STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended: 04/13/11  Bill No: Assembly Bill 1057
Tax Program: Sales and Use Tax  Author: Olsen
Sponsor: Author  Code Sections: RTC 6377.1
Related Bills: AB 204 (Halderman)  Effective Date: Upon enactment, but operative 01/01/14
AB 218 (Wieckowski)
AB 303 (Knight)
AB 979 (Silva)
SB 47 (Alquist)
SB 395 (Dutton)
SB 686 (Padilla)

BILL SUMMARY
This bill would provide, until January 1, 2020, a state (General Fund only) sales and use tax exemption for purchases of qualifying tangible personal property by persons engaged in manufacturing, as specified and defined.

ANALYSIS

CURRENT LAW
Under current law, business entities engaged in manufacturing and research and development activities that make purchases of equipment and supplies for use in the conduct of their manufacturing and related 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 and related activities.

Beginning July 1, 2011, 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):

<table>
<thead>
<tr>
<th>Rate</th>
<th>Jurisdiction</th>
<th>Purpose/Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.00%</td>
<td>State (General Fund)</td>
<td>State general purposes (Revenue and Taxation Code (RTC) Sections 6051, 6051.3, 6201, and 6201.3)</td>
</tr>
<tr>
<td>0.25%</td>
<td>State (Fiscal Recovery Fund)</td>
<td>Repayment of the Economic Recovery Bonds (RTC Sections 6051.5 and 6201.5, operative 7/1/04)</td>
</tr>
<tr>
<td>0.50%</td>
<td>State (Local Revenue Fund)</td>
<td>Local governments to fund health and welfare programs (RTC Sections 6051.2 and 6201.2)</td>
</tr>
<tr>
<td>0.50%</td>
<td>State (Local Public Safety Fund)</td>
<td>Local governments to fund public safety services (Section 35, Article XIII, State Constitution)</td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th>Rate</th>
<th>Jurisdiction</th>
<th>Purpose/Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.00%</td>
<td>Local (City/County)</td>
<td>City and county general operations (RTC Section 7203.1, operative 7/1/04); Dedicated to county transportation purposes</td>
</tr>
<tr>
<td>0.75%</td>
<td>City and County</td>
<td></td>
</tr>
<tr>
<td>0.25%</td>
<td>County</td>
<td></td>
</tr>
<tr>
<td>7.25%</td>
<td>Total Statewide Rate</td>
<td></td>
</tr>
</tbody>
</table>

The 1% General Fund tax under Sections 6051.7 and 6201.7 will expire on 6/30/11.

**PROPOSED LAW**

This bill would add RTC 6377.1 to the Sales and Use Tax Law to provide a partial exemption (General Fund only) from the sales and use tax rate of 5% (on and after July 1, 2011) for the following purchases made by a “qualified person”:

- Qualified 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 belts, shafts, computers, software, pollution control equipment, buildings and foundations), as specified.
- Qualified 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 qualified tangible personal property as an integral part of any manufacturing, processing, refining, fabricating, or recycling process or as a storage facility in connection with the manufacturing process.
- Qualified tangible personal property to be used 50 percent or more in research and development.
- Qualified tangible personal property to be used 50 percent or more to mitigate air pollution, as required by the Environmental Protection Agency and the State Air Resources Board.

The bill would define a “qualified person” as any person engaged in manufacturing activities, as described in the North American Industrial Classification System (NAICS) codes 3111 and 3399, or an affiliate of a qualified person, as defined.

“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 not 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 not 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).

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This bill also makes the following Legislative findings:

- California has the highest sales tax in the nation.
- California is one of only three states that tax the sale of equipment used in manufacturing.
- California has the fourth worst tax system for jobs in the entire country.
- California has the third highest unemployment rate in the country.

The bill would require the Legislative Analyst’s Office to complete and distribute a report to the Legislature on the effect of this exemption by January 1, 2019.

As a tax levy, the bill would become effective immediately, but would become operative on January 1, 2014. The bill’s provisions would remain in effect until January 1, 2020, 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 over 10,000), and therefore the MIC and partial sales tax exemption sunsetting 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 three Legislative Sessions include the following:

