STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
450 N STREET, SACRAMENTO, CALIFORNIA
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-80
916-445-2130 • FAX 916-324-3984
www.boe.ca.gov

May 30, 2014

To Interested Parties:

Notice of Proposed Regulatory Action

The State Board of Equalization Proposes to Adopt California Code of Regulations, Title 18, Section 1525.4, *Manufacturing and Research & Development Equipment*

NOTICE IS HEREBY GIVEN that the State Board of Equalization (Board), pursuant to the authority vested in it by Revenue and Taxation Code (RTC) section 7051, proposes to adopt California Code of Regulations, title 18, section (Regulation) 1525.4, *Manufacturing and Research & Development Equipment*. Proposed Regulation 1525.4 implements, interprets, and makes specific the partial sales and use tax exemption for the sale and storage, use, or other consumption of equipment used primarily in manufacturing, and research and development, established by RTC section 6377.1, and prescribes the form of the partial exemption certificate that must be furnished to the retailer under the statute.

PUBLIC HEARING

The Board will conduct a meeting in Room 121, at 450 N Street, Sacramento, California, on July 17-18, 2014. The Board will provide notice of the meeting to any person who requests that notice in writing and make the notice, including the specific agenda for the meeting, available on the Board's Website at *www.boe.ca.gov* at least 10 days in advance of the meeting.

A public hearing regarding the proposed regulatory action will be held at 10:00 a.m. or as soon thereafter as the matter may be heard on July 17 or 18, 2014. At the hearing, any interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of proposed Regulation 1525.4.

AUTHORITY

RTC section 7051

REFERENCE

RTC section 6377.1

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW PURSUANT TO GOVERNMENT CODE SECTION 11346.5, SUBDIVISION (a)(3)

Summary of Existing Laws and Regulations

As a general matter, California's Sales and Use Tax Law (RTC, div. 2, pt. 1, chs. 1-11 (§ 6001 et. seq.)) imposes sales tax on retailers, and the tax is measured by a retailer's gross receipts from the retail sale of tangible personal property in California, unless an exemption or exclusion applies. (RTC, §§ 6012, 6051.) Although sales tax is imposed on retailers, retailers may collect sales tax reimbursement from their customers if their contracts of sale so provide. (Civ. Code, § 1656.1; Cal. Code Regs., tit. 18, § 1700.)

When sales tax does not apply, California use tax generally applies to the use of tangible personal property purchased from a retailer for storage, use or other consumption in California. (RTC, §§ 6011, 6201.) Unless an exemption or exclusion applies, the use tax is measured by the sales price of tangible personal property and the person actually storing, using, or otherwise consuming the tangible personal property is liable for the tax. (RTC, §§ 6011, 6201, 6202, 6401; Cal. Code Regs., tit. 18, § 1685.) However, every retailer "engaged in business" in California that makes sales subject to California use tax is required to collect the use tax from its customers and remit it to the Board, and such retailers are liable for California use tax that they fail to collect from their customers and remit to the Board. (RTC, §§ 6202, 6203; Cal. Code Regs., tit. 18, §§ 1684, 1686.)

The measure of tax is generally the same regardless of whether the applicable tax is a sales tax imposed on the retailer, or a use tax imposed on the purchaser. (See RTC, §§ 6011, 6012.) The current statewide sales and use tax rate is 7.50 percent, although the combined tax rate is higher in cities and counties that impose additional district transactions (sales) and use taxes in conformity with the Transactions and Use Tax Law (RTC, § 7251 et seq.). The 7.50 percent rate is comprised of:

- The .50 percent rate of the sales and use taxes imposed and required to be deposited in the state's Local Public Safety Fund by section 35 of article XIII of the California Constitution;
- The .25 percent rate of the sales and use taxes imposed and required to be deposited in the state's Education Protection Account by section 36 of article XIII of the California Constitution;

- The 3.6875 percent rate of the sales and use taxes imposed by RTC sections 6051 and 6201 that are deposited in the state's general fund;
- The 0.50 percent rate of the sales and use taxes imposed and required to be deposited in the state's Local Revenue Fund by RTC sections 6051.2 and 6201.2;
- The 0.25 percent rate of the sales and use taxes imposed by RTC sections 6051.3 and 6201.3 that are deposited in the state's general fund;
- The 0.25 percent rate of the sales and use taxes imposed and required to be deposited in the state's Fiscal Recovery Fund by RTC sections 6051.5 and 6201.5;
- The 1.0625 percent rate of the sales and use taxes imposed by RTC sections 6051 and 6201 that are required to be deposited in the state's Local Revenue Fund 2011 by RTC sections 6051.15 and 6201.15; and
- The 1.00 percent rate specified by RTC section 7203.1 for local sales and use taxes imposed under the Bradley-Burns Uniform Local Sales and Use Tax Law (RTC, § 7200 et seq.).

RTC section 6377.1 was enacted by Assembly Bill No. (AB) 93 (Stats. 2013, ch. 69, effective July 11, 2013), and amended by Senate Bill No. (SB) 90 (Stats. 2013, ch. 70, effective July 11, 2013). RTC section 6377.1, subdivision (a), provides a partial exemption from sales and use tax on certain sales and purchase made on and after July 1, 2014, and before July 1, 2022. The partial exemption applies to: (1) qualified tangible personal property purchased by a qualified person to be used primarily in any stage of the manufacturing, processing, refining, fabricating, or recycling of tangible personal property, 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 under (1) or (2) above; and (4) qualified tangible personal property purchased for use by a contractor purchasing that property for use in the performance of a construction contract for a qualified person that will use that property for statutorily specified purposes.

RTC section 6377.1, subdivision (b), defines relevant terms used in subdivision (a), including "fabricating," "manufacturing," "primarily," "process," "processing," "qualified person," "qualified tangible personal property," "refining," "research and development," and "useful life." As relevant here, RTC section 6377.1, subdivision (b)(3), provides that "'Primarily' means 50 percent or more of the time. RTC section 6377.1, subdivision (b)(6) provides that:

> (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.
> (B) Notwithstanding subparagraph (A), "qualified person" shall not include either of the following:
> (i) An apportioning trade or business that is required to apportion its business income pursuant to subdivision (b) of Section 25128.

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

And, RTC section 6377.1, subdivision (b)(7)(A)(iv) provides that qualified tangible personal property includes "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."

RTC section 6377.1, subdivision (c), provides that the partial exemption shall not be allowed, unless the purchaser furnishes the retailer with an exemption certificate, completed in accordance with any instructions or regulations as the Board may prescribe, and the retailer retains the exemption certificate in its records and furnishes it to the Board upon request.

RTC section 6377.1, subdivision (d), specifies that the partial exemption does not apply to any local sales and use taxes levied pursuant to the Bradley-Burns Uniform Local Sales and Use Tax Law or district transactions and use taxes levied pursuant to the Transactions and Use Tax Law. Subdivision (d) also specifies that the partial exemption does not apply to any sales and use taxes levied pursuant to RTC sections 6051.2, 6051.5, 6201.2, and 6201.5, any sales and use taxes levied pursuant to section 35 of article XIII of the California Constitution, and any sales and use taxes levied pursuant to RTC sections 6051 and 6201 that are required to be deposited in the Local Revenue Fund 2011 by RTC sections 6051.15 and 6201.15. Therefore, the partial exemption applies to the state general fund taxes imposed by RTC sections 6051, 6051.3, 6201, and 6201.3, and the state's Education Protection Account tax imposed by section 36 of article XIII of the California Constitution. Accordingly, from July 1, 2014, to December 31, 2016, the partial exemption rate is 4.1875 percent. After the state's Education Protection Account tax expires on December 31, 2016, the partial exemption rate will be 3.9375 percent.

