STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

DRAFT

Date Amended:	**04/14/09**	Bill No:	**AB 829**
Tax:	**Sales and Use**	Author:	**Caballero**
Related Bills:	**SB 699 (Alquist, et al.)**		

BILL SUMMARY

Beginning January 1, 2013, this bill would:

- Provide a state sales and use tax exemption at the 5% rate for tangible personal property purchased by a manufacturer or software publisher, or their affiliates, for use as specified, and tangible personal property purchased for use by a contractor for use in the performance of a construction contract for a manufacturer or software publisher, as specified.
- Provide a state sales and use tax exemption at the 6% rate for sustainable development equipment investments of tangible personal property purchased by a manufacturer or software publisher or their affiliates for use as specified.
- Provide a state sales and use tax exemption at the 6% rate for tangible personal property purchased for use primarily during the research and development (R&D) process on qualified research, as defined.

The bill would also provide a corresponding state income tax credit for sales tax reimbursement or use tax paid by qualifying purchasers on property proposed to be exempted between January 1, 2010 and January 1, 2013.

ANALYSIS

CURRENT LAW

Under current law, entities engaged in activities such as software publishing, manufacturing and R&D that purchase equipment and other 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 entities engaged in such activities.

The statewide sales and use tax rate (8.25%) imposed on taxable sales and purchases of tangible personal property is made up of the following components (additional district taxes are levied among various local jurisdictions and are not reflected in this chart):

Rate	Jurisdiction	R & T Code
4.75% 0.25% 1.00% 6.00%	State (General Fund)	6051, 6201, 6051.3, 6201.3 6051.7, 6201.7

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 Board's formal position.

Rate	Jurisdiction	R & T Code
0.25%	State (Fiscal Recovery Fund)	6051.5, 6201.5
0.50%	Local Revenue Fund	6051.2, 6201.2
0.50%	Local Public Safety Fund	§35 Art XIII St. Constitution
1.00%	Local (0.25% County transportation funds 0.75% City and county operations)	7203.1

PROPOSED LAW

Among other things, this bill would add Revenue and Taxation Code Section 6377 to the Sales and Use Tax Law to provide a partial exemption from the statewide sales and use tax rate operative January 1, 2013 as follows:

- At the 5% rate for tangible personal property purchased by persons engaged in those lines of business described in Codes 3111 to 3300 (manufacturing sector) or 5112 (software publishing) of the North American Industrial Classification System, or their affiliates, for use as specified, and tangible personal property purchased for use by a contractor for use in the performance of a construction contract for a manufacturer or software publisher, as specified.
- At the 6% rate for sustainable development equipment investments of tangible personal property purchased by a manufacturer or software publisher or their affiliates for use as specified.
- At the 6% rate for tangible personal property purchased for use primarily during the research and development (R&D) process on qualified research, as defined.

The bill would define “fabricating,” “manufacturing,” “primarily,” “process,” “qualified person,” “qualified research,” “refining,” “sustainable development equipment,” and would describe the tangible personal property intended to be included or excluded from the proposed partial exemption.

As a tax levy, the bill would become effective immediately upon enactment.

BACKGROUND

For a ten-year period ending December 31, 2003, the law provided a state 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 exemption for sales and purchases of qualifying property, and the income tax credit was equal to 6% 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. Certain special purpose buildings were included as "qualified property" as this bill proposes.

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 over 10,000), and therefore the MIC and partial sales tax exemption sunsetted at the end of 2003.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the California Manufacturers and Technology Association (CMTA). According to the author’s office, the bill is intended to create jobs, encourage investment, and to enable California to be at the forefront of research and development as well as manufacturing of new green technologies and climate change solutions.

2. **Partial exemptions complicate administration.** Currently, most sales and use tax exemptions apply to the total applicable sales and use tax. However, there are currently a few partial exemptions in California law, where only the state tax portion (6.25%) of the state and local sales and use tax rate is exempted, such as sales and purchases of teleproduction equipment and farm equipment. These partial exemptions are difficult for both retailers and the Board. They complicate return preparation and return processing. And, errors on returns attributable to these partial exemptions occur frequently, which result in additional return processing workload for the Board.

