DRAFT

STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	**02/15/06**	Bill No:	**SB 1291**
Tax:	**Sales and Use**	Author:	**Alquist**
Related Bills:	**AB 2218 (Torrico)** **AB 2395 (Villines)** **AB 2595 (Arambula)** **SB 1643 (Runner)**		

BILL SUMMARY

This bill would provide a state sales and use tax exemption (5.25 percent) for purchases on or after January 1, 2006, of 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.

ANALYSIS

Current Law

Under current law, entities engaged in activities such as manufacturing, research and development, software production, printing, biotechnology or pharmaceuticals that make purchases of equipment and other supplies for use in the conduct of their 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. On the other hand, purchases of tangible personal property that become an ingredient or component part of an item to be resold are exempt from tax. For example, the paper and ink that a newspaper publisher purchases is exempt from tax because those items become physically incorporated into the newspaper sold.

The statewide sales and use tax rate imposed on taxable sales and purchases of tangible personal property, including manufacturing equipment, is made up of the following components (additional district taxes are levied among various local jurisdictions and are not reflected in this chart):

Rate	Jurisdiction	R & T Code
5.0%	State (General Fund)	6051, 6201, 6051.3, 6201.3
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

Proposed Law

This bill would add a new Section 6377 to the Sales and Use Tax Law to provide a state sales and use tax exemption (5.25%) beginning January 1, 2006 for the following items sold to, or used by, a manufacturer or an entity performing research and development activities:

1) Tangible personal property that will become an ingredient or component part of tangible personal property manufactured, processed, fabricated or used in research and development activities.

2) Tangible personal property directly used or consumed in or during the actual manufacturing, processing, fabrication, or research and development of tangible personal property if the use or consumption of the property is necessary or essential to the manufacturing, processing, fabrication operation or research and development, and directly makes or causes a chemical or physical change to either of the following:

   a) The product being manufactured, processed, fabricated, or used in a research and development activity.

   b) An intermediate or preliminary product that will become an ingredient or component part of the product being manufactured, processed, fabricated, or used in a research and development activity.

3) Tangible personal property used or consumed in manufacturing, processing, fabrication, or research and development of tangible personal property if the use or consumption of the property is necessary and essential to:

   a) A pollution control process.

   b) To prevent the decline, failure, lapse or deterioration of the equipment.

   c) To a quality control process that tests property that is being manufactured. processed, fabricated, or used in performing research and development activities.

   d) To comply with federal, state or local laws or rules that establish requirements related to public health.

4) Equipment, as described that generates electricity, chilled water, or steam for ultimate sale.

5) Gases used on the premises of a manufacturing plant or facility used in performing research and development activities to prevent contamination of raw material or product, or to prevent a fire, explosion, or other hazardous or environmentally damaging situation at any stage in the manufacturing or research and development process or in loading or storage of the product or raw material on premises.

6) Tangible personal property specifically installed to a) reduce water use and wastewater flow volumes from the manufacturing, processing, fabrication, research and development or repair operation; b) reuse and recycle wastewater streams

generated within the manufacturing, processing, fabrication, research and development or repair operation; or c) treat wastewater from another industrial or municipal source for the purpose of replacing existing freshwater sources in the manufacturing, processing, fabrication, research and development or repair operation.

7) Lubricants, chemicals, chemical compounds, gases, catalysts, liquids and other materials that are used for specified purposes.

8) Semiconductor, pharmaceutical, or biotechnology fabrication, or research and development clean rooms and equipment.

The bill would define “qualified person” as a manufacturer or an entity performing research and development activities.

The bill would further define “fabricating,” “manufacturing,” “process,” “processing,” “research and development,” and “semiconductor, pharmaceutical or biotechnology fabrication cleanrooms and equipment.”

The bill would provide that the production of a publication for the dissemination of news of a general character and of a general interest that is printed on newsprint and distributed to the public at a daily, weekly, or other short intervals is considered manufacturing.

The bill would further provide that the manufacturing or research and development of computer software would begin with the design and writing of the code or program for the software and includes the testing or demonstration of the software.

As a tax levy, the bill would become effective immediately upon enactment.

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 six percent of the amount paid for qualified property placed in service in California. Qualified property essentially was 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." 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 partial sales and use tax exemption and income tax credit had a conditional sunset date. The sunset was to occur in any year following a year when manufacturing employment (as determined by EDD) 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 (indeed, 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.

The manufacturer's sales and use tax partial exemption for new manufacturers and the corresponding income tax credit for existing manufacturers were added in 1994 by SB 671 (Stats. 1993, Ch. 881). The purpose of that legislation was to enable California to become competitive with the 42 other states that exempted manufacturing equipment and were luring manufacturers away from California with promises of lower taxes. SB 671 was designed to provide California companies with an immediate incentive to expand their facilities and to create new jobs.