RTC section 6377.1, subdivision (e)(1)(A), provides that the partial exemption shall not apply to "[a]ny tangible personal property purchased 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 a qualified person under this section." It also provides that "in the case of a qualified person that is required to be included in a combined report under Section 25101 or authorized to be included in a combined report under Section 25101.15, the aggregate of all purchases of qualified personal property for which an exemption is claimed pursuant to this section 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."

RTC section 6377.1, subdivision (f), provides that the partial exemption applies to leases which are classified as continuing sales and continuing purchases for purposes of the sales and use tax law. Regulation 1660, *Leases of Tangible Personal Property - In General*, prescribes the general application of sales and use tax to leases.

The partial exemption expires on July 1, 2022, in accordance with RTC section 6377.1, subdivision (a). And, RTC section 6377.1 is repealed by its own terms effective January 1, 2023, per RTC section 6377.1, subdivision (h).

RTC section 6377.1 is substantially, but not entirely, modeled after the partial sales and use tax exemption provided by RTC section 6377 (repealed by its own terms January 1, 2004) and interpreted in Regulation 1525.2, *Manufacturing Equipment*. For purchases made from January 1, 1994, through December 31, 2003, RTC section 6377 generally provided a partial exemption from sales and use tax for tangible personal property purchased for use by a qualified person to be used primarily in the manufacturing, processing, refining, fabricating, or recycling of property, or research and development. In addition, RTC section 6377, subdivision (b)(3), provided that "'Primarily' means tangible personal property used 50 percent or more of the time in an activity described in subdivision (a)." RTC section 6377, subdivision (b)(6)(B), required a "qualified person" to be "engaged in those lines business described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification Manual" 1987 edition, published by the OMB. And, RTC section 6377, subdivision (c), provided that "No exemption shall be allowed under this section unless the purchaser furnishes the retailer with an exemption certificate, completed in accordance with any instructions or regulations as the board may prescribe, and the retailer subsequently furnishes the board with a copy of the exemption certificate."

Furthermore, as relevant here, Regulation 1525.2, subdivision (c)(6)(B), explained that:

- "For purposes of classifying a line or lines of business [under RTC section 6377, subdivision (b)(6)(B)], 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 value of production"; and
- "Where distinct and separate economic activities are performed at a single physical location, such as construction activities operated out of the same physical location as a lumber yard, each activity should be treated as a separate establishment where: (i) no one industry description in the classification includes such combined activities; (ii) the employment in each such economic activity is significant; and (iii) separate reports are prepared on the number of employees, their wages and salaries, sales or receipts, property and equipment, and other types of financial data, such as financial statements, job costing, and profit center accounting."

Regulation 1525.2 also prescribed the form of the exemption certificate required by RTC section 6377, provided a sample "section 6377" exemption certificate, and prescribed the circumstances under which a seller may accept a "section 6377" exemption certificate in good faith for purposes of being relieved of the obligation to pay or collect tax.

To a lesser extent, RTC section 6377.1 was also modeled after provisions in RTC section 6378 and interpreted in Regulation 1532, *Teleproduction or Other Postproduction Service Equipment*. As relevant here, RTC section 6378 currently provides a partial exemption from sales and use tax for tangible personal property purchased for use by a qualified person to be used primarily in teleproduction and other postproduction services. In addition, RTC section 6378, subdivision (c)(1) provides that "primarily" means "tangible personal property used 50 percent or more of the time in" a qualified activity. RTC section 6378, subdivision (c)(2) provides that "qualified person" means "any person that is primarily engaged in teleproduction or other postproduction activities that are described in Code 512191 of the" NAICS, 1997 edition. And, RTC section 6378, subdivision (d), provides that "No exemption shall be allowed under this section unless the purchaser furnishes the retailer with an exemption certificate, completed in accordance with any instructions or regulations as the board may prescribe, and the retailer subsequently furnishes the board with a copy of the exemption certificate."

Furthermore, as relevant here, Regulation 1532, subdivision (c)(2), explains that:

- "For purposes of classifying a line of business [under RTC section 6378, subdivision (c)(2)], the economic unit shall be the 'establishment' and the classification of the line or lines of business will be based on the establishment's primary activity based upon gross revenues";
- "'Primarily engaged' means 50 percent or more of gross revenues, including intra-company charges, are derived from teleproduction or other postproduction activities for the financial year of the purchaser preceding the purchase of the property. In cases where the purchaser was not primarily engaged in 'teleproduction or other postproduction services' 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"; and
- "In the case of a nonprofit teleproduction or other postproduction establishment, 'primarily engaged' means 50 percent or more of the funds allocated to the establishment are attributable to teleproduction or other postproduction services.

Regulation 1532 also prescribed the form of the exemption certificate required by RTC section 6378, provided two sample "section 6378" exemption certificates, including a blanket exemption certificate, and prescribed the circumstances under which a seller may accept a "section 6378" exemption certificate in good faith for purposes of being relieved of the obligation to pay or collect tax.

Effect, Objectives, and Benefits of the Proposed Adoption of Regulation 1525.4

There is currently no regulation that specifically implements, interprets, or makes specific the partial exemption from sales and use tax established by RTC section 6377.1. There is currently no regulation that prescribes the form of the partial exemption certificate that the purchaser is statutorily required to furnish to the retailer under RTC section 6377.1, or provides a sample partial exemption certificate. Also, there is no regulation that specifically prescribes the circumstances under which a retailer may accept such a partial exemption certificate in good faith for purposes of relieving the retailer of liability for the sales tax or the duty of collecting the use tax from the purchaser.

In addition, there is currently no regulation that defines what is meant by the phrase "primarily engaged" in a qualifying line of business for purposes of RTC section 6377.1, subdivision (b)(6). There is currently no regulation that clarifies and explains the meaning of the phrase "special purpose buildings and foundations" as used in RTC section 6377.1, subdivision (b)(7)(A)(iv). There is currently no regulation that clarifies and explains how the partial exemption applies in the context of lease transactions. And, there is currently no regulation that clarifies how the partial exemption applies in the context of construction contracts.

Business Taxes Committee Process

Board staff determined that it was necessary to draft proposed Regulation 1525.4 to have the effect and accomplish the objectives of fully implementing, interpreting, and making specific the provisions of RTC section 6377.1 and specifically addressing the issues (or "problems" within the meaning of Gov. Code, § 11346.2, subdivision (b)(1)) identified above. Therefore, Board staff prepared a draft of the regulation and held its first meeting to discuss the draft with interested parties on October 9, 2013.

At the October 9, 2013, meeting, staff responded to written comments received prior to the meeting, as well as other suggestions to clarify the draft regulation, including expanding upon the definitions provided in RTC section 6377.1, clarifying the phrase "primarily engaged," clarifying how tax applies to testing equipment and manufacturing aids, allowing for the issuance of a blanket partial exemption certificate to cover multiple purchases from the same vendor, providing a separate partial exemption certificate for construction contractors to use, and clarifying the application of the $200 million annual cap. Then, staff incorporated the suggestions discussed at the meeting into a revised draft of proposed Regulation 1525.4 and, on November 14, 2013, staff posted the revised draft of the proposed regulation on the Board's website, and distributed the revised draft of the proposed regulation to the interested parties that attended the October 9, 2013, meeting and to the interested parties that submitted written comments regarding the initial draft of the proposed regulation.

