STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	**02/18/05**	Bill No:	**SB 552**
Tax:	**Sales and Use**	Author:	**Alquist, et al.**
Related Bills:	**AB 80 (Houston)** **AB 344 (Villines)** **AB 845 (Ridley-Thomas)** **AB 1580 (Torrico)** **SB 631 (Dutton)**		

BILL SUMMARY

This bill would provide 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 bill would provide that the exemption shall apply to purchases on or after January 1, 2006, but the exemption shall be postponed until the first January 1 following the fiscal year in which the state budget deficit is eliminated. Qualified persons would be 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.

ANALYSIS

Current Law

Under current law, entities engaged in activities such as manufacturing, research and development, telecommunications, 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.

Proposed Law

This bill would add a new Section 6377 to the Sales and Use Tax Law to provide a state and local[1] sales and use tax exemption, for the following items sold to, or used by, a manufacturer or an entity performing research and development or telecommunications 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) 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.

5) 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

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[1] The bill would provide that the local and district taxes would be included within the proposed exemption, unless the local government that would otherwise receive the sales tax revenues votes for the exemption not to apply.

manufacturing, processing, fabrication, research and development or repair operation.

6) Chemicals, catalysts, and other materials that are used for specified purposes.
7) 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, or engaged in telecommunication 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.

The bill provides that the exemptions granted pursuant to this measure for purchases made in calendars beginning January 1, 2006 shall be postponed until after January 1, of the first fiscal year in which the state budget deficit is eliminated, and shall be granted thereafter in the form of a refund to a qualified person, as specified.

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 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 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.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the Silicon Valley Manufacturing 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. **The local government option poses concern.** The bill would allow local governments to opt out of the proposed exemption if they vote to do so. This could be very troublesome and confusing, since it could leave California with a variety of differing rates on the items proposed to be exempted if local governments opt out. As an example, Sacramento County's tax rate is currently 7.75%. If the county government voted to opt out of the proposed exemption (the 1% rate), but the Sacramento Transportation Authority did not (1/2 percent rate), the property exempted by this measure that is sold within Sacramento County would be subject to a 5.75% (using the statewide rate of 5.25% plus the .5 percent). In addition to the likelihood of increased errors on sales and use tax returns, there would be an added burden placed on the retailers making the sales. The retailers receive no direct economic benefit from the proposed exemption, yet the retailers would be required to 1) program their computers to allow for a separate rate for the items included within the exemption, 2) obtain and retain necessary documentation to support any exempt sales to qualifying entities, and 3) account for the exempt items for purposes of properly reporting their sales and use tax obligations to the Board.

4. **Refunds would be made from the state's General Fund.** The bill would require that any refunds be made from the state's General Fund. However, it should be noted that any locally-imposed taxes that may be subject to refund would also be made from the General Fund. Is this the author's intent?

5. **What is the criteria to determine whether the state budget deficit is eliminated?** Some ways in which budget deficits have been dealt with in the past include various accounting changes, such as fund transfers or spending deferrals. Some have argued these changes do not eliminate the budget deficit, but rather, postpone problems for later years. In order to avoid any uncertainty with respect to when the state budget deficit is eliminated, perhaps the Department of Finance or a legislative budget committee should make that certification to the Board.

6. **Why create an exemption now?** A sales and use tax exemption, by its nature, is claimed at the time the purchase is made. Generally, the purchaser (as, for example, a manufacturer) issues an exemption certificate to the retailer at the time the purchase order is issued, which allows the retailer to delete the applicable tax from the sale. The retailer then reports the exempt sale on his or her return for the reporting period in which the sale was made. It would seem more appropriate to create the exemption when the state's fiscal conditions are settled.

7. **Sales tax refunds are generally allowed only to persons who actually paid the tax to the Board.** Current law provides that an overpayment of sales tax to the Board shall only be refunded or credited by the Board to the person who actually paid the tax to the state. Therefore, if a customer paid sales tax to a retailer on an amount which should not have been subject to the tax, or paid sales tax in excess of the amount of tax due, the law provides that such an overpayment can only be claimed by the retailer who actually paid the tax to the state. The refund is issued by the Board directly to the retailer, with the condition that the refund be passed on by the retailer to the person from whom the tax was collected. Generally, the Board has no authority to refund the sales tax to someone other than the person who paid the tax to the state.