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<table>
<thead>
<tr>
<th>Bill No.</th>
<th>Session</th>
<th>Author</th>
<th>Proposed Exemption</th>
</tr>
</thead>
<tbody>
<tr>
<td>AB 810</td>
<td>2009-10</td>
<td>Caballero</td>
<td>Qualifying tangible personal property, including sustainable development equipment investments, by persons engaged in manufacturing, research and development, and software publishing</td>
</tr>
<tr>
<td>AB 829</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AB 1719</td>
<td>2009-10</td>
<td>Harkey</td>
<td>Reinstate the original exemption for qualifying tangible personal property by new trades or businesses engaged in manufacturing</td>
</tr>
<tr>
<td>AB 1812</td>
<td>2009-10</td>
<td>Silva</td>
<td>Qualified tangible personal property by persons engaged in manufacturing and software production</td>
</tr>
<tr>
<td>AB 2280</td>
<td>2009-10</td>
<td>Miller</td>
<td>Equipment by manufacturers engaged in manufacturing activities</td>
</tr>
<tr>
<td>SB 1053</td>
<td>2009-10</td>
<td>Runner</td>
<td>Qualifying tangible personal property by persons engaged in manufacturing and software publishing and their affiliates</td>
</tr>
<tr>
<td>SBx6 18</td>
<td>2009-10</td>
<td>Steinberg &amp; Alquist</td>
<td>Qualifying tangible personal property by persons engaged in specific manufacturing and software production activities</td>
</tr>
<tr>
<td>SBx6 8</td>
<td>2009-10</td>
<td>Dutton</td>
<td>Qualifying tangible personal property by manufacturers and software publishers and affiliates engaged in manufacturing activities or research and development</td>
</tr>
<tr>
<td>SBx6 44</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AB 1152</td>
<td>2007-08</td>
<td>Niello</td>
<td>Qualifying tangible personal property by persons engaged in manufacturing and software production</td>
</tr>
<tr>
<td>AB 1206</td>
<td>2007-08</td>
<td>Smyth</td>
<td>Machinery and equipment used in research and development activities</td>
</tr>
<tr>
<td>AB 1681</td>
<td>2007-08</td>
<td>Houston</td>
<td>Qualified tangible personal property for use by qualified persons engaged in manufacturing, telecommunications, and electrical generation activities</td>
</tr>
<tr>
<td>AB 344</td>
<td>2005-06</td>
<td>Villines</td>
<td>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.</td>
</tr>
<tr>
<td>AB 1580</td>
<td>2005-06</td>
<td>Torrico</td>
<td>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</td>
</tr>
<tr>
<td>SB 552</td>
<td>2005-06</td>
<td>Alquist</td>
<td>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</td>
</tr>
<tr>
<td>SB 1291</td>
<td>2005-06</td>
<td>Alquist</td>
<td>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</td>
</tr>
</tbody>
</table>

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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’s office, “Enacting AB 1057 will lower the cost of doing business in California for manufacturers and will allow them to be more competitive nationally. Improving California’s business climate will incentivize manufacturers to relocate to, or expand in our state and will create more jobs for Californians. AB 1057 will also help reduce costs that are currently passed on to consumers.”

In addition, a report prepared by the Milken Institute in June 2002, *Economic Impact Of A Sales Tax Reduction On Manufacturing Equipment*, examined the impact of a sales tax reduction of 5 percent on the purchases of manufacturing and telecommunications equipment. [http://www.milkeninstitute.org/pdf/CMTA-Rev.pdf](http://www.milkeninstitute.org/pdf/CMTA-Rev.pdf). The findings indicated that enacting a 5 percent sales tax reduction would lead to higher capital formation, promote greater job and income growth, and after an initial loss, ultimately increase tax receipts in California.

2. **What types of entities do Codes 3111 to 3399 include?** 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, clothing, textiles, wood products, petroleum, chemicals, pesticides and fertilizers, pharmaceuticals, plastics and rubber products, glass, cement and concrete, steel, metals, printing, and more.

3. **Administrative and technical concerns:**

   - 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 BOE administered the sales and use tax manufacturing equipment exemption previously.

   - Another issue relates to the proposed definitions for the types of property included and excluded from the proposed exemption. For example, on page 4, lines 27 and 28, and page 5, lines 4 and 5, 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 the useful life. Perhaps some reference to the provision in the California income tax laws for depreciating assets should be incorporated into the bill.

   - Subdivision (g) of proposed Section 6377.1 (page 6, lines 14 to 24) 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 partial tax exemption solely to new manufacturers’ leases of equipment. Further, this partial exemption was available only during the first three years of operations. Since this bill would provide the exemption for all qualifying persons (would not be limited to new businesses...
during the first three years of operation), the limitation in subdivision (g) is unnecessary and should be stricken.

- Subdivision (c) would require a purchaser to furnish an exemption certificate to the retailer and the retailer to subsequently furnish the BOE with a copy of the exemption certificate (this provision was in the former Section 6377). This provision will require the BOE to store copies of each exemption certificate taken by a retailer, which is a cumbersome process for BOE staff. To address this concern, staff suggests that the bill be amended to require the retailer to retain a copy of each exemption certificate and make it available to the BOE for examination upon request. Staff will assist the author's office in drafting this proposed amendment.

