



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

DRAFT

Date:	03/20/14	Bill No:	<u>Assembly Bill 1891</u>
Tax Program:	Sales and Use	Author:	Donnelly
Sponsor:	Author	Code Sections:	RTC 6363.4
Related Bills:		Effective Date:	Operative on the first day of a calendar quarter commencing more than 90 days after enactment

BILL SUMMARY

Until January 1, 2025, this bill exempts from the state and local sales and use tax any purchases of equipment to be primarily used for water desalination.

ANALYSIS

CURRENT LAW

Except where the law provides a specific exemption or exclusion, California’s Sales and Use Tax Law¹ 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.

Under the Board of Equalization’s (BOE) Regulation 1521, *Contractors and Subcontractors*, the application of sales or use tax to contracts to improve real property, such as a contract to construct a water desalination facility, depends on whether or not the construction contractor is furnishing and installing materials (concrete, wiring, piping) or is furnishing and installing fixtures (hoists, transformers, lighting). If the latter, the contractor is generally the retailer of the fixtures; tax applies to such sales. Construction contractors are generally consumers of materials which they furnish and install in the performance of construction contracts. The taxable event is the sale to the contractor, with the supplier paying tax and collecting sales tax reimbursement or use tax from the contractor who then factors that cost into the contract price with regard to the materials purchased for the purpose of performing the contract.

For machinery and equipment, construction contractors are retailers and tax applies to the contractor's gross receipts from such sales.

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

¹ Part 1 of Division 2 (commencing with Section 6001) of the Revenue and Taxation Code (RTC).

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.

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	

PROPOSED LAW

Until January 1, 2025, this bill exempts from state and local sales and use tax any purchases of equipment to be primarily used for water desalination.

The bill defines “water desalination” as a process that removes salt and other minerals from saline water to produce fresh water suitable for human consumption or irrigation.

As a tax levy, the bill becomes effective immediately, but becomes operative on the first calendar quarter commencing more than 90 days after enactment.

COMMENTS

- 1. Sponsor and Purpose.** The author’s office has introduced this bill as part of the solution for California’s ongoing water woes. According to the author, costs associated with construction of a seawater desalination operation are significant, and a sales and use tax exemption for equipment used for desalination can reduce these costs from 7.5% to 10%, depending on the desalination plant’s location.
- 2. “Equipment” should be defined.** As drafted, the bill exempts purchases of any equipment to be primarily used for water desalination. It is recommended that the bill define the term “equipment,” consistent with the author’s intent. Desalination plants include a wide variety of construction materials and equipment that become component parts of the plant, such as pipes, screens, concrete, and pumps. The plants also include other materials used directly in the desalination process, such as chemicals, and equipment used in plant construction, for example, tools, drilling machines, and excavators. Is the intent to include all these items? This should be clarified.

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3. **“Primarily” should be defined.** The term “primarily” is defined elsewhere in law² to mean 50% or more of the time. It is recommended that this bill similarly define the term in order to avoid potential audit disputes.
4. **The bill should require the purchaser to use an exemption certificate.** When a purchasing contractor purchases tangible personal property that qualifies for the proposed exemption, the bill should specify that the contractor shall issue his or her supplier with an exemption certificate. A supplier’s good faith acceptance of the certificate relieves the seller from liability for the tax. If the purchaser uses the property in a manner not qualifying for the exemption, the purchaser becomes liable for the tax. Suggested amendments are shown on page 4.

COST ESTIMATE

The BOE will incur costs to notify retailers, audit claimed exemptions, and answer inquiries from taxpayers and the general public. A full cost estimate is pending.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

The 2007 Economic Census, Manufacturing Industry Series data, shows desalination machinery/equipment shipments valued at \$225 million. Using the most recent equipment investment forecast of *IHS Global Insight*, a national economic forecasting firm, we estimated desalination shipments to the U.S. are valued at \$263 million in 2015.

Using the percentage that California population represents to the total U.S. population as a basis, equipment shipments to California are therefore estimated to be \$32 million (12% × \$263 million = \$32 million).

REVENUE SUMMARY

The annual revenue loss from exempting desalination equipment from the sales and use tax is estimated to be \$2.7 million (\$32 million × 8.42% statewide rate = \$2.7 million).

Qualifying Remark. Industry research discusses capital costs or capital investments for desalination plants but we did not find any specific discussion or data related to equipment spending by desalination plants in California. We cannot base our revenue estimate on total capital costs of plants, as those costs include several other components unrelated to equipment.

The Census equipment shipment data reflects currently operating plants. Conversations with stakeholders indicate there are an estimated 17 brackish groundwater plants, including existing plant expansions proposed to start operations in future. An additional 15 ocean water plants are also under consideration. Our estimate of revenue impact is understated to the extent that our analysis does not factor in the proposed plants.

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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² RTC 6377.1(b)(3).

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SUGGESTED AMENDMENTS TO AB 1891

As Amended March 20, 2014

On line 10 of page 2 insert:

(c) An exemption shall not be allowed under this section unless the purchaser furnishes the retailer with an exemption certificate, completed in accordance with any instructions or regulations as the board may prescribe, and the retailer retains the exemption certificate in its records and furnishes it to the board upon request.

(d) This section shall remain in effect only until January 1, 2025, and as of that date is repealed, unless a later enacted statute, that is enacted before January 1, 2025, deletes or extends that date.