STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

DRAFT

Date Introduced:	**02/23/06**	Bill No:	**AB 2395**
Tax:	**Sales and Use**	Author:	**Villines**
Related Bills:	**AB 2218 (Torrico)** **AB 2595 (Arambula)** **SB 1291 (Alquist)** **SB 1643 (Runner)**		

BILL SUMMARY

This bill would provide a state sales and use tax exemption (5.25%) for purchases of qualifying tangible personal property by qualified persons, as described, primarily engaged in manufacturing activities, as specified.

ANALYSIS

Current Law

Under current law, entities engaged in manufacturing activities 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.

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 (County/City) 0.25% County transportation funds 0.75% City and county operations	7203.1

Proposed Law

This bill would, among other things, add Section 6377 to the Sales and Use Tax Law to provide a partial sales and use tax (5.25%t) exemption beginning January 1, 2006, for the following purchases by a "qualified person":

- Tangible personal property to be used 50 percent or more in any stage of manufacturing, processing, refining, fabricating, or recycling of property (i.e., machinery, equipment belts, shafts, computers, software, pollution control equipment), as specified.
- Tangible personal property purchased to be used 50 percent or more in maintaining, repairing, measuring, or testing any exempt manufacturing equipment.
- Tangible personal property purchased for use by a contractor, as specified, for use in the performance of a construction contract for the qualified person who will use that property as an integral part of the manufacturing process, as described.

The bill would define a "qualified person" as any person who meets all of the following:

- Is engaged in manufacturing activities, as described in the North American Industry Classification System (NAICS) Manual Codes 311 to 339999, inclusive, as the person's principal business activity (more than 50 percent of the qualified person's total business activity).
- Its gross aggregate gross assets used in the manufacturing activity do not exceed $5 million.
- It agrees to provide additional information to the Board and permits disclosure of that information for evaluation by the Legislative Analyst.

The bill would specify that the proposed exemption would *not* include 1) any tangible personal property that is used primarily in administration, general management or marketing, 2) consumables with a normal useful life of less than one year, as specified, and 3) furniture, inventory, equipment used in the extraction process, or equipment used to store finished products that have completed the manufacturing process.

The bill would also provide a six percent income tax credit for similar qualified taxpayers that may be claimed in lieu of claiming the proposed partial sales and use tax exemption.

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 partial 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." 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 and use 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 partial 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 partial 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 percent of the sales or purchases for 2006, 50 percent for 2007, and 100 percent 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 partial 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 partial 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 clean rooms 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 to make permanent the tax incentives available to smaller manufacturers.

2. **The term "gross aggregate gross assets" should be defined.** The bill would define a "qualified person" to mean, among other things, one whose "gross aggregate gross assets" used in the manufacturing activity do not exceed $5 million. This is unclear. Does the term include cash, intangibles, or an asset used incidental to the manufacturing activity (i.e., a computer that is used for payroll, inventory, or word processing)? Would the purchase price of assets be used for the basis, or the fair market value? This should be clarified in order to adequately define the entities that qualify for the proposed partial exemption.

3. **Operative date of the proposed 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 tax to the Board on the sale of the property proposed to be exempted. Consequently, for those transactions, any qualifying purchaser that seeks to receive reimbursement for any sales tax reimbursement 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. This would not only result in additional administrative costs to the Board, it would also impose a burden on retailers to accommodate customer's requests for refund, especially considering the fact that the retailer receives little economic benefit. It is therefore suggested that the bill become operative for sales or purchases made on or after January 1, 2007.

4. **Related measures.** Other measures that would provide tax incentives for manufacturing and other related activities include:

- AB 2218 (Torrico) - This bill would, for a 10-year period beginning January 1, 2007, provide a partial sales and use tax exemption (5.25%) for purchases of qualifying tangible personal property by trades or businesses and their affiliates, as specified and defined.
- 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 sales and use tax liability, as specified.
- SB 1291 (Alquist) - This bill would provide a partial sales and use tax exemption (5.25%) 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 clean rooms and equipment.

- SB 1643 (Runner) - This bill would, for calendar years beginning January 1, 2007, until January 1, 2012, allow a partial sales and use tax exemption (5.25%) 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, reviewing and processing claims for refund, auditing claimed amounts, revising sales tax returns, and programming. An estimate of these costs is pending.

REVENUE ESTIMATE

Background, methodology and assumptions

The bill would define a “qualified taxpayer’” as any taxpayer who is engaged in those of lines of business described in NAICS Codes 311 to 33999 (manufacturers) with gross aggregate gross assets used in the manufacturing activity not exceeding $5 million. “Gross aggregate gross assets” is not defined in the bill. However, we understand this is intended to narrow the proposed exemption to small manufacturers. The Franchise Tax Board (FTB) has indicated that about 6 percent of manufacturers would meet this criteria.

The bill would create either a 6 percent income tax credit or 5.25 percent sales and use tax exemption. We assume qualifying taxpayers would pursue the higher 6 percent credit. FTB staff indicated that the income tax credit would result in an estimated loss of $40 million in fiscal year 2006-07 and $45 million in fiscal year 2007-08.

Revenue Summary

The revenue loss associated with either the 6 percent income tax credit or the 5.25 percent sales and use tax exemption would amount to an estimated $40 million in fiscal year 2006-07, and $45 million in fiscal year 2007-08.

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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.