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STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

D R A F T

Date Amended:	**07/07/11**	Bill No:	**Senate Bill 116**
Tax Program:	**Sales and Use Tax**	Author:	**De Leon**
Sponsor:	**Author**	Code Sections:	**RTC 6377**
Related Bills:	**AB 103 (Assembly Budget)** **AB 218 (Wieckowski)** **AB 303 (Knight)** **AB 979 (Silva)** **AB 1057 (Olsen)** **SB 395 (Dutton)**	Effective Date:	**Upon enactment**

This analysis only addresses the provisions that impact the BOE.

BILL SUMMARY

Among other things, this bill would provide a state General Fund (5%) sales and use tax exemption for purchases of qualifying tangible personal property by new manufacturers, and a General Fund (1%) sales and use tax exemption on the same property for existing manufacturers, as specified.

ANALYSIS

CURRENT LAW

Under current law, business entities engaged in manufacturing that make purchases of equipment and supplies for use in the conduct of their manufacturing 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 purchases of equipment used by these entities in their manufacturing activities.

Beginning July 1, 2011, the statewide sales and use tax rate (7.25%) imposed on taxable sales and purchases of tangible personal property is made up of the following components (additional transactions and use taxes (also known as district taxes) are levied by various local jurisdictions and are not reflected in this chart):

Rate	Jurisdiction	Purpose/Authority
5.00%	State (General Fund)	State general purposes (Revenue and Taxation Code (RTC) Sections 6051, 6051.3, 6201, and 6201.3)
0.25%	State (Fiscal Recovery Fund)	Repayment of the Economic Recovery Bonds (RTC Sections 6051.5 and 6201.5, operative 7/1/04)
0.50%	State (Local Revenue Fund)	Local governments to fund health and welfare programs (RTC Sections 6051.2 and 6201.2)
0.50%	State (Local Public Safety Fund)	Local governments to fund public safety services (Section 35, Article XIII, State Constitution)

Rate	Jurisdiction	Purpose/Authority
1.00%	Local (City/County) 0.75% City and County 0.25% County	City and county general operations (RTC Section 7203.1, operative 7/1/04); Dedicated to county transportation purposes
7.25%	Total Statewide Rate	

PROPOSED LAW

This bill would add RTC Section 6377 to the Sales and Use Tax Law to provide a partial exemption (General Fund only) from the sales and use tax rate of 5% (new trade or business) or 1% (existing trade or business) for purchases made 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 tangible personal property (i.e., machinery, equipment, parts, belts, shafts, computers, software, pollution control equipment, buildings and foundations), as specified.
- Tangible personal property to be used 50 percent or more in research and development.
- Tangible personal property to be used 50 percent or more in maintaining, repairing, measuring, or testing any qualifying equipment.
- Tangible personal property purchased for use by a contractor, as specified, for use in the performance of a construction contract for the qualified persons who will use the property as an integral part of any manufacturing, processing, refining, fabricating, or recycling process or as a research or storage facility in connection with the manufacturing process.

This bill would define "qualified person" as either of the following:

- o A new trade or business that is primarily engaged in manufacturing activities, as described in Codes 3111 to 3399, inclusive, in the 2007 edition of the North American Industry Classification System (NAICS). In addition, this bill would specify that a new trade or business that has conducted business activities in this state for a period of three or more years is no longer considered a new trade or business for purposes of this section.
- o A trade or business, other than a new trade or business, that is primarily engaged in manufacturing activities, as described in Codes 3111 to 3399, inclusive, in the 2007 edition of the North American Industry Classification System (NAICS).

The bill specifies that a "qualified person" shall not include an apportioning trade or business described in subdivision (b) of RTC Section 25128.

"Fabricating," "manufacturing," "primarily," "process," "processing," "refining," "research and development," and "useful life," are defined and the tangible personal property intended to be included or excluded from the proposed partial exemption are described.

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 useful life of less than one year, and (3) furniture, inventory, equipment used in the extraction process or equipment used to store finished products that have completed the manufacturing process.

The proposed exemption shall not apply to any taxes levied pursuant to Sections 6501.2 and 6201.2 (Fiscal Recovery Fund), 6051.5 and 6201.5 (Local Revenue Fund), and pursuant to Section 35 of Article XIII of the California Constitution (Local Public Safety Fund). In addition, the bill specifies that the exemption shall not apply to any tax levied by a county, city, or district pursuant to the Bradley-Burns Uniform Local Sales and Use Tax Law or the Transactions and Use Tax Law (also known as district taxes).

