FT STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

DRAFT

Date Amended:	**04/06/06**	Bill No:	**AB 2595**
Tax:	**Sales and Use**	Author:	**Arambula**
Related Bills:	**AB 2218 (Arambula)** **AB 2395 (Villines)** **SB 1291 (Alquist)** **SB 1643 (Runner)**		

BILL SUMMARY

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.

ANALYSIS

Current Law

Under current law, entities engaged in activities such as manufacturing 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. Current law does not provide special tax treatment for these entities.

Generally, the Sales and Use Tax Law does not provide "offsets" against tax liabilities. However, Section 6406 of the Sales and Use Tax Law does allow purchasers of tangible personal property to take a credit for sales or use tax paid to another state to offset the California use tax due on that purchase.

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
4.75%	State (General Fund)	6051, 6201
0.25%	State (Fiscal Recovery Fund)	6051.5, 6201.5
0.50%	Local Revenue Fund	6051.2, 6201.2
0.25%	State (General Fund)	6051.3, 6201.3
0.50%	Local Public Safety Fund	§35 Art XIII St. Constitution
1.00%	Local (County/City) 0.25% County transportation funds	7203.1

	0.75% City and county operations	

Proposed Law

This bill would add Section 6458 to the Sales and Use Tax Law to require the Board to grant a "small size manufacturer" a "sales and use tax offset" against that manufacturer's tax liability under Sections 6051, 6051.2, 6051.3, 6051.5, 6201, 6201.2, 6201.3, and 6201.5 for sales and use tax paid or incurred for the purchase or acquisition of "qualified manufacturing equipment." If the credit exceeds the tax liability, the bill would allow any excess credit to be carried over to returns in succeeding periods until the total amount of offset is claimed. The bill would define the following terms:

"Sales and use tax offset" would mean an amount equal to the amount of sales or use tax, as applicable, paid or incurred by a small size manufacturer for the purchase or acquisition of qualified manufacturing equipment.

"Small size manufacturer" would mean a manufacturer whose annual gross receipts from its manufacturing activity is less than $5 million, and the manufacturing facility is located in a census tract in this state with a poverty level of 61 percent or higher, as specified.

"Qualified manufacturing equipment" would mean tangible personal property that 1) expands the manufacturing capacity of the manufacturing facility located in this state, 2) results in the creation of additional jobs at the facility, and 3) results in a reduction in harmful air emissions and liquid damages.

The bill would require the Board to annually make available to the Legislature specified information regarding the exemptions claimed pursuant to the provisions of the bill. In addition, the bill would require the qualifying manufacturers to report specified information to the Board.

Proposed Section 6458 would cease to be operative on January 1, 2013.

The bill would also add Section 17277 to the Personal Income Tax Law and Section 24417 to the Corporation Tax Law to also allow a taxpayer to take a deduction for depreciation for the cost of qualified manufacturing equipment, as specified.

Finally, the bill would add Division 11 (commencing with Section 19000) to the Unemployment Insurance Code to establish a logistics worker training initiative for the purpose of making California workers more skilled in the competitive global manufacturing value chain, as specified.

The bill would become effective January 1, 2007.

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 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."

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 (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 pharmaceutical 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 author. According to the author's office, the purpose of the bill is both to encourage the development of clean technology in California and to support small manufacturers in California through the creation of tax incentives.
2. **Why not just create an exemption, or allow a state income tax credit?** Rather than requiring small manufacturers to pay the tax on their purchases of qualifying equipment and then later receive an offset for a portion of that tax paid, a preferable approach would be either to simply provide a partial sales and use tax exemption for their purchases of qualifying equipment, or provide an income tax credit. With regard to a sales and use tax partial exemption, qualifying establishments would receive the direct economic benefit of this bill at the time of purchase, and they would not be required to track the dollar amount of credit from period to period.

Also, unlike credits established in the Personal Income Tax Law and the Corporation Tax Law administered by FTB where carryover features are commonplace and the State's General Fund is only affected, the Sales and Use Tax Law currently has no similar offset/carryover provision as this bill is proposing. Such a provision in the Sales and Use Tax Law is particularly cumbersome, as an apportionment of the credit against the various funds may be necessary. This is so, because the bill proposes to allow the offset for those components of the sales and use tax rate that would affect not only the State's General Fund, but also the State's Fiscal Recovery Fund and the Local Revenue Fund.

3. **Bill should more clearly define the property eligible for the offset.** Without clear distinctions in the type of property that would qualify for the offset, administration of the provisions of this bill would be complicated. This measure would require that the qualifying property not only expand the manufacturing capacity of the facility, but it must also create more jobs, and reduce harmful air emissions and liquid discharges. This could be particularly difficult for a Board auditor to verify whether a specific purchase of property actually met all three conditions, and could lead to more audit disputes. Also, is it the author's intent that the property must actually reduce harmful air emissions *and* liquid discharges?

4. **The bill should specify the category of poverty level to use.** The United States Census denotes the poverty level within communities based on various categories, such as the poverty level of families, the poverty level of individuals, the poverty level of families with a female householder with no husband present, and more. For purposes of the proposed exemption, the bill should specify the exact poverty level that should be considered in determining which census tracts would be a qualifying location.

5. **The bill should clarify that the provisions shall only apply to establishments engaged primarily in manufacturing activities.** Since there are a variety of industries that may perform some incidental manufacturing within their business activities (as for example, an onsite bakery at a grocery store could argue that its bakery department is manufacturing baked goods), the bill should be more specific with regard to identifying qualifying establishments. A reference to specific manufacturing industries identified in the North American Industry Classification System is recommended, as well as a requirement that the qualifying manufacturers be primarily engaged in those referenced activities.

6. **Would the taxpayer be entitled to a refund of any excess tax paid?** There are instances in which manufacturers have little or no sales or use tax liability, as all of their sales are made either for resale or in interstate commerce. If a qualifying entity has no liability to offset, it is unclear whether the taxpayer would be entitled to a refund? This should be clearly addressed in the language.

7. **The offset should only be claimed when the taxpayer can actually demonstrate that the equipment meets the criteria in the bill.** The bill requires manufacturers that are granted the offset to maintain records and to report to the Board specific information such as the number of jobs created as a result of the purchase, the average wages paid for the new employees in the new jobs, the total amount of emissions that were reduced as a result of the purchase. No deadline is provided as to when this information must be provided to the Board. If the manufacturer were to claim the offset in the same reporting period in which the equipment was purchased, it could be several reporting periods later (or even outside of the statute of limitations for the Board to assess the tax) before it is known whether the criteria in the bill was achieved. Perhaps, the offset should not be allowed until the manufacturer is able to demonstrate that the intended results of the equipment purchase have been achieved.

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

   - AB 2218 (Arambula) - 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.
   - SB 1291 (Alquist) - This bill would provide a state sales and use tax exemption for purchases made on or after January 1, 2006 of materials, supplies, machinery and equipment used by entities engaged in manufacturing, research and development, software production, and printing, and for semiconductor, biotechnology and pharmaceutical cleanrooms and equipment.
   - 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, processing the offsets and allocating credits to the various funds, tracking the offsets, and preparing the annual report to the Legislature. An estimate of these costs is pending.

REVENUE ESTIMATE

The criteria in the bill narrows the effect it would have on qualifying exempt purchases and qualifying manufacturers. Therefore, we believe the revenue loss would be minimal. We estimate that expenditures related to this measure would be approximately 1 percent or less of the overall manufacturing expenditures for the state. The estimated annual revenue loss would therefore be approximately $500,000.

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