STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**08/29/11**	Bill No:	**Senate Bill 116**
Tax Program:	**Sales and Use Tax**	Author:	**De Leon & Steinberg**
Sponsor:	**Author**	Code Sections:	**RTC 6377**
Related Bills:	**AB 103 (Assembly Budget)** **AB 218 (Wieckowski)** **AB 303 (Knight)** **AB 979 (Silva)** **AB 1057 (Olsen)** **ABx1 40 (Allen)** **SB 395 (Dutton)**	Effective Date:	**Upon enactment, but operative 01/01/12**

This analysis only addresses the provisions that impact the BOE.

BILL SUMMARY

Among other things, this bill would provide a state General Fund (3.9375%) sales and use tax exemption for purchases of qualifying tangible personal property by new manufacturers, and a General Fund (3%) sales and use tax exemption on the same property for existing manufacturers, as specified. The proposed exemption would also apply to businesses engaged in software production, biotechnology research and development, and renewable power generation facilities, as specified.

Summary of Amendments

Since the previous analysis, this bill was amended to incorporate Governor Brown's proposal known as the California Jobs First plan. Among other things, the recent amendments (1) change the exemption rates for new manufacturing businesses from 5% to 3.9375%, and for existing manufacturing businesses from 1% to 3%, and (2) expand the definition of a qualified person to include businesses engaged in software production, biotechnology research and development, and renewable power generation facilities, as specified.

ANALYSIS

CURRENT LAW

Under current law, business entities engaged in manufacturing, software producing, research and development in biotechnology, and renewable power generation activities that make purchases of equipment and 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 purchases of equipment used by these entities in their manufacturing, software producing, research and development, and renewable power generation 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)
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 3.9375% (new trade or business) or 3% (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 the North American Industry Classification System (NAICS) codes 3111 to 3399, inclusive, software production activities as described in NAICS code 5112, biotechnology research and development activities as described in NAICS code 541711, or renewable electric power generation activities as described in NAICS code 221119 of the 2007 edition of the 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 the codes 3111 to 3399, inclusive, software production activities as described in code 5112, biotechnology research and development activities as described in code 541711, or renewable electric power generation activities as described in code 221119 of the 2007 edition of NAICS.

The bill specifies that a "qualified person" shall not include an apportioning trade or business described in subdivision (b) of RTC Section 25128, as that section read on January 1, 2011.

"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 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, but would be operative January 1, 2012.

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 recent Legislative Sessions include 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

Bill No.	Session	Author	Proposed 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 authors are sponsoring this bill in an effort to encourage greater investment and economic development in the manufacturing, biotechnology, software, and clean energy industries, 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 part of Governor Brown's proposal known as the California's First Job plan, which proposes to offer tax relief to businesses that create jobs in this state.

2. **The August 29, 2011 amendments** (1) change the exemption rates for new manufacturing businesses from 5% to 3.9375%, and for existing manufacturing businesses from 1% to 3%, (2) expand the definition of a qualified person to include businesses engaged in software production, biotechnology research and development, and renewable power generation facilities, as specified, (3) change the operative date to January 1, 2012, (4) delete the January 1, 2016 sunset date, and (4) make various clarifying and technical changes.

3. **What types of entities do Codes 3111 to 3399, 5112, 221119, and 541711 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.

   Code 5112 is comprised of establishments primarily engaged in computer software publishing or publishing and reproduction. Software publishing establishments carry out the functions necessary for producing and distributing computer software, such as designing, providing documentation, assisting in installation, and providing support services to software purchasers. The software publishing industry produces and distributes information, but usually it "publishes" or distributes its information by methods, such as by CD-ROM's, the sale of new computers already preloaded with software, or through distribution over the Internet, rather than in printed form.

   Code 221119 consists of establishments primarily engaged in operating electric power generation facilities (except hydroelectric, fossil fuel, or nuclear) using renewable sources. These facilities convert other forms of energy, such as solar, wind, or tidal power, into electrical energy. The electric energy produced by these establishments is provided to electric power transmission systems or to electric power distribution systems.

   Code 541711 is comprised of establishments primarily engaged in conducting biotechnology research and experimental development. Biotechnology research and experimental development involves the study of the use of microorganisms and cellular and biomolecular processes to develop or alter living or non-living materials.

This biotechnology research and development may result in development of new biotechnology processes or in prototypes of new or genetically-altered products that may be reproduced or utilized by various industries.

4. **For new businesses, the exemption rate would be 3.9375 percent, and for existing businesses, the rate would be 3 percent.** A "qualified person" would include a person that started a new trade or business (described in the NAICS codes 3111 to 3399 (manufacturing), 5112 (software production), 221119 (renewable electric power generation), or 541711 (biotechnology research and development)) 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, 5112, 221119, or 541711. The proposed exemption would provide a 3.9375 percent exemption of the General Fund sales and use tax for new businesses and a 3 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 3 percent.

5. **Manufacturing, software, biotechnology research and development, and renewable power generation businesses 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 qualified person is required to report under 25128 (b), then that qualified person would not be eligible for this proposed partial exemption.

   What manufacturers, software, biotechnology, and renewable power generation businesses would be subject to apportionment rules for income tax purposes under Section 25128, subdivision (b)? There could be some business entities subject to the three-factor apportionment formula; however, the number of business entities 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.

6. **Funding necessary for administrative start-up costs.** The provisions of this bill would be effective immediately, but would be operative on January 1, 2012, in the middle of the 2011-12 fiscal year. The BOE would incur administrative start-up costs related to, among other things, notifying affected taxpayers, modifying tax returns, revising regulations and pamphlets, answering inquiries from industry and the public,

and programming. Since these costs would not be identified in the BOE's 2011-12 budget, the BOE would need an adequate direct appropriation to cover these costs.

