



**STATE BOARD OF EQUALIZATION  
STAFF LEGISLATIVE BILL ANALYSIS**

Date Introduced:	<b>02/18/10</b>	Bill No:	<a href="#"><u>AB 2280</u></a>
Tax:	<b>Sales and Use</b>	Author:	<b>Miller</b>
Related Bills:	<b>AB 810 Caballero)</b>	<b>SB 71 (Padilla)</b>	
	<b>AB 829 (Caballero)</b>	<b>SB 699 (Alquist)</b>	
	<b>AB 1719 (Harkey)</b>	<b>SB 1053 (Runner)</b>	
	<b>AB 1812 (Silva)</b>	<b>SBx6 8 (Dutton)</b>	
	<b>AB 2640 (Arambula)</b>	<b>SBx8 44 (Dutton)</b>	

**BILL SUMMARY**

This bill would provide a sales and use tax exemption for purchases of equipment by a manufacturer for use in its manufacturing business in this state.

**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):

<b>Rate</b>	<b>Jurisdiction</b>	<b>Purpose/Authority</b>
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)	City and county general operations (RTC Section 7203.1, operative 7/1/04);
	0.75% City and County	
	0.25% County	Dedicated to county transportation purposes
8.25%	Total Statewide Rate	

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**PROPOSED LAW**

This bill would add RTC Section 6377 to the Sales and Use Tax Law to provide a full sales and use tax exemption (8.25%, plus any applicable district taxes) for purchases of equipment by a manufacturer for use in its manufacturing business in this state.

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 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 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 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:

<b>Bill No.</b>	<b>Session</b>	<b>Author</b>	<b>Proposed Exemption</b>
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.

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Bill No.	Session	Author	Proposed Exemption
AB 1580	2005-06	Torrice	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
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

SB 71 (Ch. 10, Padilla) was signed by the Governor on March 24, 2010, and expands the range of projects which may be approved for a sales and use tax exclusion to include equipment used to manufacture products that produce energy from alternative sources such as solar, wind, and biomass. This bill allows the California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA) to authorize a state and local sales and use tax exclusion for tangible personal property utilized for the design, manufacture, production, or assembly of advanced transportation technologies or alternative source products, components, or systems. This sales and use tax exclusion would sunset on January 1, 2021.

## COMMENTS

1. **Sponsor and purpose.** The author is sponsoring this bill in an effort to stimulate job growth in California's manufacturing industry.
2. **"Manufacturer" should be defined.** Manufacturing can encompass many diverse activities, such as assembling of component parts to create a new product and manufacturing canned and pickled dried fruits and vegetables. The former manufacturing exemption (RTC Section 6377) defined such terms as fabricating, manufacturing, processing, and refining. In addition, the former Section 6377 defined manufacturers to be engaged in certain manufacturing lines of business described in the SIC codes, which have since been replaced with the North American Industry Classification System (NAICS) codes. The NAICS codes for the manufacturing sector is comprised of businesses engaged in the manufacturing of food products, beverages, tobacco, textiles, paper, printing, petroleum, pharmaceuticals, and more. Thus, to administer the proposed exemption effectively, BOE staff recommends defining the term "manufacturer." BOE staff will work with the author's office to address this concern as the bill progresses through the legislative process.
3. **What uses of "equipment" would qualify for the proposed exemption?** Would the equipment be limited to equipment used in the manufacturing process? The bill's provisions are not clear on this. What type of activities are including in the manufacturing process? Would the equipment need to be directly used in the manufacturing operation for the exemption to apply? Would the exemption apply

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only when the equipment purchased is used primarily or exclusively in the manufacturing process? The bill would need to define what percentage of use constitutes “primarily” or “exclusively” used. Would equipment used primarily in administration, management, or marketing qualify for the exemption? Would equipment used to clean and maintain a factory floor of a manufacturing facility be considered to be used in the manufacturing process? To effectively administer the proposed exemption, the bill needs to clarify what activities of a manufacturing business are qualifying activities. In addition, the bill should specify whether repair or replacement parts to repair or maintain equipment would qualify for the proposed exemption.

BOE staff is available to work with the author’s office to address these and other concerns that may be identified.

4. **Purchases of equipment by manufacturers would be fully exempt from the sales tax.** This bill would provide a full sales and use tax exemption for sales and purchases of equipment purchased by a manufacturer for use its manufacturing business. Manufacturers who qualify for the proposed exemption would not be required to pay the full statewide sales and use tax rate of 8.25 percent, plus any applicable district taxes on their purchases of equipment.
5. **A delayed operative date is recommended.** As a tax levy, the provisions of the bill would become effective immediately. However, since retailers generally rely on receiving the “official notice” of tax law changes from the BOE before implementing a law change, it is recommended that a delayed operative date be incorporated into the bill in order for the BOE to give proper advance notice. The following language is suggested to be added to proposed Section 3 of the bill:

*However, the provisions of this act shall become operative on the first day of the first calendar quarter commencing more than 90 days after the effective date of this act.*

6. **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 1719 (Harkey) would provide a partial sales and use tax exemption (General Fund only) for purchases of qualifying tangible personal property by new trades or businesses engaged in manufacturing, as specified.
- 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 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 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 add RTC Section 6377 to provide an exemption from the state and local sales and use tax for equipment purchased by a manufacturer for use in its manufacturing business in this state. Given that this bill does not provide any definitions, we make certain assumptions based on analyzing recent, similar bills:

- We assume that a *manufacturer* would be any business or entity that is primarily engaged in lines of business described in Codes 3111 to 3399 (manufacturing sector) of the North American Industry Classification System (NAICS).
- We assume that *equipment* refers to machine and equipment, building and structures and fuels purchased to be used or consumed in the manufacturing process.

**NAICS 3111 to 3399 (Manufacturing)**

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 is a breakdown expenditures:

Capital Expenditures NAICS 3111 to 3399 – California Estimate 2008  
(in billions)

Capital Expenditures <sup>1</sup> 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.

<sup>1</sup> Building and other structures expenditure was \$3.2 billion. We assume that about half of the expenditures would amount to labor chargers for installation that is exempt.

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**REVENUE SUMMARY**

This bill provides a state and local sales and use tax exemption. Effective April 1, 2009, the state sales and use tax rate was increased by 1%, from 5% to 6%. The 1% sales and use tax rate increase will expire on June 30, 2011; consequently, the state tax rate will revert to 5%. In estimating the revenue impact for FY 2010-11, an average sales and use tax rate of 9.1% is used that includes state sales and use tax rate of 6%. In estimating the revenue impact for FY 2011-12, an average sales and use tax rate of 8.1% is used that includes state sales and use tax rate of 5%. The following is a breakdown of the revenue loss:

FY 2010-11

- The revenue loss from exempting equipment purchased by manufacturers from the sales and use tax amounts to \$1,780.6 million (\$19,567 million x 9.1% = \$1,780.6 million).

FY 2011-12

- The revenue loss from exempting equipment purchased by manufacturers from the sales and use tax amounts to \$1,655.9 million (\$20,433 million x 8.1% = \$1,655.9 million).

Estimated Revenue Loss  
(in millions)

	FY 2010-11	FY 2011-12
State	\$1,174.0	\$1,022.2
Fiscal Recovery Fund (0.25%)	48.9	51.1
Local (2.00%)	391.4	408.8
Special District (0.85%)	166.3	173.8
Total Loss	\$1,780.6	\$1,655.9

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