DRAFT

STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	**02/17/04**	Bill No:	**SB 1295**
Tax:	**Sales and Use**	Author:	**Morrow**
Board Position:		Related Bills:	**AB 1998 (Dutton)** **AB 2070 (Houston)** **AB 2991 (Runner)** **SB 1554 (Karnette)**

BILL SUMMARY

This bill would reinstate the partial state sales and use tax exemption for purchases of qualifying equipment by new manufacturers for purchases on or after January 1, 2004.

ANALYSIS

Current Law

Under existing law, a sales tax is imposed on retailers for the privilege of selling tangible personal property in this state. The use tax is imposed on the storage, use, or other consumption in this state of tangible personal property purchased. Either the sales tax or the use tax applies with respect to all sales or purchases of tangible personal property, unless that property is specifically exempted.

Until January 1, 2004, Section 6377 of the Sales and Use Tax Law provided a 5 percent state sales and use tax exemption for purchases of manufacturing equipment. Under that statute, the partial exemption was available only to "qualified persons," who included only new trades or businesses that are engaged in those lines of business described in Standard Industrial Codes 2011 to 3999 (manufacturers). The partial exemption applied to the following:

- 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, buildings and foundations).
- Tangible personal property purchased for use in research and development.
- Tangible personal property purchased by a contractor or a subcontractor for use in a construction contract for a manufacturer for use in manufacturing, processing, refining, fabricating, recycling, or as a research or storage facility.
- Tangible personal property purchased to be used 50 percent or more in maintaining, repairing, measuring, or testing any exempt manufacturing equipment.

This exemption statute contained a sunset provision based on the number of manufacturing jobs in California. Under that provision, if the number of non-aerospace manufacturing jobs in California had not increased by at least 100,000 above the comparable 1994 number, the exemption would expire. Each year, the Employment Development Department was required to determine the number of non-aerospace manufacturing jobs, and if the number ever fell below 100,000, the exemption would expire on the next January 1.

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

Under the Personal Income Tax Law and the Corporation Tax Law, a 6 percent income tax credit on similar property was available to businesses who either did not qualify as a new trade or business under Section 6377, or who would have qualified as a new business, but decided to claim the 6% credit rather than the 5% exemption. A similar sunset clause was contained in these laws as well.

Proposed Law

This bill would reinstate the manufacturers' exemption contained in Section 6377 of the Sales and Use Tax Law as it appeared prior to its repeal.

The bill would also amend the Personal Income Tax Law and Corporation Tax Law to reinstate the manufacturers' income tax credit and increase that credit from 6% to 8%.

The bill would become effective immediately, but the provisions of the exemption would apply to purchases made on or after January 1, 2004.

Background

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.

According to the Employment Development Department (EDD), by January 1, 1998, manufacturing employment had increased by over 213,000 more than in 1994. However, by January 1, 2003, that employment figured dropped below the 100,000 benchmark, and the statute was repealed by its own terms effective January 1, 2004.

In an October 2002 report put out by the Legislative Analyst's Office, *An Overview of California's Manufacturers' Investment Credit*, the following arguments in support of and against 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 author. According to the author's office, the purpose of the bill is to continue the tax incentives provided to California manufacturers.
2. **The state sales and use tax rate will be 5.25% effective July 1, 2004.** The original exemption began in 1993 at the 6% rate and was reduced to 5% one year later to eliminate from the exemption the state tax portion of the sales and use tax rate, local revenues deposited into the Local Revenue Fund and the Local Public Safety Fund. With the passage of AB 9 (Ch. 2, 2003-04 Fifth Extraordinary Session), and ACA 5 (Res. Ch. 1, 2003–04 Fifth Extraordinary Session) and adoption of the Economic Recovery Bond Act approved by the voters at the March 2, 2004 statewide primary election, the state sales and use tax rate increases to 5.25%. Thus, enactment of this measure would result in a 5.25% state sales and use tax exemption for qualified purchases (local revenues would not be affected).

3. **Bill would generate claims for refund.** Since the exemption for new manufacturers expired on January 1, 2004, and the proposed exemption would become operative for purchases made on or after January 1, 2004, in order for qualifying new manufacturers to receive the benefit of the exemption, retailers making sales to these qualifying purchasers would be required to file a claim for refund for any tax collected on sales made from January 1, 2004 until the bill becomes law (for sales tax overpayments, current law only allows the retailer that remitted the tax to the Board to claim the refund, not the purchaser who reimbursed that retailer for the tax). This could be burdensome for retailers, who receive no economic benefit for filing a claim, since any tax overpaid would be required to be forwarded to the purchaser from whom it was collected. Perhaps the bill should be amended to make the exemption prospective only.
4. **Bill should have a delayed effective date for the sales and use tax exemption.** The bill would become effective immediately. In general, retailers rely on the Board's "official notice" of tax law changes before they implement any changes to their tax reporting obligations. If the amendments suggested in comment 3 above are made to this measure, in order for the Board to timely prepare and mail notices to retailers affected by this measure that may be making sales qualifying manufacturers, it is suggested that the proposed changes to Section 6377 have a delayed operative date – at a minimum of 30 days after the bill becomes law.
5. **Related legislation.** As of the date of this analysis, four other bills have been introduced this session to reinstate this exemption. These include AB 1998 (Dutton), which would restore the partial sales and use tax exemption and expand it to include purchases of qualifying equipment by establishments engaged in electric power generation and make similar amendments to the income tax credit; Assembly Bill 2070 (Houston), which would restore the partial exemption and the income tax credit effective January 1, 2005; AB 2991 (Runner), which would restore the partial sales and use tax exemption effective January 1, 2004; and SB 1554 (Karnette), which would restore both the partial sales and use tax exemption as well as the income tax credit.

COST ESTIMATE

Enactment of this measure would result in administrative costs attributable to notifying affected retailers and reviewing and approving claimed refunds and exemptions. An estimate of these costs is pending, but they are expected to be minor (between $10,000 and $50,000)

REVENUE ESTIMATE

Current purchases of qualified equipment as defined in this measure are represented in the table as total expenditures by SIC code.

SIC Codes	Classification	Equipment Expenditures
2011 to 3999	Manufacturing	$ 137.4 million

Revenue Summary

The annual revenue loss from exempting $137.4 million in equipment expenditures purchased by qualified persons beginning January 1, 2004 (assuming each retailer who collected tax reimbursement on qualifying sales during 2004 files a claim for refund) is estimated to be the following:

	Total Purchases	Revenue Loss
State (5.00%) (01/01/04 to 06/30/04)	$68.7 million	$3.4 million
State (5.25%) (07/01/04 to 12/31/04)	68.7 million	3.6 million
Total		$7.0 million

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