STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	**02/16/11**	Bill No:	**Senate Bill 395**
Tax Program:	**Sales and Use Tax**	Author:	**Dutton**
Sponsor:	**Author**	Code Sections:	**RTC 6377**
Related Bills:	**SB 47 (Dutton)** **AB 203 (Halderman)** **AB 218 (Wieckowski)** **AB 303 (Knight)** **AB 979 (Silva)** **AB 1057 (Olsen)**	Effective Date:	**Upon enactment, but operative 01/01/12**

BILL SUMMARY

This bill would provide a state (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.

ANALYSIS

CURRENT LAW

Under current law, business entities engaged in manufacturing, research and development, and software producing activities that make purchases of equipment and supplies for use in the conduct of their manufacturing and related 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 and related 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

Rate	Jurisdiction	Purpose/Authority
7.25%	Total Statewide Rate	

The 1% General Fund tax under Sections 6051.7 and 6201.7 will expire on 6/30/11.

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% (on and after July 1, 2011) for the following 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 property (i.e., machinery, equipment 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 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.

The bill would define a "qualified person" as any person engaged in manufacturing activities, as described in the North American Industrial Classification System (NAICS) codes 3111 and 3399, and software production activities as described in NAICS codes 5112, or an affiliate of a qualified person, as defined.

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

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, except for fuels used in the manufacturing process, 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 <u>not</u> 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 <u>not</u> 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 a tax levy, the bill would become effective immediately, but would become operative on 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 for sales and purchases of qualifying property, and the income tax credit was equal to six percent of the amount paid for qualified property placed in service in California. Qualified property was similar 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 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

Bill No.	Session	Author	Proposed Exemption
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 for purposes of creating incentives to spur manufacturing and research and development growth in California's private business sector. According to the author's office, this bill will also help to retain and create jobs in California by making it more competitive with other states.

2. **What types of entities do Codes 3111 to 3399 and 5112 include?** Codes 3111 to 3399 include all establishments primarily engaged in manufacturing activities. This includes manufacturers in the aerospace sector, textiles, pharmaceuticals, printing, food, 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.

3. **Administrative and technical concerns:**

- In defining "qualified person," it is recommended that the bill require that the qualifying entity be *primarily* engaged in the activities described in the referenced codes. This is an important issue and one that generated many disputes when the BOE administered Section 6377 previously.
- Another issue relates to the proposed definitions for the types of property included and excluded from the proposed exemption. For example, on page 4, lines 22 and 23, and lines 39 and 40, the bill refers to the items having a *useful life* of one year or more (or less than one year). In order to lessen potential audit disputes, the bill should contain some mechanism for determining the useful life. Perhaps some reference to the provision in the California income tax laws for depreciating assets should be incorporated into the bill.
- Subdivision (f) of proposed Section 6377 (page 6, line 11) provides for an exemption from tax for specified leases of qualified property and limits this exemption for a six-year period. This limitation is modeled after a provision in former Section 6377 that provided a partial tax exemption solely to new manufacturers' leases of equipment. Further, this partial exemption was available only during the first three years of operations. Since this bill would provide the exemption for all qualifying persons (would not be limited to new businesses during the first three years of operation), the limitation in subdivision (f) is unnecessary and should be stricken.

BOE staff is available to work with the author's office to address these and other concerns that may be identified.

4. **The term "property" needs clarifying.** The term "property," which is used throughout proposed Section 6377, needs clarifying. As currently drafted, the bill would exempt sales of tangible personal property purchased by a qualified person for use in the manufacturing, fabrication, processing, etc., of "property." Traditionally, when the Legislature addresses the manufacturing of property, it means the traditional manufacturing of tangible personal property, not the creation of intangibles or the provision of services and utilities. To the extent that the bill does not expressly limit such term to the manufacturing or fabricating of tangible personal property, then it may be asserted that it has left open the door to unintended arguments that it includes the creation of intangible property or the provision of services and utilities. To avoid any unintended consequences in administering the proposed exemption, we suggest that the term "property" be replaced with "tangible personal property."

Without this clarification, the bill would not only complicate administration of the statute, but also would potentially open the door for aggressive litigation from the providers of services, utilities, and intangibles, possibly resulting in significant revenue losses to the state far beyond what the Legislature intended. While arguments for such greater scope seem unreasonable and overbroad, clarification now would help preclude unanticipated future issues and problems.

5. **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 (6.25% (5.25% beginning July 1, 2011): General Fund (6%) 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% exemption (General Fund only), which would create a new exemption category (since current law does not have any partial exemptions other than a 6.25% exemption, which effective July 1, 2011 is reduced to 5.25%). 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% 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.

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

   - SB 47 (Alquist) would provide a partial (General Fund and Fiscal Recovery Fund) sales and use tax exemption for purchases of qualifying tangible personal property used by entities engaged in manufacturing, research and development, newspaper printing, and software production, and for semiconductor, biotechnology and pharmaceutical clean rooms and equipment.

   - AB 204 (Halderman) would provide a partial (General Fund and Fiscal Recovery Fund) sales and use tax exemption for purchases of equipment by a biomass energy facility, as defined, for use in its biomass energy production activities.

   - AB 218 (Wieckowski), among its provisions, would provide a partial (General 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.

COST ESTIMATE

Because of the *new* partial exemption, the BOE would incur administrative costs attributable to programming, return revisions, and return processing. In addition, the BOE would incur costs to notify affected retailers, prepare a special publication and exemption certificate, audit claimed exemptions, and answer inquires from the public and taxpayers. An estimate of these costs is pending.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

The U.S Census Bureau's *Annual Survey of Manufactures* (ASM) reported 2009 (most recent) NAICS 31-33 capital expenditures data (machine and equipment, buildings, fuels) for California.

The Census Bureau's *Annual Capital Expenditures Survey* (ACES) reported 2009 (most recent) U.S capital expenditures data (machine and equipment, buildings) for NAICS 5112. Based on 2007 *Economic Census* data (i.e. the ratio of California to U.S revenue or sales receipts for NAICS 5112), we estimated California capital expenditures for NAICS 5112.

We assume that manufacturing (NAICS 31-33) and software (NAICS 5112) establishments would include research and development-related capital expenditures in the capital expenditures they report in the Census surveys.

Using the most recent forecast of business equipment investment of IHS Global Insight, a national economic forecasting firm, we estimated expenditures as follows:

California Expenditures
(in billions)

	FY 2011-12	FY 2012-13	FY 2013-14
Manufacturing 31-33	$23.8	$25.3	$26.8
Software 5112	$1.8	$1.9	$2.1
	$25.6	$27.2	$28.9

REVENUE SUMMARY

The revenue impact from exempting tangible personal property purchased by manufacturers and software publishers from the state sales and use tax (5%) amounts to:

Fiscal Year	Basis	General Fund Revenue Loss
FY 2011-12:	($25.6 billion x 5%)	$0.6 billion(1st 6 mos. of 2012)
FY 2012-13:	($27.2 billion x 5%)	$1.36 billion
FY 2013-14:	($28.9 billion x 5%)	$1.45 billion

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