



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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State Controller

CYNTHIA BRIDGES
Executive Director

November 14, 2013

Dear Interested Party:

Enclosed is the Second Discussion Paper on proposed Regulation 1525.4, *Manufacturing and Research & Development Equipment*. Before the issue is presented at the Board's April 22, 2013 Business Taxes Committee meeting, staff would like to invite you to discuss the issue and present any additional suggestions or comments. Accordingly, a second interested parties meeting is scheduled as follows:

December 5, 2013
Room 122 at 10:00 a.m.
450 N Street, Sacramento, CA

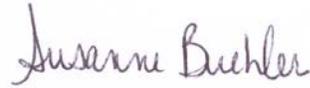
If you would like to participate by teleconference, call 1-888-636-3807 and enter access code 499201. You are also welcome to submit your comments to me at the address or fax number in this letterhead or via email at Susanne.Buehler@boe.ca.gov by December 19, 2013. Copies of the materials you submit may be provided to other interested parties, therefore, ensure your comments do not contain confidential information. Please feel free to publish this information on your website or distribute it to others that may be interested in attending the meeting or presenting their comments.

If proposed Regulation 1525.4 is determined to be a major regulation under the provisions of Senate Bill 617 (Chapter 496, Statutes of 2011), this interested parties meeting will provide an opportunity for public input regarding alternatives to the regulation. Please see the California Department of Finance webpage for information about the provisions of SB 617 (http://www.dof.ca.gov/research/economic_research_unit/SB617_regulation/view.php).

If you are interested in other Business Taxes Committee topics refer to our webpage (<http://www.boe.ca.gov/meetings/btcommittee.htm>) for copies of discussion or issue papers, minutes, a procedures manual, and calendars arranged according to subject matter and by month.

Thank you for your consideration. We look forward to your comments and suggestions. Should you have any questions, please feel free to contact our Business Taxes Committee staff member Ms. Lynn Whitaker at Lynn.Whitaker@boe.ca.gov or 1-916-324-8483, who will be leading the meeting.

Sincerely,



Susanne Buehler, Chief
Tax Policy Division
Sales and Use Tax Department

SB: lw

Enclosures

cc: (all with enclosures)

Honorable Jerome E. Horton, Chairman, Fourth District
Honorable Michelle Steel, Vice Chair, Third District
Honorable Betty T. Yee, Member, First District (MIC:71)
Senator George Runner (Ret.), Member, Second District (via email)
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel

(via email)

Mr. David Hunter, Board Member's Office, Fourth District
Mr. Michael Vigil, Board Member's Office, Fourth District
Mr. Neil Shah, Board Member's Office, Third District
Mr. Tim Treichelt, Board Member's Office, Third District
Mr. Alan LoFaso, Board Member's Office, First District
Ms. Mengjun He, Board Member's Office, First District
Mr. Sean Wallentine, Board Member's Office, Second District
Mr. James Kuhl, Board Member's Office, Second District
Mr. Lee Williams, Board Member's Office, Second District
Mr. Alan Giorgi, Board Member's Office, Second District
Ms. Lynne Kinst, Board Member's Office, Second District
Ms. Natasha Ralston Ratcliff, State Controller's Office
Ms. Cynthia Bridges (MIC:73)
Mr. Randy Ferris (MIC:83)
Mr. Jeffrey L. McGuire (MIC:43)
Mr. Jeff Vest (MIC:85)
Mr. Jeff Angeja (MIC:85)
Mr. David Levine (MIC:85)
Mr. Robert Tucker (MIC:82)
Mr. Bradley Heller (MIC:82)
Mr. Andrew Kwee (MIC:82)
Mr. Lawrence Mendel (MIC:82)
Mr. Todd Gilman (MIC:70)

Ms. Lauren Simpson (MIC:70)
Mr. Bill Benson (MIC:67)
Mr. Joe Fitz (MIC:67)
Mr. Wayne Mashihara (MIC:46)
Mr. Kevin Hanks (MIC:49)
Mr. Bradley Miller (MIC:92)
Ms. Kirsten Stark (MIC:50)
Mr. Clifford Oakes (MIC:50)
Ms. Lynn Whitaker (MIC:50)
Ms. Trista Gonzalez (MIC:44)
Mr. Jason Parker (MIC:44)
Ms. Tracy McCrite (MIC:44)
Mr. Robert Prasad (MIC: 44)

SECOND DISCUSSION PAPER
Proposed Regulation 1525.4, *Manufacturing and*
Research & Development Equipment

I. Issue

Whether the Board should approve proposed Sales and Use Tax Regulation 1525.4, *Manufacturing and Research & Development Equipment*, to implement and explain the new partial exemption from sales and use tax for sales and purchases of manufacturing equipment that was established by Revenue and Taxation Code (RTC) section 6377.1.

II. Staff Recommendation

Staff recommends Regulation 1525.4 clarify RTC section 6377.1 as follows:

- Expand the definitions provided in RTC section 6377.1 to include, where appropriate, definitions from Sales and Use Tax Regulation 1525.2, *Manufacturing Equipment*, and Franchise and Income Tax Regulations 17053.49 *et seq.* regarding the Manufacturers' Investment Credit (MIC).
- Define “primarily engaged” to mean 50 percent or more of gross revenues are derived from qualifying manufacturing or research and development activities in the preceding financial year.
- Clarify that sales and purchases of quality assurance testing equipment and manufacturing aids may qualify for the partial exemption.
- Allow for the issuance of a blanket partial exemption certificate.
- Provide a separate partial exemption certificate for construction contractors to provide to suppliers.
- Clarify that the \$200 million cap is not pro-rated for the period July 1, 2014 to December 31, 2014, nor for the period January 1, 2022 to June 30, 2022.

See Exhibit 1 for staff's proposed Regulation 1525.4.

III. Other Alternative(s) Considered

Submissions regarding areas of concern and general revision suggestions were received from Ms. Therese Twomey from the California Taxpayers Association (CalTax) and Mr. Jim Fier from Downey, Smith & Fier (see Exhibits 2 and 3). Their comments are discussed in the following sections.

IV. Background

Created by Assembly Bill 93 (AB 93) (Stats. 2013, Ch. 69), as amended by Senate Bill 90 (SB 90) (Stats. 2013, Ch. 70) Revenue and Taxation Code (RTC) section 6377.1 provides a partial exemption from sales and use tax on certain manufacturing and research and development equipment sales and purchases. The partial exemption applies to qualifying sales and purchases made on or after July 1, 2014, and before July 1, 2022.

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The current statewide sales and use tax rate is 7.50%, although the combined tax rate is higher in cities and counties that impose additional district taxes. RTC section 6377.1 exempts the purchaser from the state general fund taxes imposed by RTC sections 6051¹, 6051.3, 6201², and 6201.3 and the State's Education Protection Account tax imposed by Section 36, Article XIII of the State Constitution. Accordingly, from July 1, 2014, to December 31, 2016, the partial exemption will be 4.1875%. When the Education Protection Account tax expires on December 31, 2016, the partial exemption will be 3.9375% from January 1, 2017, to June 30, 2022.

If the Education Protection Account tax is extended, or there is any other tax rate change in the RTC sections covered by the exemption, staff will amend the partial exemption rate in Regulation 1525.4 accordingly. Changes of this type are generally processed as Rule 100 revisions³. Staff does not believe it is necessary to reference potential changes to the rate in the current regulation. In addition to updating the regulation, whenever there is a change in the tax rate, the Board of Equalization (BOE) notifies affected taxpayers of the change including any effect on partial exemptions.

It is not required that equipment purchased under the partial exemption be used in a former enterprise zone or other designated area. Although this was a requirement in AB 93, the language of RTC section 6377.1 provided in SB 90 replaced the AB 93 language and the restriction was removed. Property purchased under the partial exemption may be used anywhere in California.

