



**STATE BOARD OF EQUALIZATION  
STAFF LEGISLATIVE BILL ANALYSIS**

DRAFT

Date:	<b>02/22/13</b>	Bill No:	<b><a href="#">Assembly Bill 1326</a></b>
Tax Program:	<b>Sales and Use Tax</b>	Author:	<b>Gorell &amp; Bradford</b>
Sponsor:	<b>Authors</b>	Code Sections:	<b>RTC 6376.6</b>
Related Bills:	<b>AB 486 (Mullin) AB 653 (Perez, V.) AB 927 (Muratsuchi) SB 235 (Wyland) SB 376 (Correa) SB 412 (Knight)</b>	Effective Date:	<b>Upon enactment</b>

**BILL SUMMARY**

This bill provides unmanned aerial vehicle (UAVs) manufacturers a sales and use tax exemption on their purchases of qualifying tangible personal property, until January 1, 2024.

**ANALYSIS**

**CURRENT LAW**

Except where the law provides a specific exemption or exclusion, California’s Sales and Use Tax Law<sup>1</sup> 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.

Conversely, tax does not apply to sales of tangible personal property when the purchaser physically incorporates 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.

**PROPOSED LAW**

Beginning January 1, 2014, and before January 1, 2024, this bill provides a state and local sales and use tax exemption for a “qualified person’s” purchases of:

- Tangible personal property to be used 50% or more in UAV manufacturing,
- Tangible personal property purchased for use by a contractor, as specified, in the performance of a qualified person’s construction contract. The qualified person must use the property, however, as an integral part of any manufacturing process or as a facility for use in connection with the manufacturing process.

This bill defines “qualified person” as either:

<sup>1</sup> Part 1, Division 2 of the Revenue and Taxation Code (RTC) (commencing with Section 6001).

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- A person who manufactures UAVs and who is engaged in aircraft manufacturing described in the 2012 edition of North American Industry Classification System, Code 336411, or
- A qualified person's affiliate, if the affiliate is a member of that person's unitary group, as specified.

The bill defines "manufacturing," "primarily," and "process." The bill also specifies which tangible personal property the proposed exemption includes or excludes.

The proposed partial 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
- Any tangible personal property primarily used in administration, general management, or marketing.

## COMMENTS

1. **Sponsor and Purpose.** As sponsors, the authors note that the bill's tax incentives will attract manufacturing jobs to California in this rapidly growing industry, projected to experience a 700% growth in the next six years. They contend that the defense industry has been a huge "jobs incubator" in California, especially Southern California, and this measure will help these well-paying, high-tech manufacturing jobs to continue to grow in California.
2. **Code 336411 includes aircraft manufacturers.** Specifically, this code describes establishments primarily engaged in one or more of the following: (1) manufacturing or assembling complete aircraft; (2) developing and making aircraft prototypes; (3) aircraft conversion (i.e., major modifications to systems); and (4) complete aircraft overhaul and rebuilding (i.e., periodic restoration of aircraft to original design specifications). However, the proposed exemption is limited to purchases for UAV manufacturing by these establishments.
3. **What about ground control station manufacturing?** UAVs are aircraft piloted through ground control stations. The bill does not specify whether the proposed exemption additionally applies to qualifying tangible personal property purchased for use in ground control station manufacturing. Without such specificity, the exemption may not apply. This distinction is illustrated in the sales and use tax exemption for aircraft sold to foreign governments or non-California residents for use outside this state.<sup>2</sup> With respect to RTC Section 6366, a question arose whether ground control stations used to operate the exempt aircraft also qualified. The Legislature addressed this issue by specifically adding ground control stations to the exemption.<sup>3</sup> If the author intends to include ground control manufacturing, it is suggested that the bill so specify.

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<sup>2</sup> RTC 6366 of the Sales and Use Tax Law.

<sup>3</sup> SB 1101 (Stats. 1997, Ch. 733).

**4. Technical suggested amendments.**

- 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).<sup>4</sup> 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 6 as Amendment 1.
- The bill requires retailers to furnish the BOE with a copy of an UAV manufacturers' exemption certificate.<sup>5</sup> We suggest this requirement be deleted. Instead we suggest retailers retain a copy of each exemption certificate in his or her records and make it available to the BOE for examination upon request. The suggested amendment is shown on page 6 as Amendment 2.

