STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date:	**02/23/12**	Bill No:	**Assembly Bill 1972**
Tax Program:	**Sales and Use Tax**	Author:	**Huber**
Sponsor:	**Author**	Code Sections:	**RTC 6377**
Related Bills:	**AB 1911 (Donnelly) AB 2506 (Perez)**	Effective Date:	**Upon enactment, but operative 01/01/13**

BILL SUMMARY

This bill provides, until January 1, 2019, a sales and use tax exemption 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.

ANALYSIS

CURRENT LAW

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

PROPOSED LAW

This bill would add RTC Section 6377 to the Sales and Use Tax Law to provide a sales and use tax exemption 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 tangible personal 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 qualified equipment.
- 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 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, software production activities as described in NAICS codes 5112, biotechnology research and development activities as described in NAICS code 541711, or renewable electric power generation activities as described in NAICS code 221119 of the 2007 edition of the NAICS, or an affiliate of a qualified person, as defined.

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

As a tax levy, the bill would become effective immediately, but would become operative on January 1, 2013. The bill's provisions would remain in effect until January 1, 2019, and as of that date are repealed.

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:

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.

Bill No.	Session	Author	Proposed Exemption
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.
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 encourage greater investment and economic development in the manufacturing, biotechnology, software, and clean energy industries.

2. **What types of entities are included in Codes 3111 to 3399, 5112, 221119, and 541711?** Codes 3111 to 3399 include all establishments primarily engaged in manufacturing activities. Manufacturing activities involve the mechanical, physical, or chemical transformation of materials, substances, or components into new products. The manufacturing sector includes entities in the aerospace sector, food, beverages, tobacco, textiles and apparel, wood and paper products, petroleum,

pharmaceuticals, chemicals, pesticides and fertilizers, plastics and rubber products, glass, cement and concrete, steel, metals, printing, 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.

Code 221119 consists of establishments primarily engaged in operating electric power generation facilities (except hydroelectric, fossil fuel, or nuclear) using renewable sources. These facilities convert other forms of energy, such as solar, wind, or tidal power, into electric energy. The electric energy produced by these establishments is provided to electric power transmission systems or to electric power distribution systems.

Code 541711 is comprised of establishments primarily engaged in conducting biotechnology research and experimental development. Biotechnology research and experimental development involves the study of the use of microorganisms and cellular and biomolecular processes to develop or alter living or non-living materials. This biotechnology research and development may result in development of new biotechnology processes or in prototypes of new or genetically-altered products that may be reproduced or utilized by various industries.

3. **Technical amendments.** Recommended technical corrections are provided as follows:

   - Amendments one and two would replace the term "property" with "tangible personal property." These amendments would clarify that a qualified person purchases tangible personal property to be used primarily in fabricating or altering of tangible personal property (and not "property") to make it work in a new or different manner.

4. **The production of electricity and the transmitting of telecommunications or other electromagnetic signals should be specifically excluded.** Traditionally, when the Legislature addressed the manufacturing of property, it means the traditional manufacturing of tangible personal property, not the generation of electricity or the transmission of telecommunications or electromagnetic 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, unreasonably 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 following be specifically excluded: the production of electricity; the transmitting of telecommunications or other electromagnetic signals; or the provision of services or utilities.

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 power producers, telecommunications companies, and public utilities 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. **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.

6. **Related legislation.** Similar bills have been introduced this year:
   - AB 1911 (Donnelly) would provide a partial (3.9375% General Fund only) sales and use tax exemption, beginning January 1, 2013, on tangible personal property purchased for use in manufacturing activities by manufacturers and software publishers and affiliates.
   - 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.

COST ESTIMATE

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 certificates, 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. The U.S. Census Bureau's *Annual Survey of Manufacturers* (ASM) reports NAICS 31-33 capital expenditures data (machine and equipment, buildings) 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.

Software Publishers NAICS 5112. The U.S. Census Bureau's *Annual Capital Expenditures Survey* (ACES) reported capital expenditures data (machine and equipment, buildings) for NAICS 5112. 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.

Biotechnology Research & Development NAICS 541711. Based on 2009 and 2010 ACES data and 2007 *Economic Census* data, capital expenditures by establishments in California primarily engaged in conducting biotechnology research and experimental development amounted to an estimated $455 million in FY 2009-10.

Renewable Electric Power Generation NAICS 221119. Based on 2009 and 2010 ACES data and 2007 *Economic Census* data, capital expenditures by establishments in California primarily engaged in operating electric power generation facilities using renewable sources amounted to an estimated $149 million in FY 2009-10.

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, 5112, 541711, and 221119
Expenditures Estimate
(*in millions*)

	FY 2012-13	**FY 2013-14**
NAICS 31-33	$16,188	$17,569
NAICS 5112	$1,822	$1,977
NAICS 541711	$608	$659
NAICS 221119	$199	$216
	$18,817	$20,421

REVENUE SUMMARY

The revenue loss from exempting tangible personal property purchased by businesses primarily engaged in manufacturing, software production, biotechnology research and development, and renewable power generation from the sales and use tax amounts to:

Estimated Sales and Use Tax Loss
(*in millions*)

	FY 2012-13[1]	FY 2013-14
State General Fund 3.94%	$371	$805
Fiscal Recovery Fund0.25%	$24	$51
Local Revenue Fund 0.50%	$47	$102
Local Public Safety Fund 0.50%	$47	$102
Bradley Burns 1.00%	$94	$204
Local Revenue Fund 2011 1.06%	$100	$216
Special Districts 0.87%	$82	$178
	$765	$1,658

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[1] Given that this bill is operative January 1, 2013, the estimated $765 million in sales and use tax loss reflects the first six months for FY 2012-13.

STATE BOARD OF EQUALIZATION

PROPOSED AMENDMENTS TO AB 1972 (as introduced 02/22/12)

AMENDMENT 1

On page 2, line 13, add "<u>tangible personal</u>" after "has altered" and before "property"

AMENDMENT 2

On page 3, line 14, add "<u>tangible personal</u>" after "components or" and before "property"