As an urgency bill, the provisions would become effective immediately upon enactment. The provisions would remain in effect until July 1, 2016, and as of January 1, 2017, are repealed.

BACKGROUND

For a ten-year period ending December 31, 2003, the law provided a partial (General Fund only) 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 was identical to the property described in this bill - 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. Qualified property also included tangible personal property purchased by a contractor, as specified, for use in the performance of a construction contract for the qualified person who would use that property as an integral part of the manufacturing process, as described. Certain special purpose buildings were included as "qualified property" as this bill proposes. 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 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 (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.

Legislative History. Since the expiration of the partial exemption of manufacturing equipment, numerous bills have been introduced to either reinstate or to expand or modify the exemption, but failed to pass. A sample of bills introduced during the last three Legislative Sessions includes the following:

Bill No.	Session	Author	Proposed Exemption
AB 810 and AB 829	2009-10	Caballero	Qualifying tangible personal property, including sustainable development equipment investments, by persons engaged in manufacturing, research and development, and software publishing
AB 1719	2009-10	Harkey	Reinstate the original exemption for qualifying tangible personal property by new trades or businesses engaged in manufacturing
AB 1812	2009-10	Silva	Qualified tangible personal property by persons engaged in manufacturing and software production
AB 2280	2009-10	Miller	Equipment by manufacturers engaged in manufacturing activities
SB 1053	2009-10	Runner	Qualifying tangible personal property by persons engaged in manufacturing and software publishing and their affiliates
SBx6 18	2009-10	Steinberg & Alquist	Qualifying tangible personal property by persons engaged in specific manufacturing and software production activities
SBx6 8 and SBx6 44	2009-10	Dutton	Qualifying tangible personal property by manufacturers and software publishers and affiliates engaged in manufacturing activities or research and development
AB 1152	2007-08	Niello	Qualifying tangible personal property by persons engaged in manufacturing and software production
AB 1206	2007-08	Smyth	Machinery and equipment used in research and development activities
AB 1681	2007-08	Houston	Qualified tangible personal property for use by qualified persons engaged in manufacturing, telecommunications, and electrical generation activities
AB 344	2005-06	Villines	Qualifying tangible personal property by qualified persons primarily engaged in manufacturing, telecommunications and electrical generation activities. Would apply to 25% of the sales or purchases for 2006, 50% for 2007, and 100% thereafter.
AB 1580	2005-06	Torrico	Qualifying tangible personal property by qualified persons primarily engaged manufacturing, construction contracting, software production, telecommunications, cable distribution, scientific research and development services, and wholesale distribution of recyclable materials
SB 552	2005-06	Alquist	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 clean rooms and equipment. Includes optional Bradley-Burns local and district tax exemption
SB 1291	2005-06	Alquist	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

COMMENTS

1. **Sponsor and Purpose.** The author is sponsoring this bill in an effort to encourage greater investment and economic development in the manufacturing sector, while giving particular help to businesses that are starting up and are most likely to need assistance. According to the author's office, this exemption is modeled after the four-year partial exemption that was proposed in the Governor's May Revise.

2. **What types of entities do Codes 3111 to 3399 include?** Codes 3111 to 3399 include all establishments primarily engaged in manufacturing activities. Manufacturing activities involve the mechanical, physical, or chemical transformation of materials, substances, or components into new products. The manufacturing sector includes entities in the aerospace sector, food, beverages, clothing, textiles, wood products, petroleum, chemicals, pesticides and fertilizers, pharmaceuticals, plastics and rubber products, glass, cement and concrete, steel, metals, printing, and more.

3. **For new manufacturers, the exemption rate would be 5 percent, and for existing manufacturers, the rate would be 1 percent.** A "qualified person" would include a person that started a new trade or business (described in the NAICS codes 3111 to 3399) in this state on or after the effective date of this bill. In addition, the proposed exemption would be available only during the first three years of the new business's existence. A "qualified person" would also include a person other than a new trade or business described in the NAICS codes 3111 to 3399. The proposed exemption would provide a 5 percent exemption of the General Fund sales and use tax for new businesses and a 1 percent exemption of the General Fund for existing businesses.

