STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date:	**04/10/12**	Bill No:	**Assembly Bill 1911**
Tax Program:	**Sales and Use Tax**	Author:	**Donnelly**
Sponsor:	**Author**	Code Sections:	**RTC 6377.5**
Related Bills:	**AB 1972 (Huber) AB 2506 (Perez)**	Effective Date:	**Upon enactment, but operative 01/01/13**

BILL SUMMARY

This bill provides a state (3.9375% 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.

Summary of Amendments

Since the previous analysis, the bill was amended to add coauthors, and make non-substantive, technical changes.

ANALYSIS

CURRENT LAW

Under current law, business entities engaged in manufacturing 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.

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
3.9375%	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)
1.0625%	State (Local Revenue Fund 2011)	Counties to fund public safety programs (RTC Sections 6051.15 and 6201.15)
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)

Rate	Jurisdiction	Purpose/Authority
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 6377.5 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% for the following purchases made by a "qualified person:"

- Qualified 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.
- Qualified tangible personal property purchased for use by a contractor, as specified, for use in the performance of a construction contract for the qualified person who will use the qualified tangible personal 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 defines a "qualified person" as any person engaged in manufacturing activities, as described in the North American Industrial Classification System (NAICS) codes 3111 to 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," and "refining," are defined and the tangible personal property intended to be included or excluded from the proposed partial exemption are described.

The bill specifies that the proposed exemption would *not* include (1) consumables with a normal useful life of less than one year, except for fuels used in the manufacturing process, (2) furniture and inventory, (3) equipment used in the extraction process, or equipment used to store finished products that have completed the manufacturing process, and (4) any tangible personal property that is used primarily in administration, general management, or marketing.

The proposed exemption shall <u>not</u> apply to any taxes levied pursuant to Sections 6051.2 and 6201.2 (Local Revenue Fund), 6051.5 and 6201.5 (Fiscal Recovery Fund), 6051.15 and 6201.15 (Local Revenue Fund 2011) 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). The proposed exemption would also not apply to any taxes imposed pursuant to RTC Sections 6051.8 and 6201.8 (diesel fuel sales and use rate increase).[1]

[1] ABx8 6 (Stats. 2010, ch. 11), known as the "Fuel Tax Swap" added RTC Sections 6051.8 and 6201.8 to impose an additional state sales and use tax on the sale and purchase of diesel fuel. The Legislature,

This bill also provides the following Legislative intent:

> "Section 1. It is the intent of the Legislature to enact a competitive tax policy for manufacturers by providing for an exemption from state sales and use taxes for the sale of, or the storage, use or other consumption of, manufacturing equipment used in the manufacturing process."

As a tax levy, the bill would become effective immediately, but would become operative on January 1, 2013.

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 more than 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 two Legislative Sessions include the following:

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however, re-enacted these sections as part of AB 105 (Stats. 2011, ch. 6) in order to comply with the requirements of Proposition 26.

Bill No.	Session	Author	Proposed Exemption
AB 103	2011-12	Budget Committee	Qualifying tangible personal property used by entities engaged in manufacturing and software production. For new entities, the exemption rate would be 5% (General Fund only), and for existing entities, the exemption rate would be 1% (General Fund only). Exemption contingent upon the sale and use tax rate not falling below a specified rate.
AB 218	2011-12	Wieckowski	Qualifying tangible personal property used by persons engaged in manufacturing and software production. Dedicates the revenue generated from a proposed estate tax to supplant the reduction of General Fund revenue as a result of the sales and use tax exemption.
AB 303	2011-12	Knight	Reinstate the original exemption for qualifying tangible personal property by new trades or businesses engaged in manufacturing.
AB 979	2011-12	Silva	Qualifying tangible personal property by manufacturers and software publishers.
AB 1057	2011-12	Olsen	Qualifying tangible personal property purchased for use in manufacturing activities, research and development, and air pollution mitigation by manufacturers and affiliates. Exemption operative on January 1, 2014 and sunsets on January 1, 2020.
ABx1 40	2011-12	Allen	Qualifying tangible personal property used by manufacturers. For new manufacturers, the exemption rate would be 3.94% (General Fund only), and for existing manufacturers, the exemption rate would be 3% (General Fund only). Exemption would also apply to persons engaged in software production, biotechnology research and development, and renewable power generation facilities.
SB 116	2011-12	De Leon	Qualifying tangible personal property used by manufacturers. For new manufacturers, the exemption rate would be 3.94% (General Fund only), and for existing manufacturers, the exemption rate would be 1% (General Fund only). Exemption would also apply to persons engaged in software production, biotechnology research and development, and renewable power generation facilities.
SB 395	2011-12	Dutton	Qualifying tangible personal property by persons engaged in manufacturing and software production.
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.

Bill No.	Session	Author	Proposed Exemption
AB 2280	2009-10	Miller	Equipment purchased 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.

COMMENTS

1. **Sponsor and Purpose.** The author is sponsoring this bill in an effort to help facilitate manufacturing and job growth in California by giving manufacturers incentives to establish places of business in this state.

2. **The April 10, 2012** amendments add coauthors, and make non-substantive, technical changes.

