# STATE BOARD OF EQUALIZATION
# STAFF LEGISLATIVE BILL ANALYSIS

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| Date Amended: | **02/22/10** | | Bill No: | **AB 1719** |
| Tax: | **Sales and Use** | | Author: | **Harkey** |
| Related Bills: | **AB 810 Caballero)**<br>**AB 829 (Caballero)**<br>**AB 1812 (Silva)**<br>**AB 2280 (Miller)**<br>**AB 2640 (Arambula)** | **SB 699 (Alquist)**<br>**SB 1053 (Runner)**<br>**SBx6 8 (Dutton)**<br>**SBx8 44 (Dutton)** | | |

## BILL SUMMARY

This bill would reinstate the state sales and use tax exemption (General Fund only) for purchases of qualifying tangible personal property by new trades or businesses engaged in manufacturing.

## ANALYSIS

### CURRENT LAW

Under current law, business entities engaged in manufacturing that make purchases of equipment and supplies for use in the conduct of their manufacturing 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 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 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 |
|---|---|---|
| 5.00% | State (General Fund) | State general purposes (Revenue and Taxation Code (RTC) Sections 6051, 6051.3, 6201, and 6201.3) |
| 1.00% | State (General Fund) | State general purposes (RTC Sections 6051.7 and 6201.7, operative 4/1/09 through 6/30/11) |
| 0.25% | State (Fiscal Recovery Fund) | Repayment of the Economic Recovery Bonds (RTC Sections 6051.5 and 6201.5, operative 7/1/04) |
| 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)<br>0.75% City and County<br>0.25% County | City and county general operations (RTC Section 7203.1, operative 7/1/04);<br>Dedicated to county transportation purposes |
| 8.25% | Total Statewide Rate | |

*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.*

## PROPOSED LAW

This bill would add RTC Section 6377 to the Sales and Use Tax Law to provide a partial exemption (General Fund only) from the sales and use tax rate of 6% (5% on and after July 1, 2011) 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 property (i.e., machinery, equipment, parts, 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 qualifying equipment.
- Tangible personal property purchased for use by a contractor, as specified, for use in the performance of a construction contract for the qualified persons who will use the 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.

This bill would define "qualified person" as any new trade or business, as specified, engaged in manufacturing activities, as described in Codes 2011 to 3999, inclusive, in the 1987 Edition of the Standard Industrial Classification Manual (SIC). In addition, this bill would specify that a "qualified person" has not conducted business activities in a new trade or business for three or more years.

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

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

The proposed exemption shall <u>not</u> apply to any taxes levied pursuant to Sections 6501.2 and 6201.2 (Fiscal Recovery Fund), 6051.5 and 6201.5 (Local Revenue Fund), 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).

As a tax levy, the bill would become effective immediately upon enactment. The provisions of this bill would remain in effect until January 1, 2017, and as of that date be repealed.

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

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 1152 | 2007-08 | Niello | Qualifying tangible personal property by persons engaged in manufacturing and software production |
| AB 1206 | 2007-08 | Smyth | Machinery and equipment used in research and development activities |
| AB 1681 | 2007-08 | Houston | Qualified tangible personal property for use by qualified persons engaged in manufacturing, telecommunications, and electrical generation activities |
| AB 344 | 2005-06 | Villines | Qualifying tangible personal property by qualified persons primarily engaged in manufacturing, telecommunications and electrical generation activities. Would apply to 25% of the sales or purchases for 2006, 50% for 2007, and 100% thereafter. |
| AB 1580 | 2005-06 | Torrico | Qualifying tangible personal property by qualified persons primarily engaged manufacturing, construction contracting, software production, telecommunications, cable distribution, scientific research and development services, and wholesale distribution of recyclable materials |

| Bill No. | Session | Author | Proposed Exemption |
|---|---|---|---|
| SB 552 | 2005-06 | Alquist | Materials, supplies, machinery and equipment used by entities engaged in manufacturing, research and development, telecommunications, software production, and printing, and for semiconductor, biotechnology and pharmaceuticals clean rooms and equipment. Includes optional Bradley-Burns local and district tax exemption |
| SB 1291 | 2005-06 | Alquist | Materials, supplies, machinery and equipment used by entities engaged in manufacturing, research and development, software production, and newspaper printing, and for semiconductor, biotechnology and pharmaceutical clean rooms and equipment |

## COMMENTS

1. **Sponsor and purpose.** The author is sponsoring this bill in an effort to create jobs and encourage employers to invest in their businesses. According to the author, "Job creation is the main topic on everyone's mind right now. AB 1719 will give employers an incentive to buy new equipment so they can compete in the 21st century economy."

2. **Similar to previous manufacturing exemption, this proposed partial exemption would apply to new businesses only.** A "qualified person" would include a person that started a new trade or business (described in the SIC codes 2011 to 3999) in this state on or after the effective date of this bill. In addition, the proposed exemption would be available only during the first three years of the new business's existence.

3. **Administrative and technical concerns:**

   - Like the original Section 6377 exemption added in 1993, this bill references the SIC codes for purposes of qualifying entities. However, the North American Industry Classification System (NAICS) has replaced the SIC codes, and should be used to reference the manufacturing activities the author intends to be included within the scope of the exemption. It is our understanding that the author intends for the exemption to apply to the same manufacturing activities as provided in the original Section 6377 exemption. To convert the referenced SIC codes to NAICS, the following amendments are suggested:

     Subdivision (b)(6)(B): Engaged in those lines of business described in Codes ~~2011 to 3999~~3111 to 3399, inclusive, of the ~~Standard Industrial Classification Manual~~North American Industry Classification System published by the United States Office of Management and Budget, ~~1987~~2007 edition.