   In addition, the bill's provisions specify that a contractor performing a construction contract for a qualified person that is an existing business would be limited to an exemption rate of 1 percent.

4. **Manufacturers that are considered an apportioning trade or business described in subdivision (b) of RTC Section 25128 would not be eligible for the proposed partial exemption.** RTC Section 25128 uses an apportionment formula to determine the amount of business income attributable to California. RTC Section 25128 generally provides that business income be apportioned to California by means of a four-factor formula, consisting of a payroll factor, a property factor, and a double weighted sales factor. However, Section 25128 (b) provides an exception to this rule. Under subdivision (b) of 25128, if a taxpayer has more than 50% of its "gross business receipts" from a qualified business activity (i.e. extractive, agriculture, savings and loan, and banks and financials), then all of the income of a taxpayer shall be apportioned by a three-factor formula, consisting of a payroll factor, a property factor, and a single weighted sales factor. This bill would provide that if a manufacturer is required to report under 25128 (b), then that manufacturer would not be eligible for this proposed partial exemption.

   What manufacturers would be subject to apportionment rules for income tax purposes under Section 25128, subdivision (b)? There could be some manufacturers subject to the three-factor apportionment formula; however, the number of manufacturers that are required to use this formula is unknown.

   BOE staff does not anticipate a problem in administering this provision as this information can be verified from the business entity's income tax return.

5. **Operative date.** As an urgency bill, the provisions would take effect immediately. However, the author's fact sheet states that the proposed partial exemption would start in fiscal year 2012-13. In addition, paragraph (7)(A)(iii) of subdivision (b) provides that a person engaged in a trade or business wholly outside this state that first commences doing business in this state *on or after June 30, 2012*, shall be treated as a new business for purposes of this section. This provision, however, would apply only to these specific new manufacturers, and not to other new manufacturers or existing manufacturers.

   Since it is the author's intent for the exemption to begin in the fiscal year 2012-13, we recommend amending the bill to clarify this.

6. **Partial exemptions complicate administration of the tax.** Currently, most sales and use tax exemptions apply to the total applicable sales and use tax. However, there are currently five partial exemptions in California law, where only the state tax portion (5.25%: General Fund (5%) and Fiscal Recovery Fund (0.25%)) of the state and local sales and use tax rate is exempted. These five partial tax exemptions include: (1) farm equipment and machinery, (2) diesel fuel used for farming and food processing, (3) teleproduction and postproduction equipment, (4) timber harvesting equipment and machinery, and (5) racehorse breeding stock. These partial tax exemptions are difficult for both retailers and the BOE. They complicate return preparation and return processing. And errors on returns attributable to these partial exemptions occur frequently, which result in additional return processing workload for the BOE.

   This measure proposes a 5% and a 1% exemption (General Fund only), which would add two new exemption categories (since current law does not have any partial exemptions other than a 5.25% exemption. This would require a revision to the sales and use tax return and result in a new, separate computation on the return. Some retailers would have to segregate in their records sales subject to the 5% and 1% exemption (proposed by this bill), 5.25% exemption, sales with a full exemption (such as a sale for resale or a sale in interstate commerce), and sales that are fully taxable. This bill would add a new level of complexity, which would create a corresponding increase in errors in reporting the tax to the BOE. This increase in errors would further complicate the BOE's administration of the sales and use tax law and complicate reporting obligations of retailers.

7. **Related legislation.** Similar bills have been introduced this year:

   - AB 103 (Assembly Budget Committee), which contains similar provisions to this bill, would provide a state General Fund (5%) sales and use tax exemption for purchases of specified tangible personal property by new manufacturers and software producers, and a General Fund (1%) sales and use tax exemption on the same property for existing manufacturers and software producers. This bill would become operative only so long as the total rate of taxes imposed under Part 1 of the Sales and Use Tax Law and Section 35 of Article XIII of the California Constitution (Local Public Safety Fund) are equal to or greater than 7 percent. The proposed exemption would sunset on July 1, 2016, or earlier if the sales and use tax rate falls below a specified rate.

   - AB 218 (Wieckowski), among its provisions, would provide a partial (General Fund and Fiscal Recovery Fund only) sales and use tax exemption for purchases of certain tangible personal property by qualified persons engaged in manufacturing and software production, as specified and defined. This bill would intend to use revenue generated from the estate tax, which this bill would create, to supplant the reduction of General Fund revenue as a result of the exemption. Its enactment, however, would require voter approval at the next statewide General Election.