Board staff held a second meeting with interested parties on December 5, 2013, to discuss the revised draft of proposed Regulation 1525.4. At the meeting, staff responded to written comments received prior to the December 5, 2013, meeting, as well as other suggestions to clarify the definition of "qualified person," clarify when a purchaser is "primarily engaged" in a qualifying line of business, clarify how the partial exemption applies in the context of construction contracts, including contracts for special purpose buildings and foundations, and make various other minor revisions or edits. Then, staff incorporated the suggestions discussed at the meeting into a revised draft of the proposed regulation and, on January 31, 2014, staff posted the revised draft of the proposed regulation on the Board's website, and distributed the revised draft of the proposed regulation to the interested parties that attended the December 5, 2013, meeting.

Board staff held a third meeting with interested parties on February 18, 2014, to discuss the revised draft of proposed Regulation 1525.4. At the meeting, staff responded to written comments received prior to the December 5, 2013, meeting, and agreed to address other suggestions to clarify how tax applies when a purchaser has a qualifying four digit NAICS industry group code (but not a six digit code); further clarify the phrase "primarily engaged"; and add additional tests to ascertain if a purchaser is primarily engaged in a qualifying activity. At the meeting, staff also received suggestions to provide that a qualified person may include an otherwise qualified "establishment" in an apportioning trade or business, subject to RTC section 6377.1, subdivision (b)(6)(B), and businesses that do not have a qualifying six or four digit NAICS code described in RTC section 6377.1, subdivision (b)(6)(A). However, staff did not agree to incorporate these suggestions into the proposed regulation because they are precluded by the express language of RTC section 6377.1.

Therefore, Board staff subsequently prepared Formal Issue Paper 14-001, which recommended that the Board adopt staff's revised draft of proposed Regulation 1525.4 to implement, interpret, and make specific the provisions of RTC section 6377.1. Specifically, subdivision (a) of the revised draft of proposed Regulation 1525.4 incorporated the provisions of RTC section 6377.1, subdivision (a)(1) through (4), prescribing the types of transactions that qualify for the new partial exemption, identified the specific sales and use taxes the partial exemption provided by RTC section 6377.1 does and does not apply to, and provided notice of the partial exemption rates from July 1, 2014, to December 31, 2016, and January 1, 2017, to June 30, 2022.

Subdivision (b) of the revised draft of proposed Regulation 1525.4 incorporated the statutory definitions of "fabricating," "primarily," and "processing" verbatim from RTC section 6377.1, subdivision (b)(1), (3), and (5). Subdivision (b) incorporated the statutory definition of "manufacturing" from RTC section 6377.1, subdivision (b)(2), and clarified when tangible personal property will be treated as having a greater service life or greater functionality for purposes of that definition, using language borrowed from Regulation 1525.2, subdivision (c)(10)(B), and Regulation 1525.2, subdivision (c)(2), respectively. Subdivision (b) defined "packaging" as used in RTC section 6377.1, subdivision (a)(1) and (b)(4) based, in part, on the definition of "packaging" in Regulation 1525.2, subdivision (a)(1)(B). Subdivision (b) defined "pollution control" as used in RTC section 6377.1, subdivision (b)(7)(A)(iii), and clarified that an activity is a pollution control activity to the extent it meets or *exceeds* pollution control standards established by the state or any local or regional governmental agency within the state consistent with RTC section 6377, subdivision (b)(11)(C) and Regulation 1525.2, subdivision (c)(10)(C). Subdivision (b) incorporated the statutory definition of "process" from RTC section 6377.1, subdivision (b)(6), and clarified that the term "process" includes the activity of testing products for quality assurance before they are altered to their completed form, as referred to in RTC section 6377.1, subdivision (a)(3).
Subdivision (b) defined "recycling" and "refining" as used in RTC section 6377.1, subdivisions (a)(1) and (4), and (b)(4). Subdivision (b) incorporated the definition of "research and development" from RTC section 6377.1, subdivision (b)(9), and clarified the definition by incorporating provisions from 26 Code of Federal Regulation part 1.174-2, subdivision (a), which defines the term "research and development" for purposes of Internal Revenue Code

section 174. And, subdivision (b) implemented the definition of "useful life" provided by RTC section 6377.1, subdivision (b)(10), by explaining when property is and is not treated as having a useful life of one or more years for state income or franchise tax purposes using language borrowed from Regulation 1525.2, subdivision (c)(9)(B) and (10)(B).

Subdivision (b)(8) of the revised draft of proposed Regulation 1525.4 incorporated the definition of "qualified person" from RTC section 6377.1, subdivision (b)(6). Subdivision (b)(8) also:

- Provided a definition for the term "primarily engaged," as used in RTC section 6377.1, subdivision (b)(6);
- Clarified that "primarily engaged" is intended to have a similar meaning to "primarily engaged" as used in RTC section 6378, as interpreted by Regulation 1532, subdivision (c)(2) (the definition of "primarily" in RTC section 6377.1, subdivision (b)(3), is intended to have the same meaning as the definition of "primarily" in RTC section 6378, subdivision (c)(1) and therefore does not apply to "primarily engaged");
- Clarified that a qualified person may be primarily engaged in a qualifying activity or activities described in RTC section 6377.1, subdivision (a), either as a "legal entity" (meaning a "person" as defined in RTC, § 6005) or as an "establishment," similar to Regulation 1525.2, subdivision (c)(6)(B), and Regulation 1532, subdivision (c)(2);
- Defined the term "establishment" in a manner that is similar to Regulation 1525.2, subdivision (c)(6)(B);
- Generally incorporated the "gross revenue" test for determining when a qualified person is "primarily engaged" and the "funds allocated" test for determining when a nonprofit is "primarily engaged" from Regulation 1532, subdivision (c)(2), and, based upon input from interested parties, added "operating expense" tests for legal entities and establishments;
- Provided an alternative "value of production" test for determining when an establishment is "primarily engaged" that is similar to the "value of production" test in Regulation 1525.2, subdivision (c)(6)(B), and, based upon input from interested parties, also provided an alternative "employee salaries and wages" test for establishments;
- Clarified the reference to RTC section 25128 in RTC section 6377.1, subdivision (b)(6)(B), by generally describing the trades or businesses that are subject to the provisions of section 25128.

Subdivision (b)(9) of the revised draft of proposed Regulation 1525.4 incorporated the statutory definition of "qualified tangible personal property" from RTC section 6377.1, subdivision (a)(7). Subdivision (b) clarified when manufacturing aids are considered "qualified tangible personal property," and clarified that qualified tangible personal property includes tangible personal property used in pollution control that *exceeds* pollution control standards established by this state or any local or regional governmental agency within this state consistent with Regulation 1525.2, subdivision (c)(10)(C). Subdivision (b) further defined and clarified the meaning of "special purpose buildings and foundations" as used in the definition of qualified property in RTC section 6377.1, subdivision (a)(7)(A)(iv), using language borrowed from RTC section 6377, subdivision (b)(11)(D), and Regulation 1525.2, subdivision (c)(10)(D)1-6, and clarified when the partial exemption does and does not apply to transactions involving special purpose buildings and foundations. And, subdivision (b) provided that the "extraction processes" as used in the definition of qualified property in RTC section 6377.1, subdivision (a)(7)(B)(ii), includes such severance activities as mining, oil and gas extraction, as was also provided in Regulation 1525.2, subdivision (c)(9)(C).

