STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
LEGAL DIVISION (MIC:82)
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February 6, 1996

Mr. J--- V. M---
Senior Manager
K--- P--- M--- ---
XXX --- Street
--- ---, California XXXXX

Re: Account No. SR -- XXXXXXXXX

Dear Mr. M---:

This is in response to your December 4, 1995 letter to Mr. James B. Levinson requesting a written opinion on the qualification requirements for the Revenue and Taxation Code section 6377 partial sales and use tax exemption as it relates to your client, M--- Corporation of America ("M---").

You state:

> "M--- has been manufacturing floppy disks, and audio tapes in --- ---, California for several years. M---'s corporate policy provides that all manufacturing operations in the United States are conducted by separate operating divisions under the M--- corporate umbrella. In early 1995, M--- decided to open a new CD-ROM manufacturing operation in --- ---, California. M--- chose to locate this new manufacturing operation [in] --- ---, California as a direct result of California enacting CAR&TC Section 6377 in late 1993, effective January 1, 1994. This new manufacturing operation in the --- --- area will create more than one hundred jobs. Additionally, M--- will purchase more than $XX,000,000.00 of manufacturing equipment to use in the CD-ROM manufacturing operation in --- ---. M---'s new CD-ROM facility maintains separate books and records and operates as a separate operating division under the M--- corporate umbrella. M--- has complied will all local ordinances imposed by the City of --- ---."

You also state that M--- was denied qualification for the partial sales and use tax exemption for its CD-ROM operation since M--- had previously undertaken a manufacturing operation inside this state within the previous 36 months. You request clarification as to whether it was appropriate to deny qualification to M--- for its CD-ROM operation on the basis that a different division of the same corporate entity previously engaged in business under division "D" of the 1987 Standard Industrial Classification Manual ("SIC manual").

Discussion

Revenue and Taxation Code section 6377[1] was originally enacted by SB 671. The SB 671 version of section 6377 provided an exemption from the state component of the sales and use tax, which is imposed at the rate of 6 percent. Section 6377 was thereafter amended by the passage of SB 676, which became operative on January 1, 1995. As of January 1, 1995, the partial sales and use tax exemption provided by section 6377 was significantly revised which, among other things, reduced the exemption to tax imposed of 5 percent. Thus, if a sale meeting the requirements of the section 6377 partial exemption occurred in 1994 in a district where the sales tax rate is 7-3/4 percent, tax of 1-3/4 percent would be due. If a qualifying sale occurs in that district in 1995, tax of 2-3/4 percent is due.

Pursuant to the SB 676 version of section 6377, the partial sales and use tax exemption generally applies to persons that commence a new trade or business on or after January 1, 1994 inside this state which is described in codes 2000 to 3999 of the 1987 SIC manual. A person meeting these requirements is a "qualified person"; however, a qualified person does not include a person who undertakes a manufacturing activity inside this state within the same SIC code division as a prior trade or business operated by that person (or any related person within the meaning of sections 267 and 318 of the Internal Revenue Code) inside this state within the previous 36 months. The partial sales and use tax exemption generally applies to the sale or use of tangible personal property used primarily for manufacturing, processing, refining, fabricating, recycling, research and development and the repair of qualified property. Section 6377 makes a distinction between persons who are or were previously engaged in a trade or business inside this state and those that are not for purposes of determining "qualified person" status. A new trade or business is generally one which a person (or any related person) has not engaged in within the preceding 36 months inside this state or which is classified in a different SIC code division[2] than that person's (or any related person's) current or prior trade or business activities in this state. (Rev. & Tax. Code § 6377(b)(5)(A)(ii).) This means that a person currently or previously engaged in a trade or business activity in this state within the preceding 36 months is a "qualified person" only if that person's current or previous activity is in a non-division D SIC code activity and that person undertakes a new trade or business activity in California described in division D of the SIC manual. On the other hand, persons engaged in a trade or business activity wholly outside the state who commence doing business in California on or after January 1, 1994 qualify as a new trade or business regardless of that person's prior trade or business activity. (See Rev. & Tax. Code § 6377(b)(5)(A)(iii).) Under either scenario, the new trade or business