**5. Related legislation.** Bills introduced this year that exempt manufacturing equipment purchases include:

- AB 486 (Mullin) – provides manufacturers, software producers, and their affiliates a 5.25% exemption for their qualifying tangible personal property purchases.
- AB 653 (V. Perez) – provides manufacturers, software publishers, biotechnology research entities, and renewable power generator facilities, and their affiliates a state and local exemption for their qualifying tangible personal property purchases.
- AB 927 (Muratsuchi) – provides manufacturers, software publishers, biotechnology research and development entities, and renewable power generation facilities, and their affiliated entities, 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, provides manufacturers, software publishers, and their affiliates a 6.5% exemption for their qualifying tangible personal property; provides an income tax credit for tax paid on similar purchases beginning January 1, 2014 through January 1, 2017.
- SB 412 (Knight) – provides aerospace products and parts manufacturers a 3.9375% exemption for their qualifying tangible personal property purchases.

**COST ESTIMATE**

An estimate is pending to determine costs to reprogram, notify retailers, audit claimed exemptions, and respond to inquiries from taxpayers and the general public.

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<sup>4</sup> Page 4, lines 4 and 20.

<sup>5</sup> Page 4, lines 27 through 34.

## REVENUE ESTIMATE

### BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

For purposes of this revenue estimate, we refer to “manufacturing of UAVs” as the aerospace industry. This bill defines the aerospace industry as North American Industry Classification System (NAICS) 336411. The U.S. Census Bureau’s *2007 Economic Census* shows capital equipment spending of \$117.3 million in California for this NAICS industry.<sup>6</sup> This is the latest California data available for this industry. Another Census survey shows California capital equipment spending for NAICS Industry 336, Transportation Equipment, for 2007 and 2011.<sup>7</sup> This is a much broader industry, as it includes cars as well as aerospace products. Since “Transportation Equipment” includes aerospace, we believe growth in aerospace can be approximated by growth in this industry. We used the California Census data in this industry to calculate a growth factor from 2007 to 2011. Applying this factor to the 2007 California aerospace industry data, we provided an estimate of 2011 California aerospace equipment purchases. We followed a similar procedure to forecast the 2011 estimate into the future. To do this, we used data from *Global Insight*, an economic forecasting firm, to calculate growth factors from 2011 to 2016. The specific *Global Insight* data we used was investment in aircraft, the industrial sector most closely related to aerospace.

California fuel purchases data in Industry 336411 is unavailable. Census data are available for total materials costs, which include fuels. In 2007 California total materials costs were \$2.567 billion for Industry 336411 in California.

National data for both fuel costs and total materials costs<sup>8</sup> are available from the U.S. Bureau of Economic Analysis (BEA) for Industry 336 for 2011. These national data show that fuel purchases were 0.15% of total material purchases. We assume this percentage is the same for Industry 336411 in both the U.S. and California. We also used *Global Insight* forecast data to project these costs into the future.

Using the discussed assumptions, we forecast fiscal year 2015-16 California equipment costs of \$201 million for Industry 336411. We forecast fuel costs of \$5 million.

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<sup>6</sup> U.S. Census Bureau, *2007 Economic Census*, “Manufacturing: Geographic Area Series: Industry Statistics for the States.”

<sup>7</sup> U.S. Census Bureau, *Annual Survey of Manufactures*.

<sup>8</sup> U.S. Bureau of Economic Analysis website, “1998-2011 KLEMS Intermediate Use Estimates: Detailed Estimates of Energy, Materials, and Purchased Services Used by Industries,” <http://www.bea.gov/industry/more.htm>.

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**REVENUE SUMMARY**

Based on the equipment and fuel costs discussed previously, Research staff estimates that the total revenue lost will be \$15.9 million in fiscal year 2014-15, the first complete year of the proposed exemption.

Revenue Source	Rates	(in millions)		
		Fiscal Year		
		2013-14	2014-15	2015-16
State General Fund	3.94%	3.3	7.5	8.1
State Education Protection	0.25%	0.2	0.5	0.5
Fiscal Recovery Fund	0.25%	0.2	0.5	0.5
Local Revenue Fund	0.50%	0.4	0.9	1.0
Public Safety Fund	0.50%	0.4	0.9	1.0
Local Revenue Fund 2011	1.06%	0.9	2.0	2.2
Bradley Burns (Local Tax)	1.00%	0.8	1.9	2.1
Special District Tax	0.88%	0.7	1.7	1.8
<b>Total State and Local Revenue Loss</b>	<b>8.38%</b>	<b>\$6.9</b>	<b>\$15.9</b>	<b>\$17.2</b>

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 1326

AMENDMENT 1

On page 4, line add new paragraph (6) after line 26 as follows:

(6) “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.

AMENDMENT 2

On page 4, line 30, after “retailer” substitute “retains the exemption certificate in its records and furnishes it to the board upon request” for “subsequently furnishes the board with a copy of the exemption certificate”