     Page 5, Line 6: strikeout "Standard Industrial Classification Manual" and insert "North American Industry Classification System"

     Page 5, Line 7: strikeout "1987" and insert "2007"

   - This bill as a tax levy would take effect immediately. However, subdivision (e)(2) provides that, beginning January 1, 2011, the proposed exemption would not apply to certain state and local taxes (Fiscal Recovery Fund, Local Revenue Fund and Local Public Safety Fund). By having this provision operative January 1, 2011, this partial exemption would apply to these taxes for the period when the bill takes effect through December 31, 2010 (the partial exemption for this period would be 7.25%). Then, starting January 1, 2011, the partial exemption would not apply (the partial exemption would be reduced from 7.25% to 6%). It is our understanding that the author intends for this partial exemption to apply to General Fund taxes only. In addition, the author's office has indicated that the proposed exemption be operative January 1, 2011. In order to accomplish the author's intent (partial exemption for General Fund taxes only with an operative date of January 1, 2011) the following amendments are suggested:

Page 2, Line 3: after "(a)" insert "On and after January 1, 2011,"

Page 7, Lines 11 and 12: strikeout "on or after January 1, 2011,"

- In defining "qualified person," it is recommended 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 Board administered Section 6377 previously. BOE staff is willing to work with the author's office in drafting amendments.
- Another issue is related to the proposed definitions for the types of property included or excluded from the proposed exemption. For example, on page 6, lines 3 and 17, 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 useful life. Perhaps some reference to the provision in the California income tax laws for depreciating assets should be incorporated into the bill. Staff is willing to work with the author's office to address this concern.
- Subparagraph (6)(A)(iii) of subdivision (b) appears to reference a date (December 31, 1993) from the former Section 6377 (which was effective October 6, 1993, but operative January 1, 1994). This subparagraph describes what constitutes a "new" business when a person's business activities are conducted wholly outside of California and that person first commences doing business within California. The December 31, 1993 date should be updated to coincide with the effective date of the bill:

  Page 5, Line 13: strikeout "December 31, 1993" and insert "December 31, 2010".

4. **Related Legislation.** Last year's AB 829 (Caballero) and SB 699 (Alquist) contained similar provisions that would have provided a partial sales and use tax exemption, beginning on January 1, 2013, on tangible personal property, including sustainable development equipment investments purchased by persons engaged in manufacturing, research and development, software publishing, and their affiliates, as specified. AB 829 died in the Assembly Appropriations Committee, while SB 699 died in the Senate Revenue and Taxation Committee.

   Similar bills have been introduced this year:

   - AB 810 (Caballero) is very similar to last year's AB 829 (Caballero).
   - AB 1812 (Silva) would provide a partial sales and use tax exemption (General Fund only), beginning on January 1, 2011, on tangible personal property purchased for use in manufacturing activities by manufacturers and software publishers and affiliates, as specified.

- AB 2280 (Miller) would provide a sales and use tax exemption on equipment purchased by any manufacturer for use in its manufacturing business in California.
- AB 2640 (Arambula) would provide a partial sales and use tax exemption (General Fund only) for purchases of depreciable manufacturing equipment purchased by a qualified purchaser, as defined, with a total claimed exemption cap of $450 million annually.
- SB 1053 (Runner) and SBx6 8 and SBx8 44 (Dutton) would provide a partial sales and use tax exemption (General Fund only) for tangible personal property used in manufacturing and qualified research and development activities by manufacturers and software publishers and affiliates, as specified.

## COST ESTIMATE

The Board would incur costs to administer this bill. 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

The 2008 Annual Survey of Manufactures, a Census publication, reported manufacturing expenditures or purchases for California; the amount subject to the proposed exemption was $22 billion. The following provides a breakdown of expenditures:

2008 *Annual Survey of Manufactures* (ASM)
California Expenditures
*(in billions)*

| Capital Expenditures* Structure (new & used) | Capital Expenditures Machine & Equipment (new & used) | Purchased Fuels | Total Expenditures |
|---|---|---|---|
| $1.6 | $15.6 | $4.8 | $22 |

We estimate total expenditures subject to the proposed exemption to be $19.6 billion in 2011 and $20.4 billion in 2012.

* Building and other structures expenditures were $3.2 billion. We assume that about half of the expenditures would amount to labor charges for installation that is exempt.

In addition, the proposed exemption would only apply to new businesses (in business for three years or less). To give us an idea only as to what the qualifying expenditure would be, we looked at recent Bureau of Labor Statistics (BLS) manufacturing data related to percentage of job gains from new establishments. It was estimated that the qualifying expenditure would amount to 0.3%. This would result in expenditures of about $59 million (0.3% × $19.6 billion = $59 million) in 2011 and $61 million (0.3% × $20.4 billion = $61 million) in 2012.

## REVENUE SUMMARY

This bill provides a state sales and use exemption (General Fund only). Effective April 1, 2009, the state sales and use tax rate was increased by 1%, from 5% to 6%, but will expire on June 30, 2011. With a proposed operative date of January 1, 2011, and a reduction in the tax rate effective July 1, 2011, the discussion below analyzes the revenue loss for fiscal years 2010-11 and 2011-12:

<u>FY 2010-11 (January through June 2011)</u>

- The revenue loss from exempting from the state sales and use tax qualifying tangible personal property purchased by new manufacturers at a rate of 6% amounts to $1.8 million ($59 million x 6%) × 50% = $1.8 million).

<u>FY 2011-12</u>

- The revenue loss from exempting from the state sales and use tax qualifying tangible personal property purchased by new manufacturers at a rate of 5% amounts to $3.1 million ($61 million x 5% = $ 3.1 million).

| | State (General Fund Only) Revenue Loss *(in millions)* |
|---|---|
| 2010-11 | $1.8 |
| 2011-12 | $3.1 |

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|---|---|---|---|
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