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STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date:	**05/06/13**	Bill No:	**Assembly Bill 653**
Tax Program:	**Sales and Use**	Author:	**V. Manuel Perez, et al.**
Sponsor:	**Author**	Code Sections:	**RTC 6377**
Related Bills:	**AB 486 (Mullin)** **AB 1326 (Gorell)** **SB 235 (Wyland)** **SB 376 (Correa)** **SB 412 (Knight)**	Effective Date:	**Upon enactment but operative 01/01/14**

BILL SUMMARY

Among other things, this bill provides manufacturers, software publishers, electric power generators, and biotechnology researchers and developers, and their affiliates, a 6.5% sales and use tax exemption for their purchases of qualifying tangible personal property.

ANALYSIS

CURRENT LAW

Except where the law provides a specific exemption or exclusion, California's Sales and Use Tax Law[1] imposes the sales tax on all retailers for the privilege of selling tangible personal property at retail in this state or the use tax on the storage, use, or other consumption in this state of tangible personal property purchased from a retailer.

Generally, sales or use tax applies to the sale or purchase of tangible personal property to persons who use the property to manufacture, produce or process tangible personal property. A manufacturer's taxable purchases include machines, tools, furniture, forklifts, generators, and office equipment. A software publisher's taxable purchases include computer equipment, such as servers, routers, switches, power units, network devices, hard drives, processors, memory modules, and other computer hardware and components. An electric power generating facility's taxable purchases include transformers, alternators, generators, transmitters, turbines and solar panels. A biotechnology researcher's taxable purchases include various lab tools, workstations, monitors, and analyzers.

Conversely, tax does not apply to sales of tangible personal property when the purchasers physically incorporate that property into the manufactured article to be sold. For example, no tax applies to a manufacturer's raw material purchases when, prior to making a taxable use, they become an ingredient or component part of the manufactured article to be resold.

California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA). Existing law[2] contains a specific sales and use tax exclusion[3] for tangible

[1] Part 1 (commencing with Section 6001) Division 2 of the Revenue and Taxation Code (RTC).
[2] RTC Section 6010.8.
[3] An "exclusion" means the transfer of the property is neither a "sale" nor "purchase" and is therefore excluded from the application of the sales and use tax. An "exemption" involves a retail sale that, absent an exemption in law, would otherwise be subject to the tax.

personal property purchased for certain approved manufacturing projects. In 2010, legislation[4] authorized the CAEATFA to approve sales and use tax exclusions for tangible personal property utilized for the design, manufacture, production, or assembly of advanced transportation technologies or alternative energy source products, components or systems. In 2012, legislation[5] was enacted to authorize CAEATFA to approve sales and use tax exclusions related to advanced manufacturing projects until July 1, 2016. The law[6] provides a $100 million cap for these exclusions.

CAEATFA's approval of these exclusions is based on whether the project results in a net benefit to the State, with consideration to both fiscal and environmental benefits.

California's sales and use tax rates. Effective January 1, 2013, California imposes a statewide 7.5% sales and use tax on tangible personal property sales and purchases. The table below shows California's various sales and use tax rate components (the table excludes voter-approved city and county district taxes):

Rate	Jurisdiction	Purpose/Authority
3.9375%	State (General Fund)	State general purposes (Revenue and Taxation Code (RTC) Sections 6051, 6051.3, 6201, and 6201.3)
1.0625%	Local Revenue Fund 2011	Realignment of local public safety services (RTC Sections 6051.15 and 6201.15)
0.25%	State (Fiscal Recovery Fund)	Repayment of the Economic Recovery Bonds (RTC Sections 6051.5 and 6201.5)
0.25%	State (Education Protection Account)	Schools and community college funding (Section 36, Article XIII, State Constitution)
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
7.50%	Total Statewide Rate	

[4] SB 71 (Ch. 10, Stats. 2010, effective March 24, 2010).
[5] SB 1128 (Ch. 677, Stats. 2011, effective January 1, 2013).
[6] Public Resources Code Section 26011.8.

PROPOSED LAW

Beginning January 1, 2014, this bill provides a 6.5% sales and use tax exemption for a "qualified person's" purchases of tangible personal property to be used 50% or more in manufacturing, processing, refining, fabricating, or recycling of tangible personal property, as specified and defined.

This bill defines "qualified person" as either:

- A trade or business that is primarily engaged in manufacturing activities, as described in the North American Industrial Classification System (NAICS) (2007 edition) codes 3111 to 3399, inclusive, software publishing activities as described in NAICS code 5112, other electric power generation activities as described in NAICS code 221119, or biotechnology research and development (R&D) as described in NAICS code 541711, or
- A qualified person's affiliate, if the affiliate is a member of that person's unitary group, as specified.