Subdivision (c) of the revised draft of proposed Regulation 1525.4 prescribed the form of the partial exemption certificate that the purchaser is statutorily required to furnish to the retailer under RTC section 6377.1, allowed for the issuance of a blanket partial exemption certificate to cover multiple purchases from the same vendor, and prescribed the circumstances under which a retailer may accept such a partial exemption certificate in good faith for purposes of relieving the retailer of liability for the sales tax or the duty of collecting the use tax from the purchaser, similar to Regulation 1532, subdivision (e). Subdivision (c) also provides that qualified purchasers may use the sample partial exemption certificate set forth in appendix A, and construction contractors may use the sample partial exemption certificate in appendix B.

Subdivision (d) of the revised draft of proposed Regulation 1525.4 generally incorporated the provisions of RTC section 6377.1, subdivision (e)(1), establishing the $200 million cap and providing that the exemption does not apply to property under specified circumstances, and clarified how the "calendar year" test in subdivision (e)(1)(A) applies when the partial exemption is only effective for part of a calendar year. Subdivision (e) of the revised draft of proposed Regulation 1525.4 incorporated the provisions of RTC section 6377.1, subdivision (e)(2), prescribing the circumstances under which a purchaser is liable for sales tax.

Subdivision (f) of the revised draft of proposed Regulation 1525.4 clarified the application of the partial exemption provided by RTC section 6377.1 to lease transactions. Subdivision (f) specifically explained when rentals payable will be subject to the partial exemption in circumstances where a lease was entered into prior to the operative date of RTC section 6377.1, for a lease term expiring after the operative date, in a similar manner as Regulation 1532, subdivision (i)(1), clarified the application of the partial exemption provided by RTC section 6378 to the same circumstances. Subdivision (f) also specified how the one-year test period (for purposes of ascertaining the primary use of property) applies in the context of lease transactions.

Subdivision (g) of the revised draft of proposed Regulation 1525.4 clarified that Regulation 1521, *Construction Contractors*, still provides for the basic application of tax to construction contractors. Subdivision (g)(1) explained that a construction contractor performing a construction contract described in RTC section 6377.1, subdivision (a)(4), should obtain a partial exemption certificate (in the form shown in appendix A) from the qualified person, and a construction contractor, purchasing property from a retailer in this state or engaged in business in this state, for use in a qualified construction contract, must timely furnish its own partial exemption certificate to the retailer (in the form shown in appendix B). Subdivision (g)(2) clarified that a construction contractor may independently qualify as a "qualified person" for purposes of the partial exemption. And, subdivision (g)(3) clarified how the $200 million cap applies to fixtures and materials sold or use in the construction of special purposes buildings and foundations.

Finally, subdivision (h) of the revised draft of proposed Regulation 1525.4 clarified that purchasers of qualified tangible personal property may file claims for refund with the Board regarding use tax transactions because consumers are directly liable for use tax. However, only retailers may file claims for refund with the Board regarding sales tax transactions because sales tax is directly imposed on and paid by retailers. Subdivision (h) also provides additional notice that claims for refund of sales and use tax must be timely filed in accordance with RTC section 6902.

Furthermore, Formal Issue Paper 14-001 informed the Board that Board staff and the interested parties had agreed to the provisions of the revised draft of Regulation 1525.4 attached to the issue, except for the following three items:

1. Waste Management's recommendation to include a specific example in subdivision (b)(8)(A) of the regulation explaining when a business in the recycling industry is a "qualified person";
2. The California Taxpayers Association's (CalTax's) recommendation to include alternative tests in subdivision (b)(8)(A)1 to provide that an establishment may be "primarily engaged" based on number of employees, employee hours, number of units produced, or capital investment; and
3. The California Poultry Federation's recommendation that the regulation clarify that the "establishment" concept can apply so that a person with a qualifying establishment can be a "qualified person" for purposes of that establishment, even if the person is otherwise an apportioning trade or business that would be precluded from the definition of qualified person by RTC section 6377.1, subdivision (b)(6)(B).

Business Taxes Committee Meeting

The Board considered Formal Issue Paper 14-001 during its Business Taxes Committee meeting on April 22, 2014. During the meeting, the Board heard public comments from Ms. Therese Twomey, CalTax's Fiscal Policy Director, Mr. Joe Vinatieri from Bewley, Lassleben, & Miller LLP, Ms. Nicole Rice, the California Manufacturers & Technology Association's Policy Director, Mr. Bill Mattos, President of the California Poultry Federation, Mr. Brian Grant, Foster Farms' Tax Director, Mr. Chuck White, Director of Regulatory Affairs for the Department of Waste Management, Mr. Ralph Chandler, Regulatory Affairs Director for the California Refuse and Recycling Coalition, and Mr. Ken Dunham, Executive Director of the West Coast Lumber & Building Material Association. (See the transcript or video for more detail.) The Board also discussed the proposed regulation with Board staff.

During the Business Taxes Committee meeting, the Board also agreed with staff's recommendation to propose to adopt staff's revised draft of Regulation 1525.4, subject to two additional clarifications. First, the Board agreed with CalTax's recommendation to include an alternative test in subdivision (b)(8)(A)1 of the regulation to provide that an establishment may be primarily engaged based on "number of employees" with the condition that the number of employees be "based upon a full-time equivalency." Second, in response to Waste Management's recommendation, the Board agreed to add an example to subdivision (b)(8)(A), to provide that a business in the recycling industry may be regarded as a qualified person when the activities of the establishment are "reasonably" described in a qualifying four digit NAICS industry group. The Board Members unanimously voted to propose the adoption of the regulation, with the two clarifications noted above.

The Board determined that the adoption of the regulation is reasonably necessary for the specific purposes of implementing, interpreting, and making specific the provisions of RTC section 6377.1, prescribing the form of the partial exemption certificates that must be issued to retailers to claim the new partial exemption, and addressing all of the issues (or problems) identified above. The Board further determined that the regulation is reasonably necessary for the specific purposes of clarifying when a purchaser is primarily engaged in a qualifying line of business, and when a person is or is not a qualified person.

The Board anticipates that the adoption of proposed Regulation 1525.4 will benefit the Board, Board staff, and persons engaged in manufacturing, research and development, or both by:

- Providing guidance about and promoting awareness of the partial exemption for equipment used primarily in manufacturing and research and development provided by RTC 6377.1, and the requirements to qualify for the partial exemption;
- Implementing RTC section 6377.1, subdivision (c) by prescribing the form of the partial exemption certificate that qualified persons and construction contractors must issue to retailers, and providing sample partial exemption certificates that meet the required form for such persons to use;
- Interpreting and making specific RTC section 6377.1, subdivision (b)(6)(A) by defining what is meant by the requirement that a qualified purchaser be "primarily engaged" in a qualifying line of business;
- Interpreting and making specific RTC section 6377.1, subdivision (b)(7)(A)(iv) by further defining "special purpose buildings and foundations";
- Interpreting and making specific RTC section 6377.1, subdivision (f) by clarifying the application of the partial exemption in the context of certain lease transactions; and
- Interpreting and making specific RTC section 6377.1, subdivision (a)(4) by clarifying the application of the partial exemption to transactions involving construction contracts.