In an October 2002 report put out by the Legislative Analyst's Office, *An Overview of California's Manufacturers' Investment Credit*, the following arguments against and in support of these tax incentives were presented:

Arguments Supporting the MIC

- Investment Incentive—The MIC effectively reduces the price of new capital, and leads to greater investment. Adherents of this view suggest that a firm considering a capital investment is much more likely to undertake such investment with the MIC in place. Proponents argue that this marginal cost reduction can have a significant positive impact on investment decisions.
- Relocation Incentive—California has become a more attractive place relative to other states for business since the credit has been in place. The argument here is that tax credits do influence corporate location decisions and dissuade businesses from moving their activities out of California. Manufacturing industry representatives stated and continue to state that the MIC plays an important role in both expansion and business location decisions.
- Efficient Job Allocator—Competition for business among states is an efficient job allocator. This argument holds that the nation benefits from the redistribution of jobs that may occur due to the use of investment tax credits. This is based on the notion that jobs are worth more in areas with higher unemployment, and that such areas are likely to have relatively aggressive tax credit programs. These areas will be able to attract businesses away from regions that do not value the jobs as highly.
- Other Arguments. Advocates of the MIC also emphasize that the MIC offers significant indirect benefits to the state in terms of investment and job growth that result in additional state revenues. They also point out the importance of manufacturing to the overall state economy in terms of economic stability and the high value-added nature of the employment in this sector.

Arguments Against the MIC

- Inequitable Taxation—The MIC results in giving a tax advantage to manufacturing over other business activities, as well as providing an advantage to capital investment over labor. This view holds that since only one type of industry (and production factor) benefits from the tax credit, the remaining industries face relatively higher costs, and are therefore at a competitive disadvantage. Such preferential treatment can also result in inefficient resource allocation according to this view.
- Relocation Rather Than Creation—The MIC results in few new jobs, but rather pits states against each other in competing for jobs. The argument here is that corporate tax breaks are no more than a transfer of government funds to private businesses, and in the end, the national economy is unaffected. In this view the competition among states in offering various tax incentives represents a form of "prisoners'

dilemma"—in which each state would be better off if none offered such incentives. If one state does offer them, however, it is in the interest of other states to do the same.

- Inefficient Development Policy—Tax incentives have a negligible impact on economic growth, and any job creation that does occur does so at a substantial cost per job. Proponents of this view also hold that some of the tax credits will go to companies which would have made the same investments, regardless of the tax incentive. That is, the tax credit did not induce the investment, yet the company receives "windfall benefits" in the form of reduced taxes.

  - Ineffective Development Policy—Taxes are a very small percentage of overall business costs and thus have little effect on business decisions. Labor, transportation, land, and other factors typically constitute much more significant proportions of total costs than do taxes. Therefore, according to those who hold this view, tinkering with this particular cost is unlikely to result in a large shift or expansion of business compared to the adverse fiscal effects that such measures can have on the state.

Since it sunsetted, numerous measures have been considered by the Legislature to reinstate or restore some type of tax incentives for manufacturers and other related industries. For example, during 2005, the following measures were considered:

- AB 80 (Ridley-Thomas) would have, beginning on the first January following the fiscal year in which the state budget deficit for the 2005-06 fiscal year is eliminated, provided for a 7-year period, a state sales and use tax exemption (5.25%) for purchases of qualifying tangible personal property by qualified persons primarily engaged in manufacturing, telecommunications and electrical generation activities, as specified. This measure was held in suspense in the Assembly Revenue and Taxation Committee where it died.

- AB 344 (Villines) would have provided a state sales and use tax exemption (5.25%) for purchases of qualifying tangible personal property by qualified persons primarily engaged in manufacturing, telecommunications and electrical generation activities, as specified. The partial exemption would have applied to 25% of the sales or purchases for 2006, 50% for 2007, and 100% thereafter. This measure was also held in suspense in the Assembly Revenue and Taxation Committee where it died.

- AB 845 (Ridley-Thomas) would have reinstated the manufacturer's exemption but would have provided a conditional sunset date depending on the growth in employment. Also, this bill would have limited the exemption based on the manufacturers' aggregate gross assets and would have also included manufacturers other than new establishments. This bill, too, was held in the Assembly Revenue and Taxation Committee where it died.

- AB 1580 (Torrico) would have provided a state sales and use tax exemption (5.25%) for purchases of qualifying tangible personal property by qualified persons primarily engaged in specified activities, including manufacturing, construction contracting, software production, telecommunications, cable distribution, scientific research and development services, and wholesale distribution of recyclable materials. The bill would have postponed this exemption until after an unspecified date, and would have allowed qualifying purchasers to claim refunds for the equivalent amount of tax paid during the period of postponement. AB 1580 died also in the Assembly Revenue and Taxation Committee.

- SB 552 (Alquist) would have provided a state and an optional local and district sales and use tax exemption for purchases of 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 cleanrooms and equipment. The proposed exemption would have applied to purchases on or after January 1, 2006, but the exemption would have been postponed until the first January 1 following the fiscal year in which the state budget deficit was eliminated. Qualified persons would have been allowed to file a claim for refund with the Board equal to the amount of sales or use tax paid on the purchase or purchases of qualifying property, as specified. This measure died in the Senate Revenue and Taxation Committee

- SB 631 (Dutton) would have reinstated the partial tax exemption for purchases of tangible personal property by manufacturers for use in their manufacturing and research and development activities. This bill was never heard in committee.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the Silicon Valley Leadership Group. According to the author's office, its purpose is to help the state's economic recovery and maintain California's manufacturing base through a tax incentive.