- AB 303 (Knight) would reinstate the partial (General Fund only) sales and use tax exemption for purchases of qualifying tangible personal property by new trades or businesses engaged in manufacturing.
- AB 979 (Silva) would provide a partial (General Fund only) sales and use tax exemption, beginning January 1, 2012, on tangible personal property purchased for use in manufacturing activities by manufacturers and software publishers and affiliates.
- AB 1057 (Olsen) would provide a partial (General Fund only) sales and use tax exemption, beginning January 1, 2014 and before January 1, 2020, on tangible personal property purchased for use in manufacturing activities, research and development, and air pollution mitigation by manufacturers and affiliates.
- SB 395 (Dutton) would provide a partial (General Fund only) sales and use tax exemption for purchases of qualifying tangible personal property by persons engaged in manufacturing and software production, as specified and defined.

COST ESTIMATE

Because of the two *new* partial exemptions, the BOE would incur non-absorbable costs attributable to programming, modifying returns, notifying affected retailers, preparing a special publication and exemption certificate, auditing claimed exemptions, and answering inquiries from the public and taxpayers. In addition, it is anticipated that errors on returns would increase resulting in additional workload in the return processing area. These costs are estimated to be:

Sunset Date July 1, 2016				
Start Up FY 2011-12	Ongoing First Year FY 2012-13	Ongoing Second Year FY 2013-14	Ongoing Third Year FY 2014-15	Close Out Year following Final FY 2015-16
$ 657,000	$ 558,000	$ 516,000	$ 516,000	$ 646,000

As previously stated, the partial exemption will expire on July 1, 2016. The costs shown for the Close Out Year (FY 2015-16) are estimated costs associated with processing the termination of the partial exemption. If adjustments are needed to these estimates, a future Budget Change Proposal will be submitted.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

The U.S. Census Bureau's *Annual Survey of Manufactures* (ASM) reported NAICS 31-33 capital expenditures data (machine and equipment, buildings and other structures) for California. In FY 2008-09, capital expenditures by California manufacturers amounted to an estimated $14.7 billion. Using the most recent forecast of business equipment investment of IHS Global Insight, a national economic forecasting firm, we estimated expenditures as follows:

Expenditures Estimate (in billions)	FY 2012-13	FY 2013-14
Manufacturing 31-33	$ 20.5	$ 21.6

Exemption Impact - New & Existing Businesses. As previously stated, this bill would provide a 5 percent exemption to new trade or businesses (in business for three years or less) and a 1 percent exemption for any trade or business other than a new trade or business. To give us an idea as to what the qualifying expenditure would be for new businesses or startups, we looked at recent Bureau of Labor Statistics (BLS) U.S. manufacturing data related to percentage of manufacturing job gains from new manufacturing establishments. It was estimated that the qualifying expenditure would amount to 0.3%. This would result in expenditures as follows:

Manufacturing (NAICS 31-33) Expenditures Estimate (in millions)	FY 2012-13	FY 2013-14
New Startups	$61	$65
Existing Businesses	$20,431	$21,561
Total	$20,492	$21,626

REVENUE SUMMARY

Assuming a July 1, 2012 operative date, the revenue impact from exempting tangible personal property purchased by manufacturers (NAICS 31-33) from the state sales and use tax (General Fund) is as follows:

General Fund Loss (in millions)	FY 2012-13	FY 2013-14
New Startups (5%)	$3.1	$3.2
Existing Business (1%)	$204.3	$215.6
Total	$207.4	$218.8

Qualifying Remark

This bill provides that a qualified person shall not include an apportioning trade or business described in subdivision (b) of Section 25128. Subdivision (b) of 25128 requires taxpayers of an apportioning trade or business that derive more than 50 percent of their gross business receipts from conducting a qualified business activity (i.e., extractive, agricultural, savings and loan, and banks and financials) to use a three-factor, single-weighted sales, apportionment formula.

To the extent that certain manufacturers could be subject to the apportionment formula under subdivision (b) of Section 25128, such manufacturers would not be eligible for the proposed partial exemption in this bill. In that case, the sales and use tax revenue loss as shown in the table above could be lower.

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