Prior partial exemption for manufacturing equipment

RTC section 6377.1 is substantially modeled from the prior partial exemption for manufacturing equipment provided by RTC section 6377 and interpreted in Regulation 1525.2, *Manufacturing Equipment*. Under the prior program, from January 1, 1994 to December 31, 2003, new manufacturers could qualify for a partial exemption from sales and use tax on purchases of certain manufacturing equipment. The law also provided manufacturers income tax credits of 6% for similar equipment placed in service in California. The partial exemption and credit related to equipment used primarily for manufacturing, refining, processing, fabricating, or recycling. New manufacturers could claim the partial sales and use tax exemption or the MIC. However, existing manufacturers could only claim the MIC.

¹ Except for the taxes deposited pursuant to RTC section 6051.15.

² Except for the taxes deposited pursuant to RTC section 6201.15.

³ California Code of Regulations, Title 1, Section 100 allows an agency to add to, revise or delete regulatory text without the regular rulemaking procedures when the revision is a "change without regulatory effect." These changes include making regulatory provisions consistent with a changed California statute when the regulatory provision is inconsistent with and superseded by the changed statute, and the adopting agency has no discretion to adopt a change which differs in substance from the one chosen. Revisions to make the partial exemption rate consistent with a changed statute would fall into this category.

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V. Discussion

Staff's initial discussion paper provided a general overview of the partial exemption and included a proposed regulation consisting primarily with the language of RTC section 6377.1. This paper discusses issues that were brought up at the first meeting with interested parties on October 9, 2013 and in the submissions received following that meeting.

Definition of qualified person – 1525.4 (b)(8)(A)

Under the prior partial exemption for manufacturing equipment, qualified taxpayers were required to be engaged in the manufacturing lines of business described in specified Standard Industrial Classification Manual codes. The provisions of RTC section 6377.1, however, are more narrow in that they require that the person be *primarily* engaged in those lines of business described in North American Industry Classification System (NAICS) codes 3111 to 3399, 541711, or 541712. This “primarily engaged” requirement is also found in Regulation 1532, *Teleproduction or Other Postproduction Service Equipment*.

Also modeled after Regulation 1525.2, Regulation 1532 provides a partial exemption for purchases of qualified equipment that will be used by a qualified person primarily engaged in teleproduction or other postproduction services. When Regulation 1532 was drafted, staff initially interpreted the term “qualified person” to mean the entire entity (e.g., a corporation) and that the entire entity must be “primarily engaged” in teleproduction or other postproduction activities in order to qualify for the partial exemption. However, as the drafting of the regulation progressed, a more liberal interpretation was adopted to be consistent with Regulation 1525.2 and applied the primarily engaged test to be based on the establishment.

Both CalTax and Mr. Fier recommended that for taxpayers engaged in multiple lines of business, BOE should not look at the activity of the overall entity, but at activities of individual departments or divisions to determine whether the taxpayer is primarily engaged in the specified NAICS codes. Staff was encouraged to consider the prior MIC regulations for guidance in drafting the current regulation. CalTax also asked whether activities within and without California be considered in determining whether a company is “primarily engaged” in a qualifying activity.

Staff revised Regulation 1525.4 (b)(8) to define “primarily engaged” to mean 50 percent or more of gross revenues, including intra-company charges are derived from manufacturing or research and development activities for the financial year of the purchaser preceding the purchase of the property. In cases where the purchaser was not primarily engaged in those activities in the financial year preceding the purchase of the property, the one year period following the date of purchase of the property will be used. This revision is consistent with the provision of Regulation 1532.

Unlike RTC section 6377.1, the prior manufacturer's exemption program did not require the manufacturer to be a person that is primarily engaged in the qualified line of business. Therefore, staff does not believe the definition of “establishment” from Regulation 1525.2 can be simply copied into Regulation 1525.4. Similarly, staff does not believe the definition of “establishment” in Regulation 1532 is appropriate as it applies to a specific industry rather than

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the broad application provided in Regulation 1525.4. Staff is considering additional revisions to the definition of qualified person, using the concept of a trade or business of a person as an “establishment” from Regulation 1525.2 as a starting point. Staff is open to further discussion with interested parties on how this concept may be further refined to work within the statutory requirements provided in RTC section 6377.1, which requires that the person be primarily engaged in the qualified line of business.

In addition to determining whether a person is primarily engaged in a qualifying line of business, CalTax asked whether the determination of a “qualified person” would be made on a legal entity basis, or on an affiliated or unitary group basis. That is, would purchases by a legal entity who is not a qualified person be eligible for the partial exemption when items purchased are used by an affiliated legal entity who is a qualified person? For example, a legal entity that is not a qualified person purchases materials for a manufacturing building that is leased to an affiliate that is a qualified person. Staff believes that in order to claim the partial exemption, the purchaser must be a qualified person. An affiliate who is not a qualified person is not eligible for the exemption even if the item purchased will be used by an affiliated legal entity who is a qualified person.

Quality assurance testing – 1525.4 (b)(6)

At the interested parties meeting and in CalTax’s submission it was recommended that equipment used to test products for quality assurance during the manufacturing process qualify for the partial exemption. Staff agrees that testing products while they are being manufactured is a part of processing raw materials into a finished product. Staff has revised the definition of “process” to include this testing.

Manufacturing aids – 1525.4 (b)(9)(A)

Interested parties also asked whether special tooling such as molds and dies with a useful life of more than one year would be “qualified tangible personal property.” CalTax explained that in some cases, tooling may be designed and owned by the taxpayer, manufactured by the taxpayer’s suppliers, and used by the taxpayer to produce component parts that are incorporated into the taxpayer’s manufacturing of another product.

Staff agrees that manufacturing aids can be included in the definition of machinery and equipment and qualify for the partial exemption when they are purchased by a qualified person and meet the definition of useful life provided in 1525.4 (b)(13). For example, a company makes car parts for an automobile manufacturer. The company makes and uses a mold to create the parts; the mold is sold to the automobile manufacturer prior to use. The automobile manufacturer may issue a partial exemption certificate for the mold provided the manufacturer treats the mold as having a useful life of one or more years for state income or franchise tax purposes.

Special purpose buildings – 1525.4 (b)(9)(A) 4.

Staff expanded the definition of special purpose buildings based on the definition provided in Regulation 1525.2. CalTax recommended the regulation define “contractors,” “subcontractors,” and “material suppliers” to qualify for the exemption. Staff believes that further clarification is needed in this area and will provide it in the next paper.

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CalTax further commented that the regulation does not define “qualified tangible personal property” as it relates to a construction contractor performing a construction contract for a qualified person. CalTax suggested that the regulation define qualified tangible personal property used by construction contractors and subcontractors to broadly include such things as construction equipment purchased and used in the performance of a contract with a qualified person, permanent construction materials, long-term leased equipment, etc.

Staff disagrees that RTC section 6377.1 can be interpreted to include purchases of construction equipment used in the performance of contract with a qualified person. In describing qualified use, the statute provides in subsection (a)(4) that the exemption applies to:

Qualified tangible personal property purchased for use by a contractor purchasing that property for use in the performance of a construction contract for the qualified person, that will use the property as an integral part of the manufacturing, processing, refining, fabricating, or recycling process, or as a research or storage facility for use in connection with those processes.

Accordingly, staff believes only materials and fixtures that become a part of a special purpose building or machinery and equipment that will be used by the manufacturer in the manufacturing process can qualify for the partial exemption.

Partial exemption certificate – 1525.4 (c), Appendix A, and Appendix B

Staff revised subdivision (c) of Regulation 1525.4 to include a definition of “timely” and to explain that purchasers may issue blanket partial exemption certificates. The certificate itself was revised to reference “research & development” in the title and to remove the references to purchases by construction contractors. A separate certificate was created for contractors when they purchase property for use in a construction contract for a qualified person that will use that property in a manner qualifying for the partial exemption.