3. **What types of entities are included in Codes 3111 to 3399 and 5112?** Codes 3111 to 3399 include all establishments primarily engaged in manufacturing activities. This includes manufacturers in the aerospace sector, food and beverage, tobacco, textiles and apparel, wood and paper products, pharmaceuticals, chemicals, fertilizers, plastics and rubber, paint and coatings, printing, glass, cement and concrete product, metal fabrication and machinery, transportation and related, and computer and electronic product, and miscellaneous manufacturing.

   Code 5112 is comprised of establishments primarily engaged in computer software publishing or publishing and reproduction. Software establishments carry out the functions necessary for producing and distributing computer software in tangible form on computer media, such as designing, providing documentation, assisting in installation, and providing support services to software purchasers. The software industry produces and distributes software in tangible form on computer media such as CD-ROMs and tapes, preloaded software included in the sale of new computers, and software distributed electronically over the Internet.

3. **Administrative and technical concerns:**

   - In defining “qualified person,” BOE recommends 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 previously administered the sales and use tax manufacturing equipment exemption.

   - 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 14 and 15, and lines 31 and 32, 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 (c) would require a purchaser to furnish an exemption certificate to the retailer and the retailer to subsequently furnish the BOE with a copy of the exemption certificate (this provision was in the former Section 6377). This provision will require the BOE to store copies of each exemption certificate taken by a retailer, which is a cumbersome process for BOE staff. To address this concern, staff suggests that the bill be amended to require the retailer to retain a copy of each exemption certificate and make it available to the BOE for examination upon request. Staff can assist the author's office in drafting this proposed amendment.

4. **The term "property" needs clarifying.** The term "property," which is used throughout proposed Section 6377.5, needs clarifying since, 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, electricity, or telecommunications signals, 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, excluding the production of electricity or the transmitting of telecommunications or other electromagnetic signals, then it may be asserted, unreasonable in the BOE's opinion, that it has left open the door to unintended arguments. To avoid any unintended consequences in administering the proposed exemption, we suggest that the term "property" be replaced with "tangible personal property," and that the following be specifically excluded: "the production of electricity or the transmitting of telecommunications or other electromagnetic signals."

   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 to the BOE, 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 (5.25%: General Fund (3.9375%), Fiscal Recovery Fund (0.25%), and Local Revenue Fund 2011 (1.0625%)) 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. Additionally, 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% exemption (General Fund only), which would create a new exemption category, 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% 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 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. **The former sales and use tax manufacturing exemption did not contain provisions related to a qualified person's affiliate.** This bill allows an affiliate to be considered a "qualified person" as long as the affiliate is included as a member of that qualified person's unitary group for which a combined report is required under Article 1 (commencing with Section 25101) of Chapter 17 of the R&TC. The purchase by an affiliate considered to be a "qualified person" of qualified tangible personal property primarily used (50 percent or more of the time) in a manufacturing or other qualified activity would be subject to the partial exemption. BOE staff notes that this provision was not included in the former sales and use tax exemption for manufacturing, which expired on December 31, 2003.

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

   - AB 1972 (Huber) would provide a sales and use tax exemption, beginning January 1, 2013 and before January 1, 2019, for purchases of qualifying tangible personal property by persons engaged in manufacturing, software production, biotechnology research and development, and renewable power generation facilities, as specified and defined.

   - AB 2506 (Perez), among its provisions, would provide a sales and use tax exemption, beginning January 1, 2013, for purchases of qualifying tangible personal property by persons engaged in manufacturing, software production, biotechnology research and development, and renewable power generation facilities, as specified and defined.

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 inquiries from the public and taxpayers. An estimate of these costs 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 Manufacturers* (ASM) reports NAICS 31-33 capital expenditures data (machine and equipment, buildings and other structures) for California. The most recent data is for 2010. In FY 2009-10, capital expenditures by California manufacturers amounted to an estimated $12.1 billion.

The U.S. Census Bureau's *Annual Capital Expenditures Survey* (ACES) reported NAICS 5112 capital expenditures data (machine and equipment, buildings). The most recent data is for 2010. In order to determine what the California qualifying expenditure would be, we looked at the 2007 *Economic Census* NAICS 5112 data and estimated that the ratio of California to U.S revenue or sales receipts for NAICS 5112 was 28 percent. We applied the 28 percent to U.S capital expenditures (ACES). In FY 2009-10, capital expenditures by California software publishers amounted to an estimated $1.4 billion.

This bill would become operative on or after January 1, 2013. Using the most recent forecast of business equipment investment of IHS Global Insight, a national economic forecasting firm, estimated expenditures are as follows:

NAICS 31-33 & NAICS 5112
Expenditures Estimate

	(in billions) FY 2012-13	(in billions) FY 2013-14
Manufacturing 31-33	$16.2	$17.6
Software 5112	$1.8	$2.0
	$18.0	$19.6

REVENUE SUMMARY

The revenue loss from exempting tangible personal property purchased by manufacturers and software publishers from the state sales and use tax (3.94%) amounts to:

Estimated State Sales & Use Tax Loss
(in millions)

	6 months 2013[2]	FY 2013-14
General Fund (3.94%)	$355	$770

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[2] Given that this bill is operative January 1, 2013, the estimated $355 million in state sales and use tax loss reflects the first six months for FY 2012-13.