2. **The proposed exemption would be more complicated to administer than most other exemptions.** This is a broad-based exemption that would be difficult to administer. The taxability of the proposed items to be exempted would hinge on a very specific use to which that item would be put. In auditing purchasers of such items, the Board would be required to verify the use itself, rather than just verifying the type of property purchased. Even with strict definitions or descriptions of the items the bill is intending to exempt, administration of this bill would be difficult. It should also be noted that, due to the broad range of items proposed to be exempted, a wide variety of retailers making sales to the qualifying purchasers of the property would be affected.

3. **Operative date of the exemption would complicate the Board's administration and impose a burden on retailers.** The proposed exemption would apply to purchases of qualifying property on or after January 1, 2006. This would be problematic, since by the time the bill becomes law, retailers making sales of qualifying property would have already remitted the sales or use tax to the Board on the sale or purchase of the property proposed to be exempted. Consequently, for those transactions, any qualifying purchaser that seeks to receive reimbursement for any tax paid to a retailer for qualifying 2006 purchases would have to contact the retailer from whom the property was purchased and request a refund from that retailer. In return, since sales tax paid to the Board may only be refunded by the Board to the person who actually remitted the tax, the retailer would be required to file a claim for refund with the Board on behalf of the purchaser. Since this bill proposes such a broad-based exemption, a potentially high volume of claims for

refund could be filed, resulting in additional administrative costs. Also, this would impose a burden on retailers to accommodate customer's requests for refund, especially considering the fact that the retailer receives no economic benefit. It is therefore suggested that the bill become operative for sales or purchases made on or after January 1, 2007.

4. **The entities qualifying for the proposed exemption should be clearly defined.** The bill does not use federal classification codes (such as the North American Industry Classification System – NAICS) to describe the entities that are intended to receive the benefit of the exemption. Some type of reference should be made, since the bill, as drafted, could be interpreted to mean that the exemption would be extended to purchases of qualifying items by any entity engaging even minimally in the activities described. This would not only drastically complicate administration of the provisions, but would also substantially increase the associated revenue losses.

5. **Technical issues.** The bill has many technical issues that would need to be addressed before the bill becomes law. Staff will work with the author's office to address these issues as the bill progresses through the legislative process.

6. **Related measures**. Other measures that would provide tax incentives for manufacturing-related entities include:

   - AB 2218 (Torrico) - This bill would, for a 10-year period beginning January 1, 2007, provide a state sales and use tax exemption (5.25 percent) for purchases of qualifying tangible personal property by trades or businesses and their affiliates, as specified and defined.
   - AB 2395 (Villines) - This bill would provide, for calendar years beginning on or after January 1, 2006, a state sales and use tax exemption for tangible personal property, as defined, purchased for use by manufacturers that have "gross aggregate gross assets" used in the manufacturing activity not exceeding $5 million. The bill would also provide a corresponding 6 percent income tax credit on purchases of similar property.
   - AB 2595 (Arambula) - This bill would, among other things, require the Board to grant a "small size manufacturer," as defined, a "sales and use tax offset," as defined, against that manufacturer's tax liability, as specified.
   - SB 1643 (Runner) - This bill would, for calendar years beginning January 1, 2007, and before January 1, 2012, allow a state sales and use tax exemption for tangible personal property purchased for use by a qualified person (new manufacturers and computer programmers and designers, as specified) engaged in the manufacturing, processing, refining, fabricating, or recycling of property, 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, reviewing and processing claims for refund, revising sales tax returns, and programming. An estimate of these costs is pending.

REVENUE ESIMATE

Background, Methodology, and Assumptions

For purposes of this estimate, we have used the classifications set forth in the NAICS. This bill would provide a state sales and use tax exemption (5.25 percent) for purchases of materials, supplies, machinery and equipment used by entities engaged in manufacturing, research and development, electrical generation, software production, and newspaper printing, and for semiconductor, biotechnology and pharmaceutical clean rooms and equipment. In addition, the proposed exemption would apply to fuels, equipment rentals and materials used in these activities.

The following table, based on our analysis using US census data, depicts California annual expenditure estimates.

California Expenditures – Based on NAICS Codes

NAICS	Sector	Expenditures (Millions)
31-33	Manufacturing	10,700
31-33	Manufacturing - Cost of Fuels	1,489
31-33	Manufacturing - Machinery & Equipment Rentals	1,044
31-33	Manufacturing - Cost of Materials Consumed	15,818
5417	Research & Development	227
2221	Electrical Generation	3,754
5112	Software	245
5111	Newspaper	26
	TOTAL	33,303

Revenue Summary

The annual revenue loss from exempting $33.3 billion in expenditures is estimated to be approximately $1.75 billion

	Revenue Loss
General Fund (5%)	$1.67 billion
Fiscal Recovery Fund (0.25%)	$0.08 billion
Total	$1.75 billion

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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.