The bill defines "fabricating," "manufacturing," "primarily," "process," "processing," "refining," and "tangible personal property."

The bill specifies that the proposed exemption excludes:

- Consumables with less than a one year useful life,
- Furniture, inventory, equipment used in the extraction process or equipment used to store finished products that have completed the manufacturing process, and
- Tangible personal property primarily used in administration, general management, or marketing.

Lastly, the bill creates the California Innovation Initiatives, and increases specified research and development credits. These provisions do not impact the BOE and are not discussed in this analysis.

As a tax levy, the measure is effective immediately but operative January 1, 2014.

BACKGROUND

For a ten-year period ending December 31, 2003, the law provided new manufacturers with a state General Fund sales and use tax exemption on their purchases of specified manufacturing equipment. Also, the law provided manufacturers income and corporation tax credits (MIC) of 6% for similar equipment placed in service in California. Similar to the exemption proposed in this bill, the partial exemption and credit related to equipment used primarily for manufacturing, refining, processing, fabricating or recycling. New manufacturers could claim the partial exemption or the MIC. However, existing manufacturers could only claim the MIC.

This partial exemption and MIC contained a conditional sunset date. The law required these provisions to sunset when manufacturing employment,[7] less aerospace employment, failed to exceed January 1, 1994 manufacturing employment by more than 100,000. On January 1, 2003, the employment figures were less than the 1994 number by over 10,000. Therefore, the partial exemption and MIC sunset at the end of 2003.

[7] As determined by the Employment Development Department

Legislative History. Since then, numerous bills have been introduced to reinstate, expand, or modify the exemption and/or MIC, but all failed to pass. Bills introduced during the last two Legislative sessions that exempted similar purchases from sales and use tax include:

Bill No.	Session	Author	Proposed Exemption
ABx1 40	2011-12	Allen	3.9375% exemption for new businesses and 3% for existing businesses engaged in manufacturing, software production, biotechnology R&D, and renewable power generation facilities.
AB 103	2011-12	Budget Committee	5% exemption for new manufacturers and software producers, and 1% for existing manufacturers and software producers.
AB 218	2011-12	Wieckowski	5.25% exemption for manufacturers and software producers.
AB 303	2011-12	Knight	5% exemption for new manufacturers.
AB 979	2011-12	Silva	5% exemption for manufacturers and software producers and affiliates.
AB 1057	2011-12	Olsen	5% exemption for manufacturing, R&D, and air pollution mitigation by manufacturers and affiliates.
SB 116	2011-12	Dutton	Same as ABx1 40 above.
SB 395	2011-12	Dutton	5% exemption for manufacturing and software production.
AB 1911	2011-12	Donnelly	3.9375% exemption for manufacturing and software production.
AB 1972	2011-12	Huber	Full exemption for manufacturing, software production, biotechnology R&D, and renewable power generation facilities.
SB 686	2011-12	Padilla	Full exemption for biotechnology manufacturing and research and development activities.
AB 810 and AB 829	2009-10	Caballero	5% exemption for qualifying tangible personal property, and 6% exemption for sustainable development equipment investments by manufacturing and software production.
AB 1719	2009-10	Harkey	6% exemption for manufacturing
AB 1812	2009-10	Silva	6% exemption for manufacturing and software production
AB 2280	2009-10	Miller	Full exemption for manufacturing.
SB 1053	2009-10	Runner	6% exemption for manufacturing and software publishing and their affiliates
SBx6 18	2009-10	Steinberg & Alquist	6% exemption for specific manufacturing and software production activities
SBx6 8 & SBx6 44	2009-10	Dutton	6% exemption for manufacturers and software publishers and affiliates

COMMENTS

1. **Sponsor and Purpose.** Sponsored by the author, this bill is intended to spur innovation, workforce development, and job creation in California by leveraging the state's human resources and private sector capital through tax incentives, workforce development, and regulatory reform.

2. **The bill references various NAICS codes to describe qualifying taxpayers.** NAICS 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.

   NAICS code 5112 includes 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. This includes activities such as design, documentation, installation, and support services to software purchasers. The software publishing industry produces and distributes information mostly by CD-ROMs, through the sale of new computers with preloaded software, or through the Internet.

   NAICS code 221119 includes establishments primarily engaged in operating electric power generation facilities (except hydroelectric, fossil fuel, nuclear). These facilities convert other forms of energy, such as solar, wind, or tidal power, into electrical energy.