The Board has performed an evaluation of whether proposed Regulation 1525.4 is inconsistent or incompatible with existing state regulations and determined that the proposed regulation is not inconsistent or incompatible with existing state regulations. This is because proposed Regulation 1525.4 is the only state regulation that specifically implements, interprets, and makes specific the provisions of RTC section 6377.1, prescribes the form of the partial exemption certificate that the purchaser must furnish to the retailer under the statute, and explains when such a certificate is taken timely and in good faith. Proposed Regulation 1525.4 is consistent with Regulation 1521, which contains the general provisions applicable to transactions involving construction contracts, and Regulation 1660, which contains the general provisions applicable to lease transactions. And, the Board reviewed Regulations 1525.2 and 1532 in detail, and specifically made proposed Regulation 1525.4 consistent with Regulations 1525.2 and 1532 to the extent that those regulations contained provisions that were appropriate for implementing the new partial exemption and consistent with RTC section 6377.1. In addition, the Board has determined that there are no comparable federal regulations or statutes to proposed Regulation 1525.4.

NO MANDATE ON LOCAL AGENCIES OR SCHOOL DISTRICTS

The Board has determined that the adoption of proposed Regulation 1525.4 will not impose a mandate on local agencies or school districts, including a mandate that requires state reimbursement pursuant to title 2, division 4, part 7 (commencing with section 17500) of the Government Code.

NO COST OR SAVINGS TO ANY STATE AGENCY, LOCAL AGENCY, OR SCHOOL DISTRICT

The Board has determined that the adoption of proposed Regulation 1525.4 will result in no direct or indirect cost or savings to any state agency and will result in no cost or savings in federal funding to the State of California. The Board has also determined that the adoption of proposed Regulation 1525.4 will result in no direct or indirect cost to any local agency or school district that is required to be reimbursed under title 2, division 4, part 7 (commencing with section 17500) of the Government Code, and will result in no other non-discretionary cost or savings imposed on local agencies.

NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS

The Board has made an initial determination that adoption of proposed Regulation 1525.4 will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

NO KNOWN COST IMPACTS TO PRIVATE PERSONS OR BUSINESSES

The Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

RESULTS OF THE ECONOMIC IMPACT ASSESSMENT REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

The Board has determined that the proposed adoption of Regulation 1525.4 is not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000. Therefore, the Board has prepared the economic impact assessment required by Government Code section 11346.3, subdivision (b)(1), and included it in the initial statement of reasons. The Board has determined that the adoption of proposed Regulation 1525.4 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California. Furthermore, the Board has determined that the adoption of proposed Regulation 1525.4 will not affect the benefits of Regulation 1525.4 to the health and welfare of California residents, worker safety, or the state's environment.

NO SIGNIFICANT EFFECT ON HOUSING COSTS

The adoption of proposed Regulation 1525.4 will not have a significant effect on housing costs.

STATEMENT REGARDING ALTERNATIVES

The Board must determine that no reasonable alternative considered by it or that has been otherwise identified and brought to its attention would be more effective in carrying out the purpose for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

CONTACT PERSONS

Questions regarding the substance of the proposed regulation should be directed to Andrew Kwee, by telephone at (916) 323-3096, by e-mail at Andrew.Kwee@boe.ca.gov, or by mail at State Board of Equalization, Attn: Andrew Kwee, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

Written comments for the Board's consideration, notice of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed administrative action should be directed to Mr. Rick Bennion, Regulations Coordinator, by telephone at (916) 445-2130, by fax at (916) 324-3984 , by e-mail at Richard.Bennion@boe.ca.gov, or by mail at State Board of Equalization, Attn: Rick Bennion, MIC:80, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0080.

WRITTEN COMMENT PERIOD

The written comment period ends at 10:00 a.m. on July 17, 2014, or as soon thereafter as the Board begins the public hearing regarding proposed Regulation 1525.4 during the July 17-18, 2014, Board meeting. Written comments received by Mr. Rick Bennion at the postal address, email address, or fax number provided above, prior to the close of the written comment period, will be presented to the Board and the Board will consider the statements, arguments, or contentions contained in those written comments before the Board decides whether to adopt proposed Regulation 1525.4. The Board will only consider written comments received by that time.

AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATION

The Board has prepared a copy of the text of proposed Regulation 1525.4 illustrating its express terms; however, the proposed regulation is not illustrated in underline or italics format because California Code of Regulations, title 1, section 8, subdivision (b) provides that "[u]nderline or italic is not required for the adoption of a new regulation or set of regulations if the final text otherwise clearly indicates that all of the final text submitted to OAL for filing is added to the California Code of Regulations." The Board has also prepared an initial statement of reasons for the adoption of the proposed regulation, which includes the economic impact assessment required by Government Code section 11346.3, subdivision (b)(1). These documents and all the information on which the proposed regulation is based are available to the public upon request.

The rulemaking file is available for public inspection at 450 N Street, Sacramento, California. The express terms of the proposed regulation and the initial statement of reasons are also available on the Board's Website at *www.boe.ca.gov*.

SUBSTANTIALLY RELATED CHANGES PURSUANT TO GOVERNMENT CODE SECTION 11346.8

The Board may adopt proposed Regulation 1525.4 with changes that are nonsubstantial or solely grammatical in nature, or sufficiently related to the original proposed text that the public was adequately placed on notice that the changes could result from the originally proposed regulatory action. If a sufficiently related change is made, the Board will make the full text of the proposed regulation, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the resulting regulation will be mailed to those interested parties who commented on the original proposed regulation orally or in writing or who asked to be informed of such changes. The text of the resulting regulation will also be available to the public from Mr. Bennion. The Board will consider written comments on the resulting regulation that are received prior to adoption.

EFFECTIVE DATE

The Board is proposing to adopt Regulation 1525.4 to implement, interpret, and make specific the partial exemption from sales and use tax provided by RTC section 6377.1, which is effective on and after July 1, 2014, and, once the regulation is effective, its provisions will have a retroactive effect pursuant to RTC section 7051. Therefore, the Board has determined that there is good cause to request an early effective date for Regulation 1525.4 in order to ensure that the regulation is effective as soon possible after the partial exemption is effective, and the Board intends to request an early effective date for Regulation 1525.4, pursuant to Government Code section 11343.4, subdivision (b)(3).

AVAILABILITY OF FINAL STATEMENT OF REASONS

If the Board adopts proposed Regulation 1525.4, the Board will prepare a final statement of reasons, which will be made available for inspection at 450 N Street, Sacramento, California, and available on the Board's Website at *www.boe.ca.gov*.

Sincerely,

Joann Richmond

Joann Richmond, Chief
Board Proceedings Division

JR:reb

STATE BOARD OF EQUALIZATION

BOARD APPROVED

At the July 17, 2014 Board Meeting

Joann Richmond

Joann Richmond, Chief
Board Proceedings Division

Initial Statement of Reasons for

Proposed Adoption of California Code of Regulations,

Title 18, Section 1525.4, *Manufacturing and Research & Development Equipment*

SPECIFIC PURPOSES, PROBLEMS INTENDED TO BE ADDRESSED, NECESSITY, AND ANTICIPATED BENEFITS

Current Law

As a general matter, California's Sales and Use Tax Law (Rev. & Tax. Code (RTC), div. 2, pt. 1, chs. 1-11 (§ 6001 et. seq.)) imposes sales tax on retailers, and the tax is measured by a retailer's gross receipts from the retail sale of tangible personal property in California, unless an exemption or exclusion applies. (RTC, §§ 6012, 6051.) Although sales tax is imposed on retailers, retailers may collect sales tax reimbursement from their customers if their contracts of sale so provide. (Civ. Code, § 1656.1; Cal. Code Regs., tit. 18, § 1700.)