   This measure proposes a 5% and a 6% exemption, which would add two new exemption categories (since current law does not have any partial exemptions other than a 6.25% 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 5% exemption, 6% exemption, sales with a complete exemption (such as a sale for resale or a sale in interstate commerce), and sales that are fully taxable. This bill would add a new level of complexity, which would create a corresponding increase in errors in reporting the tax to the Board. This increase in errors would further complicate the Board’s administration of the sales and use tax law and complicate reporting obligations of retailers.

3. **The proposed exemption for property purchased for R & D is broad.** The bill would provide an exemption for virtually any qualifying purchases of tangible personal property used primarily during the R & D process. It does not limit the proposed exemption to R & D by manufacturers or software publishers, but rather, it would apply to virtually any purchase of tangible personal property that qualifies for an allowable deduction for income tax purposes by anyone performing the research. Therefore, property used in research projects in areas such as pharmaceuticals, nuclear science, biotechnology, within universities, and marketing would qualify for the proposed exemption.

4. **The definition of "qualified person" is broad.** The bill does not require that a qualified person be *primarily* engaged in manufacturing or software production. In other words, the bill does not address the issue of whether the person claiming the exemption must be *primarily* engaged in the required activities. This is an important issue and one that generated some dispute when the Board and the Franchise Tax Board administered a similar sales and use tax exemption/income tax credit for manufacturers previously. For example, a grocery store that has a bakery department may manufacture baked goods. If the ovens purchased in the bakery are used primarily in the manufacture of those baked goods, should the grocery store receive the benefit of the exemption for its purchase of the oven?

5. **What items have a "useful life" of more than a year and less than a year?** On page 5, lines 24 and 38, the taxability of certain purchases would be dependent upon the items' useful life. 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 or other suitable mechanism should be incorporated into the bill.

6. **Technical amendment.** On page 7, line 19; page 8, line 2; page 11, lines 15 and 37, "6351" should be replaced with "6001."

7. **Related measure.** SB 699 (Alquist, et al) has also been introduced to provide a similar partial exemption for these activities.

COST ESTIMATE

The Board would incur costs to administer this measure. Since the proposed partial exemptions would be operative January 1, 2013, some costs would likely be incurred in fiscal year beginning 2011 for purposes of preparing and adopting a regulation. Other costs attributable to, among other things, identifying and notifying qualifying entities, auditing claimed amounts, revising sales tax returns, reviewing returns with claimed exemptions, and programming would likely be incurred in fiscal year beginning in 2012. An estimate of these costs is pending.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

The *Annual Survey of Manufacturers 2006,* and *Annual Capital Expenditures 2007*, provided manufacturing expenditures for California adjusted for inflation those expenditures are recorded below:

	California Expenditures	Exemption Amounts		
Classification	Sector	Manufacturing Credit (5%)	Sustainable Development and R&D (6%)	
NAICS 3111-3399	Machinery and equipment	$ 11,999	$ 226	million
NAICS 3111-3399	Building & other structures[1]	1,222		million
NAICS 3111-3399	Fuel purchases	3,700		million
NAICS 5112	Software Publishers	743	14	million
	Subtotal	$ 17,664	$ 240	million
NAICS 5417	Research and Development		364	million
	Total expenditures	$ 17,664	$ 604	million

REVENUE SUMMARY

The annual revenue loss from exempting tangible personal property purchased by manufactures and software publishers from the state sales and use tax at the 5% rate amounts to $885 million ($17.7 billion x 5%).

The annual revenue loss from exempting tangible personal property purchased for sustainable development equipment and research and development from the state sales and use tax at the 6% rate amounts to $36 million ($604 million x 6%).

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[1] The building and other structures expenditure was $2.4 billion. We estimate that about half of the expenditures would amount to labor chargers for installation that is exempt from the tax.