CalTax asked that staff delete the last sentence of subdivision (c)(5) which explains that a seller cannot accept an exemption certificate in good faith when the seller has knowledge that the property is not subject to the partial exemption or will not otherwise be used in a partially exempt manner. CalTax explained that they believe this language implies that a seller must verify the eligibility of the equipment at the time of purchase or when the certificate is submitted, neither of which is feasible. Staff did not delete the sentence because it clarifies that sellers do have a certain level of responsibility when they accept an exemption certificate.

\$200 million cap on purchases – 1525.4 (d)

Regulation 1525.4 (d) provides that the partial exemption does not apply to tangible personal property purchased by a qualified person during any calendar year that exceeds \$200 million of purchases of qualified purchases for which an exemption is claimed by the qualified person. For a qualified purchaser that is required to be included in a combined report under RTC section 25101 or authorized to be included in a combined report under RTC section 25101.15, the aggregate of all purchases of qualified purchases by all persons that are required or authorized to be included in a combined report shall not exceed \$200 million in any calendar year.

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Interested parties asked whether the cap would be \$200 million or \$100 million for 2014 as the exemption begins July 1, 2014. Since the statute does not limit the amount of purchases to \$100 million in 2014, staff believes that the legislative intent was to allow the full \$200 million in 2014. Staff also believes the intent was to allow the full \$200 million for the period January 1, 2022 to June 30, 2022. Subdivision (d) has been revised to clarify this issue.

In his submission, Mr. Jim Fier recommended that qualified companies be allowed to elect a fiscal year based on its tax return filing to facilitate ease of reporting, auditing, and matching to the company's financial year. Mr. Fier also asked how the cap will treat purchases amongst a combined group. That is, does each entity reduce their qualified purchases by an equal amount, or does the taxpayer need to determine chronologically when the cap is reached for all entities in the combined group? Mr. Fier suggested that taxpayers be allowed flexibility to allocate the \$200 million at the end of the tax year to the members of the combined group to facilitate reporting.

Unlike income tax deductions, purchasers take sales and use tax exemptions when they purchase the qualifying tangible personal property, either by issuing an exemption certificate to a vendor required to collect California sales and use tax, or by claiming the exemption on their sales and use tax return when reporting a purchase subject to use tax. With regard to companies required or authorized to report as a combined group, staff does not intend to direct how the exemption is claimed amongst the group as long as the total amount of purchases made under the exemption does not exceed the cap. As for allowing purchasers to elect to track purchases on a fiscal year, staff does not believe it has the authority to allow this because RTC Section 6377.1 (e)(1)(A) specifies "calendar year."

In further discussion of the cap, CalTax suggested that the proposed regulatory language include a recordkeeping or notification function for qualified purchasers to help taxpayers avoid exceeding the \$200 million limit. Although staff agrees such notification would be useful, partial exemptions generally will be claimed on the returns filed by the equipment sellers. These sellers will not be required to provide information about individual sales made subject to the partial exemption with their returns. Thus, staff does not believe there is a way for BOE to track the amount taxpayers have purchased and notify them that they are approaching the cap amount.

Expanded definitions - 1525.4 (b); Clarified qualifying lease payments - 1525.4 (f)

As suggested by interested parties, staff reviewed the definitions in Regulation 1525.2 and Regulations 17053.49, *et seq.* and revised the definitions in proposed Regulation 1525.4 to be consistent with those regulations. Revised or added sections not discussed above include: (b)(2) "Manufacturing," (b)(3) "Packaging," (b)(4) "Pollution control," (b)(10) "Recycling," (b)(11) "Refining," and (b)(12) "Research and development."

Staff also added a general description of an apportioning trade or business in (b)(8)(B) and clarified in subdivision (f) the application of the partial exemption to lease payments when the term of the lease extends before and after the partial exemption period.

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Partial exemption rate

CalTax expressed their concern that some computer software systems are unable to accommodate a tax rate that has four digits after the decimal point. They explained that sellers whose computer systems are unable to accommodate the extra digit likely will round the exemption up. Reprogramming software is often extensive and cumbersome. CalTax suggested the proposed regulation address this issue and hold affected taxpayers harmless from penalties during the software update process.

Staff recognizes that sellers may have software difficulties with the allowed exemption; however, staff does not have the authority to allow a different rate to be imposed or waive penalties if tax is underreported. Sellers who round the partial exemption rate or their sales tax reimbursement rate up or down will be required to report tax based on the specified rate regardless of the amount of sales tax reimbursement they collected from their customer. For example, on a \$1 million sale of qualified equipment in an area that imposes a sales tax rate of 7.5%, a seller that rounds the partial exemption rate up to 4.19%, would collect \$33,100 in sales tax reimbursement from their customer ($7.5\% - 4.19\% = 3.31\%$; $\$1,000,000 \times 3.31\%$). However, the seller will owe \$33,125 in sales tax ($7.5\% - 4.1875\% = 3.3125\%$; $\$1,000,000 \times 3.3125\%$). Any under or over reporting of tax related to the partial exemption will be handled by BOE like any other over or under reporting of tax.

Tax and penalties owed when it is later determined the purchase did not qualify

CalTax commented that the statutory language appears to allow a subsequent determination by the FTB to invalidate a decision by a taxpayer or retailer that a person is a “qualified person” through reference to subsequent determination under RTC section 25101 and 25128. CalTax urged BOE to adopt a prospective application of a FTB decision in this area.

On a similar note, CalTax commented that the law specifies that interest applies to tax liabilities in instances where a qualifying purchase received a tax exemption, but was later determined to be ineligible. They further explained that the Legislature has been clear with regard to circumstances under which penalties ought to apply, and the absence of a reference to penalties is indicative of the Legislature’s intent. CalTax recommended that the regulation specify that penalties shall not be imposed in those situations.

RTC section 6377.1 (e) explains that a purchaser is liable for payment of the sales tax when the purchaser certifies in writing to the seller that property being purchased under the partial exemption will be used in a manner qualifying for the partial exemption and the purchaser exceeds the \$200 million cap, or within one year from the date of purchase, the purchaser removes the property from California, converts the property for use in a non-qualifying manner, or otherwise uses the property in a non-qualifying manner. Staff believes that the purchaser would similarly be responsible for payment of the sales tax when the purchaser issues a partial exemption certificate, but it is later determined that the purchaser is not a qualified person because they were an apportioning trade or business required to report under RTC section 25128 (b), or a trade or business that would be required to apportion its business income pursuant to RTC section 25128 (b) if it were subject to apportionment pursuant to RTC section 25101.

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With regard to penalties, staff does not believe it has the authority to exclude the application of penalties when the requirements to apply the penalty are met. Thus, the decision to apply a penalty to disallowed partial exemption transactions will be made on a case-by-case basis using the same criteria as when deciding whether to apply a penalty to any other sales and use tax transaction.

Bifurcation of individual assets

Mr. Fier suggested that the section that addresses qualified property should also incorporate the prior MIC decisions related to dual-use property not permitting the bifurcation of individual assets. Mr. Fier referred to the Appeal of the Milpitas Materials Company where the Board determined a ready mixed concrete mixer truck, comprised of a truck chassis and mixer barrel (including the accompanying components and hydraulic system), constituted a single integrated piece of manufacturing equipment, and thus the truck satisfied the requirements of qualified property for purposes of the MIC.

Staff believes this issue is addressed in the definition of “qualified tangible personal property” in Regulation 1525.4 (9)(A) which provides that machinery and equipment includes component parts of that equipment. However, staff is open to further discussion about whether clarification is needed to this general rule.

NAICS codes added or deleted

The definition of “qualified person” in RTC section 6377.1 specifically references NAICS published by the US Office of Management and Budget, 2012 edition. Staff believes this means that a business must be described under the appropriate codes in the 2012 edition in order to qualify for the partial exemption. Thus, if a future edition of the NAICS deletes a qualifying code, the business may continue to qualify for the partial exemption based on the fact that the business had a qualifying code in the 2012 edition. Similarly, if a new code is added in a future edition, a business may not qualify for the partial exemption, unless that business was also described in a qualifying code in the 2012 edition.