[1] All further references are to the Revenue and Taxation Code unless otherwise noted.
[2] The SIC code division is the largest classification standard within the SIC manual. The SIC manual defines business establishments from their broadest to smallest classifications as follows: division, major group, industry group, and industry code. For example, SIC code division D contains SIC industry codes 2000 through 3999.

must commence such operations inside this state on or after January 1, 1994. (Reg. 1525.2(c)(5)(A).) We generally regard business operations to begin upon the acquisition of operating assets that are necessary to the type of business contemplated. (See Reg. 1525.2(c)(5)(A)1.)[3]

As an alternate to the partial sales and use tax exemption, SB 676 provides a manufacturer's investment credit ("MIC") (see Rev. & Tax. Code §§ 17053.49, 23649) for purchases of certain qualified property by persons engaged in those lines of business described in SIC code 2000 to 3999. The MIC is 6 percent (1 percent higher than the partial sales and use tax exemption contained in SB 676) and is allowed only where the qualified taxpayer does not elect to take the partial exemption. (See Rev. & Tax. Code §§ 17053.49(a)(1); (b)(1)(B); 23649(a)(1); (b)(1)(B).) Questions regarding the application of the MIC should be addressed to the Franchise Tax Board - Legal Division, P.O. Box 1468, Sacramento, California 95812-1468.

You do not dispute that M--- has been engaged in manufacturing activities inside California within the previous 36 months. These activities consist of the manufacturing of floppy disks and audio tapes described in division D of the SIC manual under industry code 3695 as "Magnetic And Optical Recording Media." We also understand from your letter that you do not dispute that M---'s CD-ROM operation is part of the same M--- corporation that engages in the SIC code 3695 activities. As such, M---'s new CD-ROM operation does not qualify as a new trade or business for purposes of the partial sales and use tax exemption since it has been engaged in a division D manufacturing activity inside this state within the previous 36 months.

You assert that section 6377 should be interpreted to allow an existing California business that is engaged in a manufacturing operation to qualify for the partial sales and use tax exemption when it begins a new, but different, manufacturing operation. You believe that the plain language of SB 671 and section 6377 provide this opportunity to those types of businesses. We note, however, that the present language of section 6377 is the result of the passage of SB 676, not SB 671. SB 676 contained the express language set forth above which prevents existing companies engaged in manufacturing operations in California from obtaining "qualified person" status by simply engaging in a different manufacturing operation. We also note that section 6377(b)(5)(A)(ii), as amended by SB 676, makes specific reference to the requirement that any additional business undertaken by a person presently engaged in a trade or business in this state (or previously engaged within the previous 36 months) must be classified under a *different division of the SIC code* to be a "qualified person." This requirement is not a creation of the Board's staff, but instead is the specific design of the California Legislature that the Board may not ignore.

We are mindful of the differences that the partial sales and use tax exemption and the MIC have on the cash flow of a business as well as the availability of each tax savings provision

[3] "New trade or business" status is further limited in situations where a person acquired the assets of another business. (See Rev. & Tax. Code § 6377(b)(5)(A)(i) et seq.) We have not discussed these provisions since you do not indicate that M--- acquired the assets of another business in order to engage in its CD-ROM operation.

to qualified persons. Nevertheless, the California Legislature has opted to not regard a person as "qualified" for purposes of the partial sales and use tax exemption where that person is or was previously engaged in a manufacturing operation inside this state. Regulation 1525.2 adopted by the Board is consistent with that Legislative mandate.

We trust this answers your questions. If you have any further questions regarding the partial sales and use tax exemption, please write again. If you have any questions regarding the MIC, please write the Franchise Tax Board at the address noted above.

Sincerely,

Warren L. Astleford
Staff Counsel

WLA:rz

cc: Mr. James B. Levinson - 3rd SD
--- --- District Administrator (--)