   NAICS code 541711 includes establishments primarily engaged in conducting biotechnology research and experimental development. This involves the study of the use of microorganisms and cellular and biomolecular processes to develop or alter living or non-living materials. This biotechnology R&D may result in new biotechnology processes or in new or genetically-altered product prototypes that various industries may reproduce or utilize.

3. **Affiliates' purchases also qualify for the proposed exemption.** In addition to the entities described previously, these establishments' affiliate purchases qualify for the exemption.[8] As proposed, the law does not require that the affiliates be engaged in particular activities. Instead, their purchases of qualifying tangible personal property need only be for use in a manner described in the bill. For example, a television manufacturer's affiliate may be primarily engaged in recycling. All the affiliate's equipment purchases for recycling would qualify for the proposed exemption, even if they are unrelated to television manufacturing, i.e., the activity which makes both persons "qualified persons." This is true whether or not the manufacturer operates primarily outside this state. The original manufacturing exemption discussed previously did not have this provision. Potentially, this provision adds a new level of complexity for tax administration, and results in additional revenue losses not captured in this analysis.

4. **Partial exemptions complicate administration of the tax.** Currently, most sales and use tax exemptions apply to the total applicable sales and use tax. However, California law contains five partial exemptions, currently at a 5.5%[9] rate:

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[8] Those that are members of the entity's unitary group for which a combined report is required under RTC Article 1 (commencing with Section 25101) of Chapter 17 of Part 11 of the Corporation Tax Law.
[9] 3.9375% General Fund, 1.0625% Local Revenue Fund 2011, 0.25% Fiscal Recovery Fund, and 0.25% Education Protection Account.

(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 complicate retailers' return preparation and return processing. Return errors occur frequently with claimed partial exemptions. Accordingly, the BOE's return processing workload increases.

Also, this bill proposes a new 6.5% exemption rate. This requires a sales and use tax return revision with a new, separate return computation. If enacted, some retailers may be required to segregate the 6.5% exempt sales, the 5.50% exempt sales, fully exempted sales (e.g., a resale sale or interstate commerce sale), and fully taxable sales. This adds a new level of complexity, and potentially increases tax reporting errors. Accordingly, the BOE's tax administration functions and retailers' reporting obligations become more complicated.

5. **Technical suggested amendment.** The bill defines the types of property included and excluded from the proposed exemption, and includes items having a useful life of one or more years (or less than one year).[10] In order to minimize potential audit disputes, the bill should contain a mechanism for determining the useful life. The suggested amendment is shown on page 9.

6. **Related legislation.** Similar bills introduced this year include:

- **AB 486 (Mullin)** – provides manufacturers, software producers, biotechnology and life, engineering, and physical researchers and developers, and their affiliates, a 5.25% exemption for their qualifying tangible personal property purchases.
- **AB 1326 (Gorell)** – provides unmanned aerial vehicle manufacturers a state and local exemption for their qualifying tangible personal property purchases.
- **SB 235 (Wyland)** – provides manufacturers and their affiliates a 3.9375% exemption for their qualifying tangible personal property purchases.
- **SB 376 (Correa)** – beginning January 1, 2017 to January 1, 2022, provides manufacturers, software publishers, and their affiliates a 6.25% exemption for their qualifying tangible personal property purchases.
- **SB 412 (Knight)** – provides aerospace products and parts manufacturers a 3.9375% exemption for their qualifying tangible personal property purchases.

COST ESTIMATE

A cost estimate is pending to determine costs to program for the partial exemption, notify retailers, audit claimed exemptions, and answer taxpayers' and the general public's inquiries.

[10] Page 8, line 31, and page 10, line 14.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

NAICS codes 31-33 (Manufacturing). The United States Census Bureau's *Annual Survey of Manufacturers* (ASM) reports California manufacturing capital expenditures data (machines and equipment, buildings, fuels). In fiscal year (FY) 2010-11, California manufacturers' capital expenditures amounted to an estimated $11 billion. This bill does not exempt a manufacturer's fuel or R&D-related purchases.

NAICS code 5112 (Software Publishers). The Census Bureau's *Annual Capital Expenditures Survey* (ACES) reported U.S capital expenditures data (machines and equipment, buildings) for software publishers. For California expenditures, we looked at the 2007 *Economic Census* software publishers' data and estimated that the ratio of California to U.S revenue sales receipts for software publishers equals 28%. We applied the 28% to $5.1 billion U.S. capital expenditures (ACES). In FY 2010-11, California software publishers' capital expenditures amounted to an estimated $1.4 billion ($5.1 billion × 28% = $1.4 billion).

