DRAFT

STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date:	**05/19/14**	Bill No:	**Senate Bill 998**
Tax Program:	**Sales and Use Tax**	Author:	**Knight**
Sponsor:	**Author**	Code Sections:	**RTC 6377.1**
Related Bills:	**AB 1997 (Gorell)**	Effective Date:	**Upon enactment**

BILL SUMMARY

Among other things, this bill increases the $200 million limit to $300 million for a three year period beginning January 1, 2015, for new aerospace projects, as defined, for purposes of the annual exemption threshold for the 4.1875% partial sales and use tax exemption related to specified manufacturing and research and development purchases.

Summary of Amendments

Since the previous analysis, this bill, among other things, increases the limit related to the allowable exemption to $300 million in qualifying purchases each calendar year for "new aerospace projects," and requires the Board of Equalization (BOE) to report the purchase amounts to the Legislature.

ANALYSIS

CURRENT LAW

Except where the law provides a specific exemption or exclusion, California's Sales and Use Tax Law[1] imposes the sales tax on all retailers for the privilege of selling tangible personal property at retail in this state or the use tax on the storage, use, or other consumption in this state of tangible personal property purchased from a retailer.

Beginning July 1, 2014, and until July 1, 2022, existing law[2] provides manufacturers, and certain other qualified persons, a partial state sales and use tax exemption for their qualifying tangible personal property purchases. The exemption rate through December 31, 2016 is 4.1875%; and is reduced to 3.9375% beginning January 1, 2017. Currently, the exemption consists of two components of the overall statewide sales and use tax rate of 7.5%. This includes the 3.9375% state General Fund rate, and the 0.25% state Education Protection Account rate (this component expires January 1, 2017).

This provision limits the allowable exemption to $200 million in qualifying purchases each calendar year by each qualified person or by all qualified persons required or authorized to be included in a combined report under the Corporation Tax Law.[3]

This partial sales and use tax exemption applies to a "qualified person's" purchases of qualified tangible personal property:

- To be used primarily in manufacturing, processing, refining, fabricating, or recycling of property (i.e., machinery, equipment, parts, belts, shafts, computers, software,

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[1] Part 1 (commencing with Section 6001) of Division 2 of the Revenue and Taxation Code (RTC).
[2] RTC Section 6377.1.
[3] RTC Section 25101 or 25101.15.

pollution control equipment, buildings and foundations), as specified.

- To be used primarily to maintain, repair, measure, or test any qualified tangible personal property.
- Purchased by a contractor, as specified, for use in the performance of a qualified person's construction contract. The qualified person must use the property, however, 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.
- To be used primarily in research and development.

The law excludes from the "qualified person" definition, an apportioning trade or business that is required to apportion its business income pursuant to specified provisions, or a trade or business that would be required to apportion business income under those provisions if it apportioned its income. This includes, among other things, business activity relating to the production, refining, or processing of oil, natural gas, or mineral ore and specified agricultural activities.

This partial sales and use tax exemption excludes:

- Consumables with less than a one year useful life,
- Furniture, inventory, equipment used in the extraction process or equipment used to store finished products that have completed the manufacturing process, and
- Tangible personal property primarily used in administration, general management, or marketing.

California's sales and use tax rates. California imposes a statewide 7.5% sales and use tax on tangible personal property sales and purchases. The table below shows California's various sales and use tax rate components (the table excludes voter-approved city and county district taxes):

Rate	Jurisdiction	Purpose/Authority
3.9375%	State (General Fund)	State general purposes (Revenue and Taxation Code (RTC) Sections 6051, 6051.3, 6201, and 6201.3)
1.0625%	Local Revenue Fund 2011	Realignment of local public safety services (RTC Sections 6051.15 and 6201.15)
0.25%	State (Fiscal Recovery Fund)	Repayment of the Economic Recovery Bonds (RTC Sections 6051.5 and 6201.5)
0.25%	State (Education Protection Account)	Schools and community college funding (Section 36, Article XIII, State Constitution) (until 01/01/17)
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) 0.75% City and County 0.25% County	City and county general operations (RTC Section 7203.1, operative 7/1/04); Dedicated to county transportation purposes
7.50%	Total Statewide Rate	

PROPOSED LAW

Among other things, this bill specifies that manufacturing and research and development equipment purchased for use in a new aerospace project, as defined, shall not exceed $300 million each calendar year for purposes of the partial exemption. This provision applies for a three-year period, beginning January 1, 2015, and ending January 1, 2018.

The bill defines "new aerospace project" to mean the manufacturing, design, or testing of aircraft, aircraft engine, guided missiles, space vehicles, propulsion units, or related parts or components by the qualified taxpayer, pursuant to a contractual agreement between the qualified taxpayer and a purchaser, that commences in this state on or after January 1, 2015, and has not commenced outside of this state prior to that date.

The bill also requires the BOE to report to the Legislature on January 1, 2017 on the amount of manufacturing equipment purchased for new aerospace projects.

The bill becomes effective immediately upon enactment.