4. **The term “property” needs clarifying.** The term “property,” which is used throughout proposed Section 6377.1, needs clarifying. As currently drafted, the bill would exempt sales of tangible personal property purchased by a qualified person for use in the manufacturing, fabrication, processing, etc., of “property.” Traditionally, when the Legislature addresses the manufacturing of property, it means the traditional manufacturing of tangible personal property, not the creation of intangibles 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, then it may be asserted that it has left open the door to unintended arguments that it includes the creation of intangible property or the provision of services and utilities. To avoid any unintended consequences in administering the proposed exemption, we suggest that the term “property” be replaced with “tangible personal property.”

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 services, utilities, and intangibles, 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, clarification now would help preclude unanticipated future issues and problems.

5. **Partial exemptions complicate administration of the tax.** Currently, most sales and use tax exemptions apply to the total applicable sales and use tax. However, there are currently five partial exemptions in California law, where only the state tax portion (6.25% (5.25% beginning July 1, 2011): General Fund (6%) and Fiscal Recovery Fund (0.25%)) of the state and local sales and use tax rate is exempted. These five partial tax exemptions include: (1) farm equipment and machinery, (2) diesel fuel used for farming and food processing, (3) teleproduction and postproduction equipment, (4) timber harvesting equipment and machinery, and (5) racehorse breeding stock. These partial tax exemptions are difficult for both retailers and the BOE. 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 BOE.

This measure proposes a 5% exemption (General Fund only), which would create a new exemption category (since current law does not have any partial exemptions other than a 6.25% exemption, which effective July 1, 2011 is reduced to 5.25%). 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

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records sales subject to the 5% exemption (proposed by this bill), 5.25% exemption, sales with a full 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 BOE. This increase in errors would further complicate the BOE’s administration of the sales and use tax law and complicate reporting obligations of retailers.

6. Related legislation. Similar bills have been introduced this year:

- AB 204 (Halderman) would provide a partial (General Fund and Fiscal Recovery Fund) sales and use tax exemption for purchases of equipment by a biomass energy facility, as defined, for use in its biomass energy production activities.

- AB 218 (Wieckowski), among its provisions, would provide a partial (General Fund only) sales and use tax exemption for purchases of certain tangible personal property by qualified persons engaged in manufacturing and software production, as specified and defined. This bill would intend to use revenue generated from the estate tax, which this bill would create, to supplant the reduction of General Fund revenue as a result of the exemption. Its enactment, however, would require voter approval at the next statewide General Election.

- AB 303 (Knight) would reinstate the partial (General Fund only) sales and use tax exemption for purchases of qualifying tangible personal property by new trades or businesses engaged in manufacturing.

- AB 979 (Silva) would provide a partial (General Fund only) sales and use tax exemption, beginning January 1, 2012, on tangible personal property purchased for use in manufacturing activities and software production by manufacturers and affiliates.

- SB 47 (Alquist) would provide a partial (General Fund and Fiscal Recovery Fund) sales and use tax exemption for purchases of qualifying tangible personal property used by entities engaged in manufacturing, research and development, newspaper printing, and software production, and for semiconductor, biotechnology and pharmaceutical clean rooms and equipment.

- SB 395 (Dutton) would provide a partial (General Fund only) sales and use tax exemption, until January 1, 2019, on tangible personal property purchased for use in manufacturing activities by manufacturers and software publishers and affiliates.

- SB 686 (Padilla) would provide a full sales and use tax exemption, beginning January 1, 2012, on tangible personal property purchased for use in biotechnology manufacturing and research and development activities.

COST ESTIMATE

Because of the new partial exemption, 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 certificate, audit claimed exemptions, and answer inquiries from the public and taxpayers. An estimate of these costs is pending.

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REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

The U.S. Census Bureau’s Annual Survey of Manufactures (ASM) reports NAICS 31-33 capital expenditures data (machine and equipment, buildings and structures, fuels) for California. In FY 2008-09 (most recent), capital expenditures by California manufacturers amounted to an estimated $18.5 billion.

This bill would become operative on or after January 1, 2014. Using the most recent forecast of business equipment investment of IHS Global Insight, a national economic forecasting firm, we estimated that capital expenditures in FY 2013-14 would be $27.1 billion and $28.7 billion in FY 2014-15.

REVENUE SUMMARY

The revenue impact from exempting tangible personal property purchased by manufacturers (NAICS 31-33) from the state sales and use tax (5%) amounts to:

<table>
<thead>
<tr>
<th>General Fund Revenue Loss</th>
<th>(In billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1st 6 months of 2014</td>
</tr>
<tr>
<td>General Fund (5%)</td>
<td>$0.7$</td>
</tr>
</tbody>
</table>

1 Given that this bill is operative January 1, 2014, the estimated $0.7 billion in state (General Fund only) sales and use tax loss reflects six months of FY 2013-14.

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