NAICS code 541711 (Biotechnology R&D). The Census Bureau's *Annual Capital Expenditures Survey* (ACES) reported U.S capital expenditures data for biotechnology R&D. For California expenditures, we looked at the 2007 *Economic Census* data and estimated that the ratio of California to U.S revenue sales receipts for these R&D entities equals 53%. We applied the 53% to $0.92 billion U.S. capital expenditures (ACES). We estimated that capital expenditures by California establishments primarily engaged in biotechnology research and experimental development amounted to $0.48 billion in FY 2010-11 (53% × $0.92 = $0.48 billion).

NAICS code 221119 (Other Electric Power Generation). The Census Bureau's *Annual Capital Expenditures Survey* (ACES) reported U.S capital expenditures data (machines and equipment, buildings) for other electric power generation. For California expenditures, we looked at the 2007 *Economic Census* other electric power generation data and estimated that the ratio of California to U.S revenue sales receipts for these entities equals 24%. We applied the 24% to $0.61 billion U.S. capital expenditures (ACES). We estimated that California capital expenditures by NAICS 221119 establishments amounted to $0.13 billion in FY 2010-11 (24% × $0.61 = $0.13 billion).

Pollution Control. The May 1, 2013 amendments exclude tangible personal property purchased for use in pollution control from the proposed exemption. Based on Census data, the manufacturing sector's spending on pollution control amounts to approximately 3% of total capital expenditures. Accordingly, capital expenditures related to pollution control amounts to:

FY 2013-14: $0.50 billion

FY 2014-15: $0.54 billion

FY 2015-16: $0.57 billion

Capital Expenditures. Based on the Census data, total capital expenditures in FY 2010-11 amounted to an estimated $13 billion (NAICS 31-33, $11 billion + NAICS 5112, $1.4 billion, NAICS 541711, $0.48 billion, NAICS 221119, $0.13 billion).

The partial exemption becomes operative January 1, 2014. To forecast expenditures from the 2010-11 data described previously, we used a national economic forecasting firm's (IHS Global Insight) most recent business equipment investment forecast. The estimated expenditures are as follows:

Capital Expenditures - California
(In billions)

	FY 2013-14	FY 2014-15	FY 2015-16
NAICS 31-33	$14.05	$15.08	$16.12
NAICS 5112	$1.80	$1.93	$2.06
NAICS 541711	$0.61	$0.65	$0.70
NAICS 221119	$0.17	$0.18	$0.19
	$16.63	$17.85	$19.07
Pollution Control	-0.50	-0.54	-0.57
	$16.13	$17.31	$18.50

REVENUE SUMMARY

The revenue loss from exempting from the sales and use tax qualifying tangible personal property purchased by establishments primarily engaged in lines of business described in the above-referenced NAICS codes amounts to:

Revenue Impact - Sales & Use Tax Loss
(In millions)

		FY 2013-14 **(6 month impact)**	FY 2014-15	FY 2015-16
State General Fund	3.94%	$319	$682	$730
Fiscal Recovery Fund	.25%	$20	$43	$46
State Education Protection	.25%	$20	$43	$46
Local Revenue Fund	.50%	$40	$87	$92
Local Public Safety Fund	.50%	$40	$87	$92
Local Revenue Fund 2011	1.06%	$85	$183	$196
Estimated SUT Loss	6.50%	$524	$1,125	$1,202

Qualifying Remarks. We do not have information related to the revenue loss associated with purchases by a qualified person's affiliated entities. Therefore, the revenue estimate is understated to the extent it does not account for any sale or use tax associated with these entities' qualifying purchases.

In addition, the revenue estimate is overstated to the extent that it does not account for manufacturing-related sales and use tax exclusions authorized by CAEATFA. The 2009 legislation has resulted in sales and use tax revenue losses of approximately $37 million in 2010, $4.7 million in 2011, and $8.7 million in 2012. We have no information on exclusions related to advanced manufacturing purchases authorized by the 2012 legislation. However, the law caps the allowable sales and use tax exclusions for both programs at $100 million annually.

This revenue estimate does not account for any changes in economic activity that may or may not result from enactment of the proposed law.

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STATE BOARD OF EQUALIZATION

PROPOSED AMENDMENTS TO AB 653

On page 10, add new paragraph (9) after line 24 as follows:

(9) “Useful life” for tangible personal property that is treated as having a useful life of one or more years for state income or franchise tax purposes shall be deemed to be one or more years for purposes of this section. “Useful life” for tangible personal property that is treated as having a useful life of less than one year for state income or franchise tax purposes shall be deemed to be less than one year for purposes of this section.