BACKGROUND

In 2013, the Governor approved an economic development plan that made various changes in the state tax system.[4] The statutory changes were related to the Governor's Budget to address budgetary aspects of one of the state's largest and fastest growing tax expenditure programs, and provide additional tax incentive programs to encourage economic development. The 4.1875% sales and use tax exemption that applies to manufacturers was created under that plan.

Also during the 2013 Legislative Session, and prior to this plans' enactment, AB 1326 (Gorell and Bradford) was introduced to provide unmanned aerial vehicle manufacturers a full sales and use tax exemption on their qualifying tangible personal property purchases, until January 1, 2024. The Assembly Appropriations Committee held the bill.

COMMENTS

1. **Sponsor and Purpose.** As sponsor, the author notes, "SB 998 helps to position California as an attractive state to expand upon new aerospace manufacturing and create thousands of jobs in this era of high unemployment. Beyond helping the businesses that may be awarded new DOD contracts, the multiplier effect to hundreds of small suppliers in this state is a win-win for all Senate and Assembly districts across California."

2. **The May 19, 2014 amendments** (1) increase from $200 million to $300 million each calendar year, the allowable qualified purchases for new aerospace projects for purposes of the partial sales and use tax exemption for manufacturing and research and development, (2) require the BOE to prepare a report identifying the amount of these qualifying purchases, and (3) remove the income tax provisions previously contained in the bill, and incorporate the "new aerospace project" definition in the sales and use tax provision.

3. **Report requires additional reporting by affected manufacturers.** In order to prepare the required report, the BOE must rely on manufacturers to segregate in their records, and report to the BOE, their equipment and other qualifying tangible personal property purchases for use in the manufacture of an item for a "new

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[4] AB 93 (Ch. 69, Stats. of 2013) and SB 90 (Ch. 70, Stats. of 2013).

aerospace project." For example, a "new aerospace project" includes such things as an aircraft's component parts. When a bolt manufacturer purchases equipment to make bolts that become an aircraft engine's component part, the bolt manufacturer must separately account for, and report to the BOE, the bolt manufacturing equipment's purchase price. Under the bill, to complete the report, the BOE must rely on all the various manufacturers to voluntarily report their equipment purchases that are used to manufacture, design, or test aircraft, aircraft engine, guided missiles, space vehicles, propulsion units, or related parts or components. This type of reported data could be unreliable, because there's no economic incentive to accurately report such purchases.

4. **The increased limit would not materially affect the BOE's operations.** The increase in the $200 million limitation does not add complexity to the BOE's administration of the partial sales and use tax exemption.
5. **Related legislation.** AB 1997 (Gorell) provides a full sales and use tax exemption (rather than the current 4.1875%) for qualifying tangible personal property purchases by manufacturers of unmanned aerial vehicles.

COST ESTIMATE

We anticipate non-absorbable costs to notify affected manufacturers, programming costs to summarize data and prepare the report, audit claimed exemptions, and respond to inquiries from taxpayers and the general public. A detailed cost estimate is pending, however, at a minimum, we expect one-time programming costs between $100,000 to $200,000.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

Only a few very large companies would have the financial resources to spend over $200 million per year in qualifying purchases. Our analysis of SB 90 (Ch. 70, Stats. 2013), which enacted this exemption, estimated qualifying capital spending of about $16.26 billion in fiscal year 2015-16, and an associated revenue loss of $681 million. According to the Department of Finance, about 22% of these revenues are attributable to a small number of companies making capital spending investments of $200 million or more.[5] Applying 22% of $16.26 billion implies capital spending of about $3.58 billion. If all excluded companies were to spend $200 million each, this would imply that no more than 18 companies would account for spending over $200 million.

Data from the U.S. Census Bureau, *County Business Patterns,* indicates that there were four aircraft manufacturing companies in California in 2011 with more than 1,000 employees.[6] Our analysis of average capital spending by industry suggests that a company would need to be of at least this size to be able to spend $200 million on equipment.[7] If all four aerospace companies with more than 1,000 employees were to spend more than $200 million each on capital equipment per year, the implied revenue loss would be about $34 million (0.041875 x 4 x 200 = $33.5 million). We have no data that indicates to what extent the annual qualifying purchases fall within the $200 million to $300 million range.

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[5] Source: http://www.leginfo.ca.gov/pub/13-14/bill/asm/ab_0051-0100/ab_93_cfa_20130625_215551_sen_floor.html
[6] Source: http://www.census.gov/econ/cbp/
[7] Source: http://www.boe.ca.gov/news/pdf/ep414.pdf

REVENUE SUMMARY

We are unable to determine how many companies plan to spend more than $200 million but less than $300 million on qualified capital investment or how much they plan to spend. The annual revenue loss resulting from increasing the $200 million limit to $300 million for new aerospace projects as defined in this bill is likely to be no more than $34 million.

This revenue estimate does not account for any changes in economic activity that may or may not result from enactment of the proposed law.

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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 BOE's formal position.