and software publishers from the state sales and use tax (5%) amounts to $1.1 billion ($21.1 billion x 5% = $1.1 billion).

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