7. **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 3.9375% and a 3% 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 3.9375% and 3% 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.

8. **Technical considerations.** Recommended technical corrections are provided as follows:
   - Amendments one and two would replace the term "property" with "tangible personal property." These amendments would clarify that a qualified person purchases tangible personal property to be used primarily in fabricating or processing of tangible personal property (and not "property") to make it work in a new or different manner.
   - Amendment three would clarify that a new trade or business that has conducted business activities in this state for three or more years would no longer be considered a new trade or business for purposes of the proposed exemption.
   - Amendments four and five would delete the requirement that a retailer furnish a copy of an exemption to the BOE, and instead would require a retailer to retain a copy of each exemption certificate in his or her records and make it available to the BOE for examination upon request.
   - Amendment six would make a technical correction.

9. **Related legislation.** Similar bills have been introduced this year:
   - ABx1 40 (Allen) is identical to this bill.
   - 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 significant 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.

The BOE had prepared a cost estimate on the July 7, 2011 version of this bill, which provided a 5% state sales and use tax exemption for new manufacturing businesses and a 1% state sales and use tax exemption for existing businesses. That bill's provisions would have been operative July 1, 2012. The BOE estimated its costs to be:

FY 2011-12 (Start Up)	FY 2012-13 (First Year)	FY 2013-14 (and Ongoing)
$ 657,000	$ 558,000	$ 516,000

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 BOE's formal position.

This bill, as amended August 29, 2011, would expand the definition of a qualified person to include three new industry groups—software producers, biotechnology research and development, and renewable power generation facilities. Due to the higher number of affected taxpayers, the BOE's workload to administer the proposed exemption will increase. Consequently, BOE staff anticipates a material increase in the cost estimate it prepared on the prior version of the bill that applied only to manufacturers. A revised cost estimate is pending.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

Manufacturing NAICS 31-33 & Software Publishers NAICS 5112

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. The U.S Census Bureau's *Annual Capital Expenditures Survey* (ACES) reported NAICS 5112 expenditures. In FY 2008-09, capital expenditures by California software publishers amounted to an estimated $1.4 billion, resulting in total (NAICS 31-33 + NAICS 5112) estimated expenditures of $16.1 billion.

Using the most recent forecast of business equipment investment of IHS Global Insight, a national economic forecasting firm, we estimated expenditures as follows: FY 2011-12, $21 billion and FY 2012-13, $22.5 billion.

Exemption Impact - New Businesses & Existing Business

This bill would provide a 3.94 percent exemption to new trade or businesses (in business for three years or less) and 3 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 Census 'age of business' data. Based on that data, we estimated expenditures as follows:

NAICS 31-33 & NAICS 5112
Expenditures Estimate
(in millions)

	FY 2011-12	FY 2012-13
New Startups	$690	$739
Existing Businesses	$20,314	$21,736
Total	$21,004	$22,474

Research & Development in Biotechnology NAICS 541711

Based on data from ACES and the 2007 *Economic Census*, and using IHS Global Insight forecast, we estimated NAICS 541711 expenditures as follows: FY 2011-12, $370 million and FY 2012-13, $395 million.

Other Electric Power Generation NAICS 221119

According to the *California Energy Commission's* Investor-Owned Utility (IOU) Contracts database, an estimated 53 wind and solar facilities located in California will come online between now and the end of 2013, representing about 7,000 MW of capacity. These are signed contracts between renewable energy facilities and IOU's such as PGE. Based on the IOU MW data and by using plant cost data i.e. cost estimates (cost per gross MW) for the pertinent technologies (wind, solar), it is estimated that overall construction costs for these technologies would amount to an estimated $12 billion. Assuming that a renewable facility could take about two years to construct, construction costs in FY 2011-12 is estimated to be $6 billion.

REVENUE SUMMARY

The revenue analysis below reflects a January 1, 2012 operative date; FY 2011-12 reflects a half year effect.

Estimated Sales & Use Tax Loss
(in millions)

NAICS Code	FY 2011-12 half year effect	FY 2012-13
New startups (31-33, 5112)	$14	$29
Existing businesses (31-33, 5112)	$305	$652
New startups (541711)	$1	$2
Existing businesses (541711)	$5	$10
New startups (221119)	$118	$237
Total loss	$443	$931

Qualifying Remarks 1. This bill would provide a sales and use tax exemption for construction of renewable facilities (such as solar and wind). Each of these various technologies has its own distinctive capabilities, cost drivers and trends. Although we have been able to estimate the revenue impact based on current *Commission* data, a comprehensive analysis of each technology or industry is needed to better understand the proposal's longer-term revenue impact.

2. This bill would provide 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 qualified entities could be subject to the apportionment formula under subdivision (b) of Section 25128, such entities 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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STATE BOARD OF EQUALIZATION

PROPOSED AMENDMENTS TO SB 116 (as amended 08/29/11)

AMENDMENT 1

On page 11, line 9, add "tangible personal" after "components or" and before "property"

AMENDMENT 2

On page 11, line 40, add "tangible personal" before "property"

AMENDMENT 3

On page 13, line 20, the following subsection should be added:

"(v) A "qualified person" shall not be regarded as a new trade or business when the qualified person has conducted business activities in a new trade or business for three or more years."

AMENDMENT 4

On page 15, line 6, delete "subsequently furnishes" and insert "retains"

AMENDMENT 5

On page 15, line 7, delete "the board with a copy of" and after "exemption certificate" add "in his or her records"

AMENDMENT 6

On page 15, line 16, substitute "7200" for "4200"