AB 398 Expands California's Partial Sales and Use Tax Exemption

Overview

On July 25, 2017, California Governor Jerry Brown signed Assembly Bill ("AB") 398.[1] While the centerpiece of the legislation was to extend California's cap-and-trade emissions control program through 2030, it also expands California's partial sales and use tax exemption (unchanged at 3.9375% resulting in taxation at a rate of 3.3125% plus applicable district taxes) currently available for manufacturing and research and development to include, with some limitations, electric power generation and agricultural businesses, effective January 1, 2018.

AB 398 also extends the sunset date of the partial sales and use tax exemption for all qualified taxpayers through June 30, 2030 (previously set to expire in 2022) and adds clarifying language to the definition of "useful life."[2]

This Tax Alert summarizes the elements of AB 398 affecting the partial sales and use tax exemption as well as provides some taxpayer considerations.

Extension of eligibility for exemption to electric power industry

In general, the partial sales and use tax exemption applies to purchases of "qualified tangible personal property" made by a "qualified person."[3] Prior to the enactment of AB 398, a "qualified person" was limited to companies operating in the manufacturing sector, and/or performing certain scientific research and development activities as described in Codes 3111 to 3399, inclusive, 541711 or, 541712 of the North American Industry Classification System ("NAICS").[4] Further, "qualified tangible personal property" was limited to machinery and equipment and certain other items of tangible personal property purchased by a qualified person for use "primarily" (meaning 50% or more of the time) in any stage of manufacturing or research and development or used primarily to maintain, repair, measure, or test property used in manufacturing or research and development.[5]

Effective January 1, 2018, the definition of "qualified person" is amended to include a person that is primarily engaged in those lines of business described in Codes 22111 to 221118, inclusive, and 221122, of the NAICS.[6]

The additional NAICS Codes 22111- 221118 contain both conventional and renewable electric power generation facilities, including power from hydroelectric, fossil fuels, nuclear, solar and wind. AB 398, however, appears to exclude power generation from fossil fuels other than cogeneration facilities when it limits the definition of the phrase "generation and production" to mean "the activity of making, producing, creating, or converting electric power from sources *other than a conventional power source*, as defined in

[1] AB 398, 2017-2018 Reg. Sess. (Cal. 2017), available here.
[2] AB 398, 2017-2018 Reg. Sess. (Cal. 2017), Section 16, modifying Cal. Rev. & Tax Code §§ 6377.1(a) and (b)(13)(A).
[3] Cal. Rev. & Tax Code § 6377.1(a).
[4] NAICS Codes 3111 to 3399 describe manufacturing activities. NAICS Codes 541711 and 541712 are research and development in life and physical sciences, respectively.
[5] Cal. Rev. & Tax Code § 6377.1.
[6] AB 398, 2017-2018 Reg. Sess. (Cal. 2017), Section 16, modifying Cal. Rev. & Tax Code § 6377.1(b)(8)(A)(ii).

Section 2805 of the Public Utilities Code."[7] NAICS Code 221122 "comprises electric power establishments primarily engaged in either (1) operating electric power distribution, or (2) operating as electric power brokers."[8]

> *Observation:* Plants that generate power from a conventional power source generally include coal, natural gas, diesel or nuclear energy. Although such power plants will be considered "qualified persons," they will not be eligible for the partial exemption on "generation or production" unless they are also engaged in cogeneration of thermal energy using waste heat. It should also be noted that conventional power plants may be eligible to claim the exemption on qualified property used primarily for "storage and distribution" of electricity as well as the existing categories of qualified property such as pollution control.[9]

Extension of eligibility for exemption to agricultural businesses

Current law excludes from the definition of a "qualified person" businesses operating in the agriculture, extractive, finance or banking industries if they are required to apportion their income under the traditional three factor formula pursuant to Cal. Rev. & Tax Code ("CRTC") Section 25128(b).[10] Effective January 1, 2018, AB 398 provides that agricultural businesses meeting the requirements of a "qualified person" may be eligible for the partial sales and use tax exemption.[11]

> *Observation:* AB 398 extends the partial exemption to agricultural businesses involved in manufacturing food and other products that were previously excluded due to CRTC Section 25128(b). The agricultural business must still meet all of the other requirement to qualify for the partial exemption such as being primarily engaged in activities under the qualifying NAICS codes. It should also be noted that the partial exemption for machinery and equipment used primarily in producing and harvesting agricultural products continues to be available to agricultural businesses.[12]

Clarification of the definition of "useful life"

Prior to AB 398, California law excluded from the definition of "useful life" property with a useful life of less than one year.[13] Based on that prior definition, it was unclear whether "useful life" was determined by reference to the actual life of the property **or** was instead determined by reference to the taxpayers' treatment of that property for income tax purposes. According to published guidance from the California Department of Tax and Fee Administration ("CDTFA"), formerly the State Board of Equalization ("SBE"), "[i]f property is not capitalized and depreciated for income tax purposes, it will be presumed that the property does not have a useful life of one or more years and will not qualify for the partial exemption."[14] In addition, auditors appear to have also disallowed property that was claimed under Internal Revenue Code ("IRC") Section 179 under this income tax characterization test of capitalization.

AB 398 amends the applicable useful life provisions, retroactive to July 1, 2014, such that "tangible personal property deducted under Sections 17201 *and* 17255 or 24356 of the Revenue and Tax Code shall be deemed to have a useful life of one or more years."[15] [Emphasis added.] The latter two code sections refer to the

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[7] Conventional power means "power derived from nuclear energy or the operation of a hydropower facility greater than 30 megawatts or the combustion of fossil fuels, except for cogeneration technology…." AB 398, 2017-2018 Reg. Sess. (Cal. 2017), Section 16, adding Cal. Rev. & Tax Code § 6377.1((b)(3).
Cal. Rev. & Tax Code § 6377.1(b)(3).

[8] 2017 NAICS definition.

[9] "Storage and distribution" is defined as "storing and distributing through the electrical grid, but not transmission of, electrical power to consumers regardless of source." AB 398, 2017-2018 Reg. Sess. (Cal. 2017), Section 16, adding Cal. Rev. & Tax Code § 6377.1((b)(12).

[9] Cal. Rev. & Tax Code § 6377.1(a).

[10] Cal. Rev. & Tax Code § 6377.1(b)(8)(B)(i).

[11] AB 398, 2017-2018 Reg. Sess. (Cal. 2017), Section 16, adding Cal. Rev. & Tax Code § 6377.1((b)(8)(B)(ii).

[12] 18 Cal Code Regulation § 1533.1.

[13] Cal. Rev. & Tax Code § 6377.1(b)(7)(B)(i).

[14] https://www.boe.ca.gov/sutax/manufacturing_exemptions.htm#Examples

[15] AB 398, 2017-2018 Reg. Sess. (Cal. 2017), Section 13, modifying Cal. Rev. & Tax Code § 6377.1(b)(7)(B)(i).

election to expense certain amounts of depreciable assets under IRC Section 179. Thus, AB 398 provides that the partial exemption can apply to otherwise qualified property expensed pursuant to IRC Section 179.

Considerations

AB 398 extends through June 30, 2030 the currently available California partial sales and use tax exemption and expands the scope of potential eligible industries to include those operating in electric power generation and agriculture. As required, companies that believe they may take the exemption must otherwise be a “qualified person” and purchase “qualified property” as defined under the amended provisions of CRTC Section 6377.1. Additionally, AB 398 clarifies that tangible personal property expensed for California income/franchise tax purposes pursuant to IRC Section 179 is also included in the scope of eligible property.

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