STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	**02/23/07**	Bill No:	**AB 1206**
Tax:	**Sales and Use**	Author:	**Smyth**
Related Bills:	**AB 1152 (Niello)** **AB 1681 (Houston)** **SB 359 (Runner & Dutton)**		

BILL SUMMARY

This bill would provide a state sales and use tax exemption (5.25%) for purchases of machinery, equipment, and replacement parts used directly in research and development (R&D), as specified.

ANALYSIS

CURRENT LAW

Under current law, entities engaged in activities such as 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 (7.25%) 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
5.0%	State (General Fund)	6051, 6201, 6051.3, 6201.3
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

This bill would add Section 6377 to the Sales and Use Tax Law to provide a partial exemption (5.25%) from the statewide sales and use tax rate operative January 1, 2008 for machinery, equipment, and replacement parts used directly in R&D relating to inventions, products, or technologies that are exempt from sales and use taxes.

The bill would define “research and development” by reference to Section 41(d)(1) of the Internal Revenue Code

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

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the California Manufacturers and Technology Association (CMTA). It is intended to end the "double taxation" that R&D equipment is subject to now (taxing the equipment used to produce ideas that, in turn, lead to products that are once again taxed and sold). California's existing 15 percent R&D income tax credit applies only to labor costs and not machinery. CMTA believes the current policy is uncompetitive and needs to be altered to encourage future research in California.

2. **The language of the bill for the proposed exemption is confusing.** The language would require that the machinery and equipment that would qualify for the proposed exemption must be used directly in R&D relating to “inventions, products, or technologies that are exempt from sales and use taxes…”. This language is confusing. The sales and use tax law does not provide exemptions for inventions, products, or technologies. Instead, the law provides a variety of exemptions related to specific sales and purchases of tangible personal property, or sales by certain sellers or to certain purchasers. Staff will work with the author’s office in refining the language consistent with the author’s intent.

3. **Machinery and equipment should be clearly defined.** In order to avoid any uncertainty in determining the scope of the proposed exemption, it is recommended that the bill incorporate a definition of the machinery and equipment intended to be included. For example, would only those items for which a deduction for depreciation is allowed qualify? Would such items as supplies, hand tools, or data processing equipment qualify? Would component parts of a prototype qualify?

4. **What does “used directly” exactly mean**? To be exempt, the bill requires that the machinery and equipment be “used directly” in R&D. If an item is “used directly” in R&D activities, but only ten percent of the time (it’s used for other purposes for the remaining time), would that item qualify? Would a computer system, an air conditioner, telephone, or light fixture be regarded as “used directly” when the items are used solely by persons conducting the R&D? To avoid these uncertainties, and to minimize administrative issues, it is recommended that this be clarified in the bill.

5. **Technical issues.** Subdivision (g) of proposed Section 6377 (page 3, line 7) provides for an exemption from tax for specified leases of qualified property and limits this exemption for a six-year period. This limitation is modeled after a provision in former Section 6377 that provided a state tax exemption solely to new manufacturers’ leases of equipment. Since this bill would provide the exemption for all R&D, it appears the limitation in subdivision (g) is unnecessary and should be stricken. Otherwise, long-term leases of qualifying property would not enjoy the

same tax privileges that the bill would provide to actual purchases of the same property.

6. **Related measures.** Other measures that would provide a partial sales and use tax exemption for purchases of items used in R&D and other related activities include:

   - AB 1152 (Niello), which is also sponsored by the CMTA, would provide a 5.25% exemption for, among other things, purchases of special purpose buildings and foundations that constitute a research or storage facility used during the manufacturing process by persons engaged in manufacturing and software production, as specified and defined.
   - AB 1681 (Houston) would provide a 5.25% exemption for purchases of tangible personal property to be used primarily in, among other things, R&D, as defined, for use by qualified persons engaged in manufacturing, telecommunications, and electrical generation activities.
   - SB 359 (Runner and Dutton) would provide a 5.25% exemption for purchases of tangible personal property for use by qualified manufacturers or software producers, as defined, to be used primarily in R&D, and tangible personal property purchased for use by a contractor for subsequent resale to qualified persons for use in the performance of a construction contract of a research or storage facility for use in connection with the manufacturing process.

COST ESTIMATE

The Board would incur costs to administer this measure. These costs would be attributable to, among other things, identifying and notifying qualifying entities, auditing claimed amounts, revising sales tax returns, reviewing returns with claimed exemptions, and programming. An estimate of these costs is pending.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

This bill would provide a partial exemption (5.25%) from the statewide sales and use tax rate operative January 1, 2008 for machinery, equipment, and replacement parts used directly in R&D relating to inventions, products, or technologies that are exempt from sales and use tax.

As currently drafted, it is unclear exactly what sales of tangible personal property would be exempt and which establishments would qualify for the exemption. The NAICS code 5417 is the classification *Scientific Research & Development Services*. According to the Department of Commerce's Economic Census data, machinery and equipment expenditures for businesses coded 5417 is estimated to be $2.27 billion nationwide. If we assume that California represents 10% of this amount, expenditures by California firms would amount to $227 million annually.

REVENUE SUMMARY

The annual revenue loss to the state from exempting $227 million in expenditures by firms with NAICS code 5417, Scientific Research & Development Services, from the state sales and use tax (5.25%) is estimated to be $11.9 million.

Analysis prepared by:	Sheila T. Waters	(916) 445-6579	04/30/07
Revenue estimate by:	Dave Hayes	(916) 445-0840	
Contact:	Margaret S. Shedd	(916) 322-2376	

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