

STATE BOARD OF EQUALIZATION

450 N STREET, SACRAMENTO, CALIFORNIA
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0044
1-916-324-2916 • FAX 1-916-322-0187
www.boe.ca.gov

SEN. GEORGE RUNNER (Ret.)
First District, Lancaster

FIONA MA, CPA
Second District, San Francisco

JEROME E. HORTON
Third District, Los Angeles County

DIANE L. HARKEY
Fourth District, Orange County

BETTY T. YEE
State Controller

December 18, 2015

[REDACTED]

CYNTHIA BR DGES
Executive Director

[REDACTED]:

This is in response to your [REDACTED] letter on behalf of an anonymous client regarding the partial exemption for manufacturing equipment. The anonymous client, Company A, operates a desalination plant located in California. You inquire if the company is engaged in a qualifying business.

As a preliminary matter, section 6596, "Excusable Delay-Reliance on Advice," of the California Sales and Use Tax Law grants taxpayers relief from future liabilities if the underreported tax is based on incorrect written advice provided by a Board representative. However, without specific details regarding the transactions in question, I cannot provide you with a specific opinion. The answer given is intended to provide general information regarding the application of tax based on the information you have provided and will not serve for relief of liability under section 6596.

As you may know, California Revenue and Taxation Code section 6377.1 provides that a "qualified person" may be entitled to a partial exemption from sales and use tax for purchases of "qualified tangible personal property." Regulation 1525.4 "Manufacturing and Research & Development Equipment", which explains and interprets the partial exemption, provides that a "qualified person" means a person who is primarily engaged (50 percent or more of the time) in those lines of business described in the NAICS Codes 3111 to 3399, inclusive, 541711, or 541712 published by the United States Office of Management and Budget (OMB), 2012 edition.

A qualified person may be "primarily engaged" either as a legal entity *or* as an establishment within a legal entity. To be primarily engaged as a legal entity or as an establishment you must, in the prior financial year, either derive 50 percent or more of gross revenue (including inter-company charges) from, or expend 50 percent or more of operating expenses in a qualifying line of business.

Regulation 1525.4 also provides that qualifying property must be treated as having a useful life of one or more years for state income or franchise tax purposes. Tangible personal property that is treated as having a useful life of less than one year for state income or franchise tax purposes will not qualify for the partial exemption.

You discuss Company A's desalination operations in California and the following description of the process:

Desalination is the process of removing salts and other minerals from saline water or salt water to produce fresh water suitable for human consumption or agricultural irrigation. The desalination process uses reverse osmosis technology whereby seawater is pumped and forced through semipermeable membranes under high pressures to separate salts and other inorganic impurities. The process converts seawater into drinking water. The process involves several steps and equipment.

You ask if Company A is primarily engaged in a qualifying line of business described in Regulation 1525.4, *Manufacturing and Research & Development Equipment*. You believe NAICS code 3259, *Other Chemical Product and Preparation Manufacturing*, describes their activities. The specific NAICS code 325998 includes distilled water manufacturing, which you believe is similar to desalination.

Your client's NAICS code is that which best describes their business activities, based on either their primary revenues or primary operating expenses. If there is no six digit NAICS code for their specific business activity, they may still qualify for the partial exemption if the business activities are reasonably described in a qualifying four digit industry group. NAICS code 3259, covers United States industries manufacturing chemicals that also include examples such as salt manufacturing, matches, swimming pool chemicals and ink. There is no specific 4 or 6 digit NAICS code for the operation of a desalination plant.

I agree with the USCB's opinion that operating a desalination plant is best described under NAICS code 221310 and does not qualify under the manufacturing NAICS code 325998. While there is no specific NAICS code for the operation of a desalination plant, construction of a desalination plant is specifically classified under NAICS code 237110. NAICS code 237110 includes water desalination plant construction and other water treatment plant construction. Since the construction of a desalination plant is grouped with the construction of other water supply and treatment systems, operation of a desalination plant should be classified in a similar matter. Thus, the operation of a desalination plant is best classified under NAICS code 221310 "Water Supply and Irrigation Systems."

You also ask if the customer receiving the end product affects our response. Based on my response above, the type of customer will not change the classification.

I hope this information is helpful. If there are further questions about this or any other sales and use tax matter, please call me at (916) 324-2916 or you may contact me via e-mail at jason.parker@boe.ca.gov.

Sincerely,

Jason Parker, Supervisor
Audit and Information Section

JAP:dot

cc:	Mr. Greg Buehrer	(MIC 44)
	Mr. Brad Miller	(MIC 92)
	Mr. David Theiss	(MIC 44)
	Ms. Ivy Woolledge	(MIC 44)
	Ms. Dorothy Edwards	(MIC 44)