When sales tax does not apply, California use tax generally applies to the use of tangible personal property purchased from a retailer for storage, use or other consumption in California. (RTC, §§ 6011, 6201.) Unless an exemption or exclusion applies, the use tax is measured by the sales price of tangible personal property and the person actually storing, using, or otherwise consuming the tangible personal property is liable for the tax. (RTC, §§ 6011, 6201, 6202, 6401; Cal. Code Regs., tit. 18, § 1685.) However, every retailer "engaged in business" in California that makes sales subject to California use tax is required to collect the use tax from its customers and remit it to the State Board of Equalization (Board), and such retailers are liable for California use tax that they fail to collect from their customers and remit to the Board. (RTC, §§ 6202, 6203; Cal. Code Regs., tit. 18, §§ 1684, 1686.)

The measure of tax is generally the same regardless of whether the applicable tax is a sales tax imposed on the retailer, or a use tax imposed on the purchaser. (See RTC, §§ 6011, 6012.) The current statewide sales and use tax rate is 7.50 percent, although the combined tax rate is higher in cities and counties that impose additional district transactions (sales) and use taxes in conformity with the Transactions and Use Tax Law (RTC, § 7251 et seq.). The 7.50 percent rate is comprised of:

- The .50 percent rate of the sales and use taxes imposed and required to be deposited in the state's Local Public Safety Fund by section 35 of article XIII of the California Constitution;
- The .25 percent rate of the sales and use taxes imposed and required to be deposited in the state's Education Protection Account by section 36 of article XIII of the California Constitution;

- The 3.6875 percent rate of the sales and use taxes imposed by RTC sections 6051 and 6201 that are deposited in the state's general fund;
- The 0.50 percent rate of the sales and use taxes imposed and required to be deposited in the state's Local Revenue Fund by RTC sections 6051.2 and 6201.2;
- The 0.25 percent rate of the sales and use taxes imposed by RTC sections 6051.3 and 6201.3 that are deposited in the state's general fund;
- The 0.25 percent rate of the sales and use taxes imposed and required to be deposited in the state's Fiscal Recovery Fund by RTC sections 6051.5 and 6201.5;
- The 1.0625 percent rate of the sales and use taxes imposed by RTC sections 6051 and 6201 that are required to be deposited in the state's Local Revenue Fund 2011 by RTC sections 6051.15 and 6201.15; and
- The 1.00 percent rate specified by RTC section 7203.1 for local sales and use taxes imposed under the Bradley-Burns Uniform Local Sales and Use Tax Law (RTC, § 7200 et seq.).

RTC section 6377.1 was enacted by Assembly Bill No. (AB) 93 (Stats. 2013, ch. 69, effective July 11, 2013), and amended by Senate Bill No. (SB) 90 (Stats. 2013, ch. 70, effective July 11, 2013). RTC section 6377.1, subdivision (a), provides a partial exemption from sales and use tax on certain sales and purchase made on and after July 1, 2014, and before July 1, 2022. The partial exemption applies to: (1) qualified tangible personal property purchased by a qualified person to be used primarily in any stage of the manufacturing, processing, refining, fabricating, or recycling of tangible personal property, 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 under (1) or (2) above; and (4) qualified tangible personal property purchased for use by a contractor purchasing that property for use in the performance of a construction contract for a qualified person that will use that property for statutorily specified purposes.

RTC section 6377.1, subdivision (b), defines relevant terms used in subdivision (a), including "fabricating," "manufacturing," "primarily," "process," "processing," "qualified person," "qualified tangible personal property," "refining," "research and development," and "useful life." As relevant here, RTC section 6377.1, subdivision (b)(3), provides that "'Primarily' means 50 percent or more of the time. RTC section 6377.1, subdivision (b)(6) provides that:

> (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.
> (B) Notwithstanding subparagraph (A), "qualified person" shall not include either of the following:

(i) An apportioning trade or business that is required to apportion its business income pursuant to subdivision (b) of Section 25128.
(ii) A trade or business conducted wholly within this state that would be required to apportion its business income pursuant to subdivision (b) of Section 25128 if it were subject to apportionment pursuant to Section 25101.

And, RTC section 6377.1, subdivision (b)(7)(A)(iv) provides that qualified tangible personal property includes "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."

RTC section 6377.1, subdivision (c), provides that the partial exemption shall not be allowed, unless the purchaser furnishes the retailer with an exemption certificate, completed in accordance with any instructions or regulations as the Board may prescribe, and the retailer retains the exemption certificate in its records and furnishes it to the Board upon request.

RTC section 6377.1, subdivision (d), specifies that the partial exemption does not apply to any local sales and use taxes levied pursuant to the Bradley-Burns Uniform Local Sales and Use Tax Law or district transactions and use taxes levied pursuant to the Transactions and Use Tax Law. Subdivision (d) also specifies that the partial exemption does not apply to any sales and use taxes levied pursuant to RTC sections 6051.2, 6051.5, 6201.2, and 6201.5, any sales and use taxes levied pursuant to section 35 of article XIII of the California Constitution, and any sales and use taxes levied pursuant to RTC sections 6051 and 6201 that are required to be deposited in the Local Revenue Fund 2011 by RTC sections 6051.15 and 6201.15. Therefore, the partial exemption applies to the state general fund taxes imposed by RTC sections 6051, 6051.3, 6201, and 6201.3, and the state's Education Protection Account tax imposed by section 36 of article XIII of the California Constitution. Accordingly, from July 1, 2014, to December 31, 2016, the partial exemption rate is 4.1875 percent. After the state's Education Protection Account tax expires on December 31, 2016, the partial exemption rate will be 3.9375 percent.

RTC section 6377.1, subdivision (e)(1)(A), provides that the partial exemption shall not apply to "[a]ny tangible personal property purchased 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 a qualified person under this section." It also provides that "in the case of a qualified person that is required to be included in a combined report under Section 25101 or authorized to be included in a combined report under Section 25101.15, the aggregate of all purchases of qualified personal property for which an exemption is claimed pursuant to this section 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."

RTC section 6377.1, subdivision (f), provides that the partial exemption applies to leases which are classified as continuing sales and continuing purchases for purposes of the sales and use tax law. California Code of Regulations, title 18, section (Regulation) 1660, *Leases of Tangible Personal Property - In General*, prescribes the general application of sales and use tax to leases.

The partial exemption expires on July 1, 2022, in accordance with RTC section 6377.1, subdivision (a). And, RTC section 6377.1 is repealed by its own terms effective January 1, 2023, per RTC section 6377.1, subdivision (h).

RTC section 6377.1 is substantially, but not entirely, modeled after the partial sales and use tax exemption provided by RTC section 6377 (repealed by its own terms January 1, 2004) and interpreted in Regulation 1525.2, *Manufacturing Equipment*. For purchases made from January 1, 1994, through December 31, 2003, RTC section 6377 generally provided a partial exemption from sales and use tax for tangible personal property purchased for use by a qualified person to be used primarily in the manufacturing, processing, refining, fabricating, or recycling of property, or research and development. In addition, RTC section 6377, subdivision (b)(3), provided that "'Primarily' means tangible personal property used 50 percent or more of the time in an activity described in subdivision (a)." RTC section 6377, subdivision (b)(6)(B), required a "qualified person" to be "engaged in those lines business described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification Manual" 1987 edition, published by the OMB. And, RTC section 6377, subdivision (c), provided that "No exemption shall be allowed under this section unless the purchaser furnishes the retailer with an exemption certificate, completed in accordance with any instructions or regulations as the board may prescribe, and the retailer subsequently furnishes the board with a copy of the exemption certificate."