There is a practical reason why the law prohibits a person who has not paid the sales tax to the Board to claim a refund directly from the Board. It ensures a safeguard against the possibility of issuing a tax refund twice on the same transaction. Without this safeguard, the opportunity for both the retailer and the person who paid tax to the retailer to file a claim for refund would be available, thereby increasing the possibility of duplicate refunds being issued. As drafted, this measure would deviate from this safeguard by enabling either the purchaser or retailer to claim a refund.

8. **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) 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.

9. **Many telecommunication companies may not be currently registered with the Board.** Telecommunication entities include not only the typical telecommunications companies, such long distance carriers, cellular phone carriers, etc., but also those primarily engaged in such activities as paging services, earth stations for satellite communication carriers, resellers of satellite telecommunications, ship-to-shore broadcasting communications carriers, microwave telecommunications resellers, and others. Many of these entities may not be registered with the Board, since they are not engaged in the business of making sales of tangible goods.

10. **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.

11. **Related measures.** Other measures that would provide an exemption for manufacturing activities and other related activities include:

    - AB 80 (Houston) would, beginning on the first January following the fiscal year in which the state budget deficit for the 2005-06 fiscal year is eliminated, provide a state sales and use tax exemption for purchases of qualifying tangible personal property by qualified persons primarily engaged in manufacturing, telecommunications and electrical generation activities, as specified.

    - AB 344 (Villines) would state legislative intent to reinstate the exemption and credit previously provided to manufacturers.

    - AB 845 (Ridley-Thomas) would reinstate the manufacturer's exemption but provide a conditional sunset date depending on the growth in employment and limit the exemption based on the manufacturers' aggregate gross assets. AB 845 would also include manufacturers other than new establishments.

- AB 1580 (Torrico) would provide a state sales and use tax exemption, contingent upon the elimination of the state budget deficit, for manufacturers, and a variety of other industries, including electrical contractors, telecommunications carriers, software producers, and many more. This measure would also provide a refund mechanism in a similar manner as this measure would.
- SB 631 (Dutton) would reinstate the manufacturers' exemption and income tax credit, and would broaden that exemption to include purchases of equipment by electrical generators.

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 claims for refund, revising sales tax returns, and programming. An estimate of these costs is pending.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

For this estimate, we reviewed data from the 1997 Economic Census for both California and for the United States. We relied on California-specific data where such data was available, and estimated California's portion of the national figures where specific California data was not available.

We used data classified using the North American Industry Classification System (NAICS) codes. We extracted data for manufacturing firms (NAICS codes 31-33), which includes firms engaged in pharmaceutical (NAICS code 3254), and semiconductor (NAICS code 3344); research and development firms (NAICS code 5417); electrical generation (NAICS 2211); software production firms (NAICS code 5112); telecommunications (NAICS code 5133) and printers and publishers, including newspaper publishers, (NAICS codes 5111 – 5199).

Current annual purchases of qualified equipment as defined in this bill are estimated to be the following:

NAICS Code	Description	Qualifying Expenditures
2211	Electrical Generation	$ 3.8 billion
31-33	Manufacturing	$ 31.6 billion
5111-99	Publishers	$ 0.5 billion
5112	Software	$ 0.2 billion
5133	Telecommunications	$ 4.3 billion
5417	Research & Development	$ 0.2 billion
	Total	$ 40.6 billion

Revenue Summary

The annual revenue loss from exempting from the sales and use tax equipment purchased by businesses engaged in electrical generation, manufacturing, research and development, telecommunications, software production, and printing, and for semiconductor, biotechnology and pharmaceuticals cleanrooms and equipment is as follows:

	Revenue Loss
State loss (5.25%)	$2.1 billion
Local loss (2.00%)	$0.8 billion
Special District loss (0.67%)	$0.3 billion
Total	$3.2 billion

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