VI. Summary

Staff welcomes any comments, suggestions, and input from interested parties on this issue. Staff also invites interested parties to participate in the December 5, 2013, interested party meeting.

Prepared by the Tax Policy Division, Sales and Use Tax Department

Current as of 11/13/13

The underline and strikethrough text shows changes from the text proposed in staff's first discussion paper. Because this is a new regulation, all of the proposed text will be underlined when the issue is presented to the Board.

Regulation 1525.4, Manufacturing and Research & Development Equipment

Reference: Section 6377.1, Revenue and Taxation Code

(a) PARTIAL EXEMPTION FOR PROPERTY PURCHASED FOR USE IN MANUFACTURING AND RESEARCH AND DEVELOPMENT. Except as provided in subdivision (d), beginning July 1, 2014, and before July 1, 2022, section 6377.1 of the Revenue and Taxation Code (RTC) provides a partial exemption from sales and use tax for certain sales and purchases of tangible personal property as described in this regulation.

For the period beginning July 1, 2014, and ending on December 31, 2016, the partial exemption applies to the taxes imposed ~~or deposited~~ by sections 6051 (except the taxes deposited pursuant to section 6051.15), 6051.3, 6201 (except the taxes deposited pursuant to section 6201.15), and 6201.3 of the RTC and Section 36 of Article XIII of the California Constitution (4.1875%). The partial exemption does not apply to the taxes imposed or deposited pursuant to sections 6051.2, 6051.5, 6051.15, 6201.2, 6201.5, or 6201.15 of the RTC, the Bradley-Burns Uniform Local Sales and Use Tax Law, the Transactions and Use Tax Law, or Section 35 of Article XIII of the California Constitution.

For the period beginning January 1, 2017, and ending on June 30, 2022, the partial exemption applies to the taxes imposed ~~or deposited~~ by sections 6051 (except the taxes deposited pursuant to section 6051.15), 6051.3, 6201 (except the taxes deposited pursuant to section 6201.15), and 6201.3 of the RTC (3.9375%). The partial exemption does not apply to the taxes imposed or deposited pursuant to sections, 6051.2, 6051.5, 6051.15, 6201.2, 6201.5, or 6201.15 of the RTC, the Bradley-Burns Uniform Local Sales and Use Tax Law, the Transactions and Use Tax Law, or Section 35 of Article XIII of the California Constitution.

Subject to the limitation set forth above, this partial exemption from tax applies to ~~gross receipts from~~ the sale of and the, storage, use, or other consumption in this state, of the following items:

(1) Qualified tangible personal property purchased for use by a qualified person to be used primarily in any stage of the manufacturing, processing, refining, fabricating, or recycling of tangible personal property, beginning at the point any raw materials are received by the qualified person and introduced into the process and ending at the point at which the manufacturing, processing, refining, fabricating, or recycling has altered tangible personal property to its completed form, including packaging, if required.

(2) Qualified tangible personal property purchased for use by a qualified person to be used primarily in research and development.

(3) Qualified tangible personal property purchased for use by a qualified person to be used primarily to maintain, repair, measure, or test any qualified tangible personal property described in subdivision (a) (1) or (2).

(4) Qualified tangible personal property purchased for use by a contractor purchasing that property for use in the performance of a construction contract for the qualified person, that will use that property as an integral part of the manufacturing, processing, refining, fabricating, or

recycling process, or as a research or storage facility for use in connection with those processes.

(b) DEFINITIONS. For the purposes of this regulation:

(1) “Fabricating” means to make, build, create, produce, or assemble components or tangible personal property to work in a new or different manner.

(2) “Manufacturing” means the activity of converting or conditioning tangible personal property by changing the form, composition, quality, or character of the property for ultimate sale at retail or use in the manufacturing of a product to be ultimately sold at retail. Manufacturing includes any improvements to tangible personal property that result in a greater service life or greater functionality than that of the original property. Tangible personal property shall be treated as having a greater service life if such property can be used for a longer period than such property could have been used prior to the conversion or conditioning of such property. Tangible personal property shall be treated as having greater functionality if it has been improved in such a manner that it can be used to perform new or different functions.

(3) “Packaging” means to wrap, seal, box, or put together as a unit, but includes only that packaging necessary to prepare the goods for delivery to and placement in the qualified person’s finished goods inventory, or to prepare goods so that they are suitable for delivery to and placement in finished goods inventory. Any additional packaging, such as that packaging necessary to consolidate the goods prior to shipping or to protect them during transportation, shall not be considered to be “packaging” for purposes of this regulation.

(4) “Pollution control” means any activity that results in the abatement, reduction, or control of water, land, or atmospheric pollution or contamination by removing, altering, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes, or heat, but only to the extent that such activity meets or exceeds standards established by this state or by any local or regional governmental agency within this state.

(35) “Primarily” means 50 percent or more of the time.

(46) “Process” means the period beginning at the point at which any raw materials are received by the qualified person and introduced into the manufacturing, processing, refining, fabricating, or recycling activity of the qualified person and ending at the point at which the manufacturing, processing, refining, fabricating, or recycling activity of the qualified person has altered tangible personal property to its completed form, including packaging, if required. “Process” includes testing products for quality assurance which occurs prior to the tangible personal property being altered to its completed form. Raw materials shall be considered to have been introduced into the process when the raw materials are stored on the same premises where the qualified person’s manufacturing, processing, refining, fabricating, or recycling activity is conducted. Raw materials that are stored on premises other than where the qualified person’s manufacturing, processing, refining, fabricating, or recycling activity is conducted shall not be considered to have been introduced into the manufacturing, processing, refining, fabricating, or recycling process.

(57) “Processing” means the physical application of the materials and labor necessary to modify or change the characteristics of tangible personal property.

(68) (A) "Qualified person" means a person that is primarily engaged in those lines of business described in Codes 3111 to 3399, inclusive, 541711, or 541712 of the North American Industry Classification System (NAICS) published by the United States Office of Management and Budget (OMB), 2012 edition. For the purpose of this subdivision:

1. "Primarily engaged" means 50 percent or more of gross revenues, including intra-company charges, are derived from the manufacturing or research and development activities described in subdivision (a)(1) – (3) for the financial year of the purchaser preceding the purchase of the property. In cases where the purchaser was not primarily engaged in manufacturing or research and development activities for the financial year preceding the purchase of the property, the one year period following the date of purchase of the property will be used. In the case of a nonprofit organization, "primarily engaged" means 50 percent or more of the funds allocated to the establishment are attributable to qualifying activities.

2. For purposes of classifying a line or lines of business, the economic unit shall be the "establishment" and the classification of the line or lines of business will be based on the establishment's single most predominant activity based upon gross revenue, including intra-company charges. An establishment is not necessarily identical with the enterprise or company which may consist of one or more establishments. Also, an establishment is to be distinguished from subunits of the establishment such as departments.

3. Where a person conducts business at more than one establishment within the meaning of this subdivision, then that person shall be considered to be a "qualified person" for purposes of this regulation only as to those purchases that are intended to be used and are actually used in an establishment in which the purchaser is primarily engaged in those lines of business described in Codes 3111 to 3399, inclusive, 541711, or 541712 of the North American Industry Classification System (NAICS) published by the United States Office of Management and Budget (OMB), 2012 edition.

(B) Notwithstanding subdivision (b)(8)(A), "Qualified person" does not include:

1. An apportioning trade or business that is required to apportion its business income pursuant to subdivision (b) of RTC section 25128.

2. A trade or business conducted wholly within this state that would be required to apportion its business income pursuant to subdivision (b) of RTC section 25128 if it were subject to apportionment pursuant to RTC section 25101.

In general, these apportioning trades or businesses derive more than 50 percent of their gross business receipts from an agricultural business activity, an extractive business activity, a savings and loan activity, or a banking or financial business activity.

(79) (A) "Qualified tangible personal property" includes, but is not limited to, all of the following:

1. Machinery and equipment, including component parts and contrivances such as belts, shafts, moving parts, and operating structures. For purposes of this subdivision, manufacturing aids as described in Regulation 1525.1, *Manufacturing Aids*, may be considered machinery and equipment, when purchased by a qualified person for use by that person in a manner qualifying for exemption, even though such property may subsequently be delivered to

or held as property of the person to whom the manufactured product is sold. The manufacturing aids must meet the useful life requirement of subdivision (b)(13).

2. Equipment or devices used or required to operate, control, regulate, or maintain the machinery, including, but not limited to, computers, data-processing equipment, and computer software, together with all repair and replacement parts with a useful life of one or more years therefor, whether purchased separately or in conjunction with a complete machine and regardless of whether the machine or component parts are assembled by the qualified person or another party.

3. Tangible personal property used in pollution control that meets standards established by this state or any local or regional governmental agency within this state.

4. Special purpose buildings and foundations used as an integral part of the manufacturing, processing, refining, fabricating, or recycling process, or that constitute a research or storage facility used during those processes. Buildings used solely for warehousing purposes after completion of those processes are not included. For purposes of this subdivision:

a. "Special purpose building and foundation" means only a building and the foundation immediately underlying the building that is specifically designed and constructed or reconstructed for the installation, operation, and use of specific machinery and equipment with a special purpose, which machinery and equipment, after installation, will become affixed to or a fixture of the real property, and the construction or reconstruction of which is specifically designed and used exclusively for the specified purposes as set forth in subdivision (a) of this regulation (the qualified purpose).

b. A building is specifically designed and constructed or modified for a qualified purpose if it is not economic to design and construct the building for the intended purpose and then use the structure for a different purpose.

c. A building is used exclusively for a qualified purpose only if its use does not include a use for which it was not specifically designed and constructed or modified. Incidental use of a building for nonqualified purposes does not preclude the building from being a special purpose building. "Incidental use" means a use which is both related and subordinate to the qualified purpose. A use is not subordinate if more than one-third of the total usable volume of the building is devoted to a use which is not a qualifying purpose.

d. If an entire building does not qualify as a special purpose building, a taxpayer may establish that a portion of a building, and the foundation immediately underlying the portion, qualifies for treatment as a special purpose building and foundation if the portion satisfies all of the definitional provisions in this subdivision.

e. Buildings and foundations that do not meet the definition of a special purpose building and foundation set forth above include, but are not limited to, buildings designed and constructed or reconstructed principally to function as a general purpose manufacturing, industrial, or commercial building; or storage facilities that are used primarily before the point raw materials are introduced into the process and/or after the point at which the manufacturing, processing, refining, fabricating, or recycling has altered tangible personal property to its completed form.

f. The term "integral part" means that the special purpose building or foundation is used directly in the activity qualifying for the partial exemption from sales and use tax and is essential to the completeness of that activity. In determining whether property is used as an integral part of manufacturing, all properties used by the qualified person in processing the raw materials into the final product are properties used as an integral part of manufacturing.

(B) "Qualified tangible personal property" does not include any of the following:

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

(10) "Recycling" means the process of modifying, changing, or altering the physical properties of manufacturing, processing, refining, fabricating, secondary or postconsumer waste which results in the reduction, avoidance or elimination of the generation of waste, but does not include transportation, baling, shredding, grinding, compressing, or any other activity that does not otherwise change the physical properties of any such waste.

(811) "Refining" means the process of converting a natural resource to an intermediate or finished product, but does not include any transportation, storage, conveyance or piping of the natural resources prior to commencement of the refining process, or any other activities which are not part of the process of converting the natural resource into the intermediate or finished product.

(912) "Research and development" means those activities that are described in Section 174 of the Internal Revenue Code or in any regulations thereunder. Research and development shall include activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. For this purpose, uncertainty exists if the information available to the qualified taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product.

(4013) "Useful life" for tangible personal property that the qualified person treats as having a useful life of one or more years for state income or franchise tax purposes shall be deemed to have a useful life of one or more years for purposes of this regulation. "Useful life" for tangible personal property that the qualified person treats as having a useful life of less than one year for state income or franchise tax purposes shall be deemed to have a useful life of less than one year for purposes of this regulation.

(c) PARTIAL EXEMPTION CERTIFICATE.

(1) IN GENERAL. Qualified persons who purchase or lease qualified tangible personal property from an in-state retailer, or an out-of-state retailer obligated to collect use tax, must provide the retailer with a partial exemption certificate in order for the retailer to claim the partial exemption. If the retailer takes a timely partial exemption certificate in the proper form as set forth in subdivision (c)(23) and in good faith as defined in subdivision (c)(4), from a qualified person, the partial exemption certificate relieves the retailer from the liability for the sales tax

subject to exemption under this regulation or the duty of collecting the use tax subject to exemption under this regulation. A certificate will be considered timely if it is taken any time before the seller bills the purchaser for the property, any time within the seller's normal billing or payment cycle, or any time at or prior to delivery of the property to the purchaser.

The exemption certificate form set forth in Appendix A may be used as an exemption certificate.

Contractors purchasing property for use in the performance of a construction contract for a qualified person as described in subdivision (a)(4), who purchase qualified tangible personal property from an in-state retailer, or an out-of-state retailer obligated to collect use tax, must provide the retailer with a partial exemption certificate in order for the retailer to claim the partial exemption. If the retailer takes a timely partial exemption certificate in the proper form as set forth in subdivision (c)(3) and in good faith as defined in subdivision (c)(4), from the contractor, the partial exemption certificate relieves the retailer from the liability for the sales tax subject to exemption under this regulation or the duty of collecting the use tax subject to exemption under this regulation.

The exemption certificate form set forth in Appendix B may be used as an exemption certificate.

(2) BLANKET PARTIAL EXEMPTION CERTIFICATE. In lieu of requiring a partial exemption certificate for each transaction, a qualified person may issue a blanket partial exemption certificate. The partial exemption certificates form set forth in Appendix A and Appendix B may be used as a blanket partial exemption certificate. Qualified persons or contractors claiming the partial exemption through a blanket exemption certificate must make a clear reference to the blanket partial exemption certificate in documents such as their written purchase orders, sales agreements, leases, or contracts. Such documents referencing the blanket partial exemption certificate must include a description of the property being purchased.

When purchasing tangible personal property not qualifying for the partial exemption, the qualified person or contractor must clearly state in documents such as a written purchase order, sales agreement, lease, or contract that the sale or purchase is not subject to the blanket partial exemption certificate.

(23) FORM OF PARTIAL EXEMPTION CERTIFICATE. Any document, such as a letter or purchase order, timely provided by the purchaser to the seller will be regarded as a partial exemption certificate with respect to the sale or purchase of the tangible personal property described in the document if it contains all of the following essential elements:

(A) The signature of the purchaser, purchaser's employee, or authorized representative of the purchaser.

(B) The name, address and telephone number of the purchaser.

(C) The number of the seller's permit held by the purchaser. If the purchaser is not required to hold a permit because the purchaser sells only property of a kind the retail sale of which is not taxable, e.g., food products for human consumption, or because the purchaser makes no sales in this state, the purchaser must include on the certificate a sufficient explanation as to the reason the purchaser is not required to hold a California seller's permit in lieu of a seller's permit number.

(D) A statement that the property purchased is:

1. To be used primarily for a qualifying activity as described in subdivision (a)(1) – (3), or

2. For use by a contractor purchasing that property for use in the performance of a construction contract for the qualified person as described in subdivision (a)(4).

(E) A statement that the purchaser is:

1. a person primarily engaged in a manufacturing business described in NAICS Codes 3111 to 3399 or in research and development activities as described in NAICS Codes 541711 and 541712 (OMB 2012 edition).

2. a contractor performing a construction contract for a qualified person primarily engaged in manufacturing business described in NAICS Codes 3111 to 3399 or in a research and development activities as described in NAICS Codes 541711 and 541712 (OMB 2012 edition).

(F) A statement that the property purchased is qualified tangible personal property as described in subdivision (7)(A).

(G) A description of property purchased.

(H) The date of execution of the document.

~~A document containing the essential elements described in this subdivision is the minimum form which will be regarded as a partial exemption certificate. However, in order to preclude potential controversy, the seller should timely obtain from the purchaser a certificate substantially in the form shown in the Appendix of this regulation.~~

(34) RETENTION AND AVAILABILITY OF PARTIAL EXEMPTION CERTIFICATES. A retailer must retain each partial exemption certificate received from a qualified person for a period of not less than four years from the date on which the retailer claims a partial exemption based on the partial exemption certificate.

(45) GOOD FAITH. A seller will be presumed to have taken a partial exemption certificate in good faith in the absence of evidence to the contrary. A seller, without knowledge to the contrary, may accept a partial exemption certificate in good faith where a qualified person or a contractor performing a construction contract for a qualified person provides a certificate meeting the requirements provided in subdivision (c)(23). However, a partial exemption certificate cannot be accepted in good faith where the seller has knowledge that the property is not subject to a partial exemption, or will not be otherwise used in a partially exempt manner.

(d) WHEN THE PARTIAL EXEMPTION DOES NOT APPLY. The exemption provided by this regulation shall not apply to either of the following:

(1) Any tangible personal property purchased by a qualified person during any calendar year that exceeds two hundred million dollars (\$200,000,000) of purchases of qualified tangible personal property for which an exemption is claimed by the qualified person under this regulation. For purposes of this subdivision, in the case of a qualified person that is required to be included in a combined report under RTC section 25101 or authorized to be included in a

combined report under RTC section 25101.15, the aggregate of all purchases of qualified personal property for which an exemption is claimed pursuant to this regulation by all persons that are required or authorized to be included in a combined report shall not exceed two hundred million dollars (\$200,000,000) in any calendar year.

For the purposes of this subdivision, "calendar year" includes the period July 1, 2014 to December 31, 2014, and the period January 1, 2022 to June 30, 2022. Accordingly, for calendar years 2014 and 2022, a qualified person may not exceed \$200,000,000 in purchases of qualified tangible personal property for which an exemption is claimed by the qualified person under this regulation.

(2) The sale or storage, use, or other consumption of property that, within one year from the date of purchase, is removed from California, converted from an exempt use under subdivision (a) to some other use not qualifying for exemption, or used in a manner not qualifying for exemption.

(e) PURCHASER'S LIABILITY FOR THE PAYMENT OF SALES TAX. If a purchaser certifies in writing to the seller that the tangible personal property purchased without payment of the tax will be used in a manner entitling the seller to regard the gross receipts from the sale as exempt from the sales tax, and the purchase exceeds the two-hundred-million-dollar (\$200,000,000) limitation described in subdivision (d)(1), or within one year from the date of purchase, the purchaser removes that property from California, converts that property for use in a manner not qualifying for the exemption, or uses that property in a manner not qualifying for the exemption, the purchaser shall be liable for payment of sales tax, with applicable interest, as if the purchaser were a retailer making a retail sale of the tangible personal property at the time the tangible personal property is so purchased, removed, converted, or used, and the cost of the tangible personal property to the purchaser shall be deemed the gross receipts from that retail sale.

(f) LEASES. Leases of qualified tangible personal property classified as "continuing sales" and "continuing purchases" in accordance with Regulation 1660, *Leases of Tangible Personal Property – In General*, may qualify for the partial exemption subject to all the limitations and conditions set forth in this regulation. The partial exemption established by this regulation shall apply to the rentals payable pursuant to the lease, provided the lessee is a qualified person and the tangible personal property is used in an activity described in subdivision (a). The exemption applies to lease payments for use of the qualifying property during the period the partial exemption is in effect. For example, a 10-year lease begins January 1, 2013 and ends December 31, 2023. The lease payments for use from July 1, 2014 to December 31, 2022 qualify for the partial exemption.

Appendix A

PARTIAL EXEMPTION CERTIFICATE FOR MANUFACTURING AND RESEARCH & DEVELOPMENT EQUIPMENT – SECTION 6377.1

This is a partial exemption from sales and use taxes at the rate of 4.1875% from July 1, 2014 to December 31, 2016, and from 3.9375% from January 1, 2017 to June 30, 2022. You are not relieved from your obligations for the remaining state tax and local and district taxes on this transaction. This partial exemption also applies to lease ~~payments made~~periods occurring on or after July 1, 2014 and before July 1, 2022, for qualified tangible personal property even if the lease agreement was entered into prior to July 1, 2014.

I hereby certify that the tangible personal property described below and purchased or leased from:

SELLER'S/LESSOR'S NAME
SELLER'S/LESSOR'S ADDRESS (Street, City, State, Zip Code)

is qualified tangible personal property and will be used by me primarily (please check one):

- 1. for manufacturing, processing, refining, fabricating, or recycling, or
- 2. for research and development, or
- 3. to maintain, repair, measure, or test any property being used for (1) or (2) above.

~~4. Will be used in the performance of a construction contract for a qualified person, that will use that property as an integral part of the manufacturing, processing, refining, fabricating, or recycling process, or as a research or storage facility for use in connection with these processes.~~

Description of qualified tangible property purchased or leased*:

*See Regulation 1525.4 (b)(~~79~~) for a description of what is included and excluded from "qualified tangible personal property."

I, as the undersigned purchaser, hereby certify I am primarily engaged in manufacturing, processing, refining, fabricating, or recycling as described in Codes 3111 to 3399 of the North American Industry Classification System (NAICS)¹ or I am primarily engaged in biotechnology, or physical, engineering, and life sciences research and development as described in Codes 541711 and 541712 of the NAICS.

I understand that if such property is, within one year from the date of purchase or lease, removed from California or used in a manner not qualifying for the partial exemption that I am required by the Sales and Use Tax Law to report and pay the state tax measured by the sales price/rentals payable of the property to/by me.

I further understand that the Section 6377.1 partial exemption is limited to \$200 million in qualifying purchases per qualified person per calendar year.

NAME OF PURCHASER	SIGNATURE OF PURCHASER, PURCHASER'S EMPLOYEE, OR AUTHORIZED REPRESENTATIVE
PRINTED NAME OF PERSON SIGNING	TITLE
ADDRESS OF PURCHASER	
PERMIT NUMBER (IF YOU ARE NOT REQUIRED TO HOLD A PERMIT, EXPLAIN WHY)	TELEPHONE NUMBER
EMAIL ADDRESS OF PERSON SIGNING	DATE

¹ Published by the US Office of Management and Budget, 2012 edition.

Appendix B

CONSTRUCTION CONTRACTS - PARTIAL EXEMPTION CERTIFICATE MANUFACTURING
AND RESEARCH & DEVELOPMENT EQUIPMENT – SECTION 6377.1

This is a partial exemption from sales and use taxes at the rate of 4.1875% from July 1, 2014 to December 31, 2016, and from 3.9375% from January 1, 2017 to June 30, 2022. You are not relieved from your obligations for the remaining state tax and local and district taxes on this transaction.

I hereby certify that the tangible personal property described below and purchased from:

<u>SELLER'S/LESSOR'S NAME</u>
<u>SELLER'S/LESSOR'S ADDRESS (Street, City, State, Zip Code)</u>

is qualified tangible personal property and will be used by me in the performance of a construction contract for a qualified person who will use that property as an integral part of the manufacturing, processing, refining, fabricating, or recycling process, or as a research or storage facility for use in connection with those processes.

Description of qualified tangible property purchased *:

*See Regulation 1525.4 (b)(9) for a description of what is included and excluded from “qualified tangible personal property.”

I further certify I am performing a construction contract for a qualified person primarily engaged in manufacturing, processing, refining, fabricating, or recycling as described in Codes 3111 to 3399 of the North American Industry Classification System (NAICS)¹ or primarily engaged in biotechnology, or physical, engineering, and life sciences research and development as described in Codes 541711 and 541712 of the NAICS.

I understand that if I use the property for any purpose other than indicated above, I am required to report and pay the state tax measured by the sales price of the property to me.

<u>NAME OF PURCHASER</u>	<u>SIGNATURE OF PURCHASER, PURCHASER'S EMPLOYEE, OR AUTHORIZED REPRESENTATIVE</u>
<u>PRINTED NAME OF PERSON SIGNING</u>	<u>TITLE</u>
<u>ADDRESS OF PURCHASER</u>	
<u>PERMIT NUMBER (IF YOU ARE NOT REQUIRED TO HOLD A PERMIT, EXPLAIN WHY)</u>	<u>TELEPHONE NUMBER</u>
<u>EMAIL ADDRESS OF PERSON SIGNING</u>	<u>DATE</u>

¹ Published by the US Office of Management and Budget (OMB), 2012 edition,

From: [Buehler, Susanne](#)
To: [Stark, Kirsten](#); [Whitaker, Lynn](#); [Oakes, Clifford](#)
Subject: FW: CalTax Comments to Proposed Reg 1525.4
Date: Wednesday, October 23, 2013 2:44:01 PM
Attachments: [Comments to BOE Manuf SUT Exemption 10-23-13.docx](#)

From: Therese Twomey [mailto:Therese@caltax.org]
Sent: Wednesday, October 23, 2013 2:08 PM
To: Buehler, Susanne
Subject: CalTax Comments to Proposed Reg 1525.4

Susanne,

Attached please find CalTax's comments pertaining to proposed regulation 1525.4, dealing with the sales/use tax exemption for manufacturing and research-and-development equipment. Please let me know if you have any questions, or would like to discuss our submittal. Thank you.

Therese Twomey

Fiscal Policy Director
California Taxpayers Association
1215 K Street, Suite 1250
Sacramento, CA 95814
916.930.3105
therese@caltax.org
www.caltax.org



As of October 23, 2013

**Comments to State Board of Equalization's Proposed Regulation
1525.4 (Manufacturing and Research & Development Equipment)**

General Observations:

1. The proposed regulations, where applicable, should mirror or be predicated on the former Manufacturers' Investment Credit (MIC) definitions, terminology, concepts, etc. These provisions have been vetted, and some have been reinforced or further clarified by case law. In instances where MIC terminology is inapplicable, we urge the BOE to interpret and draft qualification/eligibility criteria to be as broad and inclusive as possible – consistent with the Legislature's intent to maximize utilization of the exemption and promote economic growth.

Specific Comments:

1. The law defines "primarily" to mean 50 percent or more of the time, for purposes of determining whether a taxpayer is engaged in a qualifying line of business. The regulations should clarify how this definition would be applied to taxpayers engaged in multiple lines of business, particularly taxpayers who are engaged in multiple lines of business and the percent of involvement in a business may vary from year to year. For example, a manufacturer of electronics may also be a retailer of these and others electronics within the state of California. This would lead to a year-by-year look back analysis to determine if this manufacturer was "primarily" an electronics manufacturer or a retail dealer of electronics and accessories. The old MIC regulations addressed these fact patterns and timing issues specifically. We urge the BOE to consider these MIC provisions in drafting the regulations pertaining to NAICS classification. Additionally, the BOE staff may want to review the [Appeal of Save Mart](#) (2002-SBE-002, decided on February 6, 2002) decision in which the taxpayer successfully contended it did have valid multiple lines of business (Retail grocery and a manufacturing line of business, a bakery and meat processing.) Here is a link for more information about this matter from 2001.

http://www.caltax.org/california's_first_MIC_appeal.htm

2. The law defines “primarily” to mean 50 percent or more of the *time*. How will “time” be defined for purposes of determining which businesses qualify for the exemption? For federal purposes, NAICS code affiliations are generally determined by reference to revenue. How will the revenue and time factors be reconciled when determining if a company meets the 50-percent threshold? Will each employee’s “time” be looked at individually? Will non-manufacturing and/or non-R&D employees and activities be considered within the applicable NAICS codes? For example, if a company is a manufacturer, but also sells the products it manufactures, will the sales, marketing and related administrative “time” be considered when determining the 50-percent test? Also, will intercompany activity be considered in meeting the 50-percent test?

3. The language appears to allow a subsequent determination by the FTB to invalidate a decision by a taxpayer or retailer that a person is a “qualified person” through reference to a subsequent determination under RTC Section 25101 and 25128. (See draft regulation section b. Definitions (6)(B)(1) and (6)(B)(2).) This seems to leave multiple parties subject to potential whipsaw positions by the BOE and FTB. We urge the BOE to adopt a prospective only application of a FTB decision in this area. This would be clarified through regulatory language that protects the retailer who relied, in presumed good faith, upon an exemption certificate. There has been extensive discussion about the legal priority of FTB v. BOE when there are overlapping authorities.
See: <http://www.caltax.org/member/digest/jun2002/6.2002.Micheli-DoesTheSBEHavePower.03.htm>

4. The law defines “qualified person” to mean a person that is primarily engaged in specified lines of businesses. Will the determination of a “qualified person” be determined on a legal entity basis, or on an affiliated or unitary group basis? Will purchases by legal entity who is not a “qualified person” be eligible for the partial exemption when items purchased are used by affiliated legal entity who is a “qualified person” (for example, legal entity is not a “qualified person” and purchases materials for a manufacturing building that is leased to affiliate who is a “qualified person”)? Also, will activities within and without California be considered in determining whether a company is “primarily engaged” in a qualifying activity?

5. The proposed regulation states that “qualified tangible personal property purchased for use by a construction contractor purchasing that property for use in the performance of a construction contract for the qualified person...” is eligible for the partial exemption. However, the regulation does not define “qualified tangible personal property” as it relates to a construction contractor performing a construction contract for a qualified person. The intent of the legislature was to make sure that the building costs of the qualified plant or research and development facility owned by a qualified person is covered in the definition

section. The regulations should define qualified tangible personal property used by construction contractors and subcontractors to broadly include such things as construction equipment purchased and used in the performance of a contract with a qualified person, permanent construction materials, long-term leased equipment, etc.

6. The law allows specified purchases by contractors to qualify, as mentioned above, but does not define contractors, subcontractors, etc. The regulations provide an inclusive definition of “contractors”, “subcontractors”, etc. and also qualify “material suppliers” who supply the raw materials for the project and are the construction contractors for the project.
7. Special purpose buildings and foundations, and specified properties that are “integral” to manufacturing, processing, refining, etc., are considered to be qualifying factors. However, “integral” is not defined. The regulations should clarify “integral” to broadly include tangible personal property that may not directly come in physical contact with the product but is a part of bringing the product to completion, such as equipment used to test the finished product.
8. The law does not define “special purpose buildings and foundations”. The regulations should broadly define “special purpose buildings and foundations” to parallel the MIC definitions (which includes properties such as clean rooms, vibration-free foundations, etc.) and should include an update that reflects current-technology special purpose buildings and foundations.
9. Qualifying tangible personal property is generically defined in statutes to include specified machinery, equipment and tangible personal property. In some cases, tooling may be designed and owned by the taxpayer, manufactured by the taxpayer’s suppliers, and is used by the taxpayer to produce component parts that are then incorporated into the taxpayer’s manufacturing of another product. As tooling and fixtures are tangible property used to manufacture components, and since various tooling and fixtures have a useful life of more than one year, the regulations should clarify that tooling and fixtures with a useful life of one or more years be considered qualifying equipment/property.
10. The exemption is capped at \$200 million in qualifying purchases per year. The regulations should clarify whether the cap is \$200 million or \$100 million for 2014, as the exemption commences on July 1, 2014. CalTax urges the BOE to adopt the higher cap in keeping with the Legislature’s intent to maximize utilization in order to spur economic activity and recovery.
11. Also pertaining to the \$200 million cap, the proposed language should include a recordkeeping or notification function for qualified purchases to help taxpayers

avoid exceeding the \$200 million limit.

12. The proposed certification process imposes a very difficult burden on in-state retailers regarding enforcement of exemption certificates and the law's annual spending cap of \$200 Million per "qualified person." The qualified person is to provide an exemption certificate to the retailer prior to purchases being made. The retailer is not in a legal position to determine if the exemption certificate is appropriate under the customers' specific facts and circumstances. Further, how is the retailer to know when a customer has exceeded the \$200 Million annual cap on tax reduced purchases when the customer is likely purchasing from multiple retailers? The prior MIC regulations did not address this issue and we suggest the BOE review and consider the adoption of auditable and predictable standards identical to the streamlined sales tax exemption certificate process which shifts the burden from the retailer to the purchaser. The draft exemption certificate should also be modified or expanded to address the leasing of manufacturing equipment which we anticipate will be a common fact pattern.
13. The proposed regulation does not contemplate how refunds would be addressed when a "qualified person" who only knows in a subsequent period that they are a "qualified person" and has paid sales taxes to their vendor(s) for prior period purchases. Further, the draft anticipates that "qualified persons" will always provide the exemption certificate in advance and then will be using use tax accruals or promptly notify retailers to turn off exemptions to make "corrections" with the fact and circumstances. This appears to add significant burdens to taxpayers, manufacturers and the BOE audit staff in sorting out these likely fact patterns. BOE staff may wish to consider adding a direct pay permit process for in-state purchases, which would allow the beneficiary of the sales tax rate reduction to monitor and control its use tax accruals. This likely would be easier to audit and administer.
14. The proposed regulations prohibit the seller from accepting an exemption certificate if the seller has knowledge that the property is not a qualifying purchase. The sentence beginning with "However, a partial exemption certificate cannot be accepted in good faith where the seller has knowledge that the property is not subject to a partial exemption, or will not be otherwise used in a partially exempt manner" should be deleted. This language implies that the seller must verify the eligibility of the equipment at the time of purchase or when the certificate is submitted, neither of which is feasible.
15. The law specifies that interest be applied to tax liabilities in instances where a qualifying purchase received a tax exemption, but was later determined to be ineligible. The Legislature has been clear with regard to circumstances under which penalties ought to apply, and the absence of a reference to penalties is indicative of the Legislature's intent. The regulations should specify that penalties

shall not be imposed in the specified situations.

16. Some computer software systems are unable to accommodate a tax rate that has four digits after the decimal point. Taxpayers making purchases from sellers whose computer systems are unable to accommodate the extra digit likely will round the exemption rate up. Reprogramming of software is often extensive and cumbersome. The regulations should address this issue, and hold affected taxpayers harmless from penalties during the software update process.
17. The proposed regulations establish the tax exemption rate at 3.9375 percent beginning January 1, 2017. To the extent that the .25 tax increase enacted by Proposition 30 is extended by subsequent law, and a Rule 100 change is not adopted immediately following the change, regulations would be inconsistent with statutes. We suggest that the regulations add “unless the tax enacted by Section 36, Article XIII of the State Constitution is extended or otherwise changed” after “RTC (3.9375%)” on page 1 paragraph 3 of the proposed regulation.
18. The sample exemption certificate references “MANUFACTURING” only in the title. We recommend that the certificate also reference “Research and Development” where applicable. The certificate also should incorporate provisions pertaining to leases and purchases made by contractors for use in the performance of a construction contract for a qualified person.



DOWNEY·SMITH·FIER
STATE & LOCAL TAX

October 23, 2013

Susanne Buehler, Chief
Board of Equalization
Tax Policy Division
Sales and Use Tax Department
450 N Street
Sacramento, CA 94279-0092

Re: Downey, Smith and Fier Comments for Proposed Reg. 1525.4

Dear Ms. Buehler:

Downey, Smith & Fier participated in the first interested party discussion (via phone) and looks forward to continuing to work with you and the Board to support the drafting of a final Regulation 1525.4 - Manufacturing and Research & Development Equipment. This letter outlines our comments and provides areas to consider as this process moves forward. Our points are based on experience in other states with manufacturing exemptions and with California's previous manufacturer's investment credit, along with managing BOE audits involving mixed businesses where a segment of the Client's operations qualified for the partial exemption as Teleproduction and Other Post Production activities under Regulation 1532.

Qualified Person

The proposed Regulation defines a qualified person as follows: (6) (A) "Qualified person" means a person that is primarily engaged in those lines of business described in Codes 3111 to 3399, inclusive, 541711, or 541712 of the North American Industry Classification System (NAICS) published by the United States Office of Management and Budget (OMB), 2012 edition.

We believe that this portion of the Regulation needs to be expanded to include guidance to clarify qualified person when a business includes more than *one activity* of which at least one involves activities that would be classified under the NAICS codes defined as manufacturing. The clarification should be consistent with the stream of appeal decisions that followed the initial adoption of CA's previous Manufacturer Investment Credit (Save Mart Supermarkets and Costco). It is our opinion that qualified person should not simply be based on the overall NAICS of the Company but the activities conducted in California by a department or division, similar to a "line of business". Regulation 1532 – Teleproduction and other Postproduction addresses this same topic and applies a concept of "establishment". The existing language in Regulation 1532 may provide a starting point for addressing this topic. That said, we would point out that the revenue evaluation to determine "primary" in Regulation 1532 has been difficult and extremely time consuming to work through during audit. Although separate accounting and costs of operation were readily available, auditors have struggled with their verification when such segments do not have direct revenue.

Susanne Bremer
Mfg. Comments from DSF
October 23, 2013

In addition, while use may be measurable in some activities based on hours or a similar time unit, we believe other methods should be included to define primary. Alternatively, the Board should consider developing and including a series of examples or facts and circumstances scenarios that would assist with this determination.

Qualified Property

Similar to the above discussion of qualified person, we believe the section that addresses qualified property should also incorporate the prior Manufacturer's Investment Credit decisions related to dual-use property, not permitting the bifurcation of individual assets (*Appeal of Milpitas Materials Company*).

Other Issues

The \$200 million dollar cap needs to address purchases for 2014. Will the cap be pro-rated so that \$100M will qualify or will the \$200M be allowed for 2014? Although the Regulation states the cap is based on purchases in a calendar year, we believe qualified companies should be allowed to elect a fiscal year based on its tax return filing to facilitate ease of reporting, auditing and matching to the company's financial year.

In addition, how the cap will treat purchases amongst a combined group should be addressed. For example, if three companies that file a combined report each purchase \$70M of qualified property, does each entity reduce their qualified purchases by \$3.333M? Or, does the taxpayer need to determine chronologically when the \$200M cap is reached for all entities in the combined group? We suggest the taxpayer be allowed flexibility to allocate the \$200M at the end of the tax year to the members of the combined group to facilitate reporting. Otherwise, tracking purchases during the year for multiple entities would be overly burdensome.

Further, we believe the vendor should not be responsible for any use tax liability that the purchaser would occur for exceeding the \$200M cap. It would be too difficult for the vendor to track. Accordingly, similar to a resale certificate, the vendor would be relieved of any liability provided it accepted the exemption certificate in good faith.

Thank you for considering these comments and we look forward to further discussions with you. Please call me at (562) 249-6002 if you have any questions.

Sincerely,



Jim Fier
Partner
Downey, Smith & Fier