Furthermore, as relevant here, Regulation 1525.2, subdivision (c)(6)(B), explained that:

- "For purposes of classifying a line or lines of business [under RTC section 6377, subdivision (b)(6)(B)], 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 value of production"; and
- "Where distinct and separate economic activities are performed at a single physical location, such as construction activities operated out of the same physical location as a lumber yard, each activity should be treated as a separate establishment where: (i) no one industry description in the classification includes such combined activities; (ii) the employment in each such economic activity is significant; and (iii) separate reports are prepared on the number of employees, their wages and salaries, sales or receipts, property and equipment, and other types of financial data, such as financial statements, job costing, and profit center accounting."

Regulation 1525.2 also prescribed the form of the exemption certificate required by RTC section 6377, provided a sample "section 6377" exemption certificate, and prescribed the circumstances under which a seller may accept a "section 6377" exemption certificate in good faith for purposes of being relieved of the obligation to pay or collect tax.

To a lesser extent, RTC section 6377.1 was also modeled after provisions in RTC section 6378 and interpreted in Regulation 1532, *Teleproduction or Other Postproduction Service Equipment*. As relevant here, RTC section 6378 currently provides a partial exemption from sales and use tax for tangible personal property purchased for use by a qualified person to be used primarily in teleproduction and other postproduction services. In addition, RTC section 6378, subdivision (c)(1) provides that "primarily" means "tangible personal property used 50 percent or more of the time in" a qualified activity. RTC section 6378, subdivision (c)(2) provides that "qualified person" means "any person that is primarily engaged in teleproduction or other postproduction activities that are described in Code 512191 of the" NAICS, 1997 edition. And, RTC section 6378, subdivision (d), provides that "No exemption shall be allowed under this section unless the purchaser furnishes the retailer with an exemption certificate, completed in accordance with any instructions or regulations as the board may prescribe, and the retailer subsequently furnishes the board with a copy of the exemption certificate."

Furthermore, as relevant here, Regulation 1532, subdivision (c)(2), explains that:

- "For purposes of classifying a line of business [under RTC section 6378, subdivision (c)(2)], the economic unit shall be the 'establishment' and the classification of the line or lines of business will be based on the establishment's primary activity based upon gross revenues";
- "'Primarily engaged' means 50 percent or more of gross revenues, including intra-company charges, are derived from teleproduction or other postproduction activities for the financial year of the purchaser preceding the purchase of the property. In cases where the purchaser was not primarily engaged in 'teleproduction or other postproduction services' 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"; and
- "In the case of a nonprofit teleproduction or other postproduction establishment, 'primarily engaged' means 50 percent or more of the funds allocated to the establishment are attributable to teleproduction or other postproduction services.

Regulation 1532 also prescribed the form of the exemption certificate required by RTC section 6378, provided two sample "section 6378" exemption certificates, including a blanket exemption certificate, and prescribed the circumstances under which a seller may accept a "section 6378" exemption certificate in good faith for purposes of being relieved of the obligation to pay or collect tax.

<u>Proposed Regulation</u>

There is currently no regulation that specifically implements, interprets, or makes specific the partial exemption from sales and use tax established by RTC section 6377.1. There is currently no regulation that prescribes the form of the partial exemption certificate that the purchaser is statutorily required to furnish to the retailer under RTC section 6377.1, or provides a sample partial exemption certificate. Also, there is no regulation that specifically prescribes the circumstances under which a retailer may accept such a partial exemption certificate in good faith for purposes of relieving the retailer of liability for the sales tax or the duty of collecting the use tax from the purchaser.

In addition, there is currently no regulation that defines what is meant by the phrase "primarily engaged" in a qualifying line of business for purposes of RTC section 6377.1, subdivision (b)(6). There is currently no regulation that clarifies and explains the meaning of the phrase "special purpose buildings and foundations" as used in RTC section 6377.1, subdivision (b)(7)(A)(iv). There is currently no regulation that clarifies and explains how the partial exemption applies in the context of lease transactions. And, there is currently no regulation that clarifies how the partial exemption applies in the context of construction contracts.

Business Taxes Committee Process

Board staff determined that it was necessary to draft proposed Regulation 1525.4 to have the effect and accomplish the objectives of fully implementing, interpreting, and making specific the provisions of RTC section 6377.1 and specifically addressing the issues (or "problems" within the meaning of Gov. Code, § 11346.2, subdivision (b)(1)) identified above. Therefore, Board staff prepared a draft of the regulation and held its first meeting to discuss the draft with interested parties on October 9, 2013.

At the October 9, 2013, meeting, staff responded to written comments received prior to the meeting, as well as other suggestions to clarify the draft regulation, including expanding upon the definitions provided in RTC section 6377.1, clarifying the phrase "primarily engaged," clarifying how tax applies to testing equipment and manufacturing aids, allowing for the issuance of a blanket partial exemption certificate to cover multiple purchases from the same vendor, providing a separate partial exemption certificate for construction contractors to use, and clarifying the application of the $200 million annual cap. Then, staff incorporated the suggestions discussed at the meeting into a revised draft of proposed Regulation 1525.4 and, on November 14, 2013, staff posted the revised draft of the proposed regulation on the Board's website, and distributed the revised draft of the proposed regulation to the interested parties that attended the October 9, 2013, meeting and to the interested parties that submitted written comments regarding the initial draft of the proposed regulation.

Board staff held a second meeting with interested parties on December 5, 2013, to discuss the revised draft of proposed Regulation 1525.4. At the meeting, staff responded to written comments received prior to the December 5, 2013, meeting, as well as other suggestions to clarify the definition of "qualified person," clarify when a purchaser is "primarily engaged" in a qualifying line of business, clarify how the partial exemption applies in the context of construction contracts, including contracts for special purpose buildings and foundations, and make various other minor revisions or edits. Then, staff incorporated the suggestions discussed at the meeting into a revised draft of the proposed regulation and, on January 31, 2014, staff posted the revised draft of the proposed regulation on the Board's website, and distributed the revised draft of the proposed regulation to the interested parties that attended the December 5, 2013, meeting.

Board staff held a third meeting with interested parties on February 18, 2014, to discuss the revised draft of proposed Regulation 1525.4. At the meeting, staff responded to written comments received prior to the December 5, 2013, meeting, and agreed to address other suggestions to clarify how tax applies when a purchaser has a qualifying four digit NAICS industry group code (but not a six digit code); further clarify the phrase "primarily engaged"; and add additional tests to ascertain if a purchaser is primarily engaged in a qualifying activity. At the meeting, staff also received suggestions to provide that a qualified person may include an otherwise qualified "establishment" in an apportioning trade or business, subject to RTC section 6377.1, subdivision (b)(6)(B), and businesses that do not have a qualifying six or four digit NAICS code described in RTC section 6377.1, subdivision (b)(6)(A). However, staff did not agree to incorporate these suggestions into the proposed regulation because they are precluded by the express language of RTC section 6377.1.

Therefore, Board staff subsequently prepared Formal Issue Paper 14-001, which recommended that the Board adopt staff's revised draft of proposed Regulation 1525.4 to implement, interpret, and make specific the provisions of RTC section 6377.1. Specifically, subdivision (a) of the revised draft of proposed Regulation 1525.4 incorporated the provisions of RTC section 6377.1, subdivision (a)(1) through (4), prescribing the types of transactions that qualify for the new partial exemption, identified the specific sales and use taxes the partial exemption provided by RTC section 6377.1 does and does not apply to, and provided notice of the partial exemption rates from July 1, 2014, to December 31, 2016, and January 1, 2017, to June 30, 2022.

Subdivision (b) of the revised draft of proposed Regulation 1525.4 incorporated the statutory definitions of "fabricating," "primarily," and "processing" verbatim from RTC section 6377.1, subdivision (b)(1), (3), and (5). Subdivision (b) incorporated the statutory definition of "manufacturing" from RTC section 6377.1, subdivision (b)(2), and clarified when tangible personal property will be treated as having a greater service life or greater functionality for purposes of that definition, using language borrowed from Regulation 1525.2, subdivision (c)(10)(B), and Regulation 1525.2, subdivision (c)(2), respectively. Subdivision (b) defined "packaging" as used in RTC section 6377.1, subdivision (a)(1) and (b)(4) based, in part, on the definition of "packaging" in Regulation 1525.2, subdivision (a)(1)(B). Subdivision (b) defined "pollution control" as used in RTC section 6377.1, subdivision (b)(7)(A)(iii), and clarified that an activity is a pollution control activity to the extent it meets or *exceeds* pollution control standards established by the state or any local or regional governmental agency within the state consistent with RTC section 6377, subdivision (b)(11)(C) and Regulation 1525.2, subdivision (c)(10)(C). Subdivision (b) incorporated the statutory definition of "process" from RTC section 6377.1, subdivision (b)(6), and clarified that the term "process" includes the activity of testing products for quality assurance before they are altered to their completed form, as referred to in RTC section 6377.1, subdivision (a)(3).

Subdivision (b) defined "recycling" and "refining" as used in RTC section 6377.1, subdivisions (a)(1) and (4), and (b)(4). Subdivision (b) incorporated the definition of "research and development" from RTC section 6377.1, subdivision (b)(9), and clarified the definition by incorporating provisions from 26 Code of Federal Regulation part 1.174-2, subdivision (a), which defines the term "research and development" for purposes of Internal Revenue Code section 174. And, subdivision (b) implemented the definition of "useful life" provided by RTC section 6377.1, subdivision (b)(10), by explaining when property is and is not treated as having a useful life of one or more years for state income or franchise tax purposes using language borrowed from Regulation 1525.2, subdivision (c)(9)(B) and (10)(B).

Subdivision (b)(8) of the revised draft of proposed Regulation 1525.4 incorporated the definition of "qualified person" from RTC section 6377.1, subdivision (b)(6). Subdivision (b)(8) also:

- Provided a definition for the term "primarily engaged," as used in RTC section 6377.1, subdivision (b)(6);
- Clarified that "primarily engaged" is intended to have a similar meaning to "primarily engaged" as used in RTC section 6378, as interpreted by Regulation 1532, subdivision (c)(2) (the definition of "primarily" in RTC section 6377.1, subdivision (b)(3), is intended to have the same meaning as the definition of "primarily" in RTC section 6378, subdivision (c)(1) and therefore does not apply to "primarily engaged");
- Clarified that a qualified person may be primarily engaged in a qualifying activity or activities described in RTC section 6377.1, subdivision (a), either as a "legal entity" (meaning a "person" as defined in RTC, § 6005) or as an "establishment," similar to Regulation 1525.2, subdivision (c)(6)(B), and Regulation 1532, subdivision (c)(2);
- Defined the term "establishment" in a manner that is similar to Regulation 1525.2, subdivision (c)(6)(B);
- Generally incorporated the "gross revenue" test for determining when a qualified person is "primarily engaged" and the "funds allocated" test for determining when a nonprofit is "primarily engaged" from Regulation 1532, subdivision (c)(2), and, based upon input from interested parties, added "operating expense" tests for legal entities and establishments;
- Provided an alternative "value of production" test for determining when an establishment is "primarily engaged" that is similar to the "value of production" test in Regulation 1525.2, subdivision (c)(6)(B), and, based upon input from interested parties, also provided an alternative "employee salaries and wages" test for establishments;
- Clarified the reference to RTC section 25128 in RTC section 6377.1, subdivision (b)(6)(B), by generally describing the trades or businesses that are subject to the provisions of section 25128.

Subdivision (b)(9) of the revised draft of proposed Regulation 1525.4 incorporated the statutory definition of "qualified tangible personal property" from RTC section 6377.1, subdivision (a)(7). Subdivision (b) clarified when manufacturing aids are considered "qualified tangible personal property," and clarified that qualified tangible personal property includes tangible personal property used in pollution control that *exceeds* pollution control standards established by this state or any local or regional governmental agency within this state consistent with Regulation 1525.2, subdivision (c)(10)(C). Subdivision (b) further defined and clarified the meaning of "special purpose buildings and foundations" as used in the definition of qualified property in RTC section 6377.1, subdivision (a)(7)(A)(iv), using language borrowed from RTC section 6377, subdivision (b)(11)(D), and Regulation 1525.2, subdivision (c)(10)(D)1-6, and clarified when the partial exemption does and does not apply to transactions involving special purpose buildings and foundations. And, subdivision (b) provided that the "extraction processes" as used in the definition of qualified property in RTC section 6377.1, subdivision (a)(7)(B)(ii), includes such severance activities as mining, oil and gas extraction, as was also provided in Regulation 1525.2, subdivision (c)(9)(C).

Subdivision (c) of the revised draft of proposed Regulation 1525.4 prescribed the form of the partial exemption certificate that the purchaser is statutorily required to furnish to the retailer under RTC section 6377.1, allowed for the issuance of a blanket partial exemption certificate to cover multiple purchases from the same vendor, and prescribed the circumstances under which a retailer may accept such a partial exemption certificate in good faith for purposes of relieving the retailer of liability for the sales tax or the duty of collecting the use tax from the purchaser, similar to Regulation 1532, subdivision (e). Subdivision (c) also provides that qualified purchasers may use the sample partial exemption certificate set forth in appendix A, and construction contractors may use the sample partial exemption certificate in appendix B.

Subdivision (d) of the revised draft of proposed Regulation 1525.4 generally incorporated the provisions of RTC section 6377.1, subdivision (e)(1), establishing the $200 million cap and providing that the exemption does not apply to property under specified circumstances, and clarified how the "calendar year" test in subdivision (e)(1)(A) applies when the partial exemption is only effective for part of a calendar year. Subdivision (e) of the revised draft of proposed Regulation 1525.4 incorporated the provisions of RTC section 6377.1, subdivision (e)(2), prescribing the circumstances under which a purchaser is liable for sales tax.

Subdivision (f) of the revised draft of proposed Regulation 1525.4 clarified the application of the partial exemption provided by RTC section 6377.1 to lease transactions. Subdivision (f) specifically explained when rentals payable will be subject to the partial exemption in circumstances where a lease was entered into prior to the operative date of RTC section 6377.1, for a lease term expiring after the operative date, in a similar manner as Regulation 1532, subdivision (i)(1), clarified the application of the partial exemption provided by RTC section 6378 to the same circumstances. Subdivision (f) also specified how the one-year test period (for purposes of ascertaining the primary use of property) applies in the context of lease transactions.

Subdivision (g) of the revised draft of proposed Regulation 1525.4 clarified that Regulation 1521, *Construction Contractors*, still provides for the basic application of tax to construction contractors. Subdivision (g)(1) explained that a construction contractor performing a construction contract described in RTC section 6377.1, subdivision (a)(4), should obtain a partial exemption certificate (in the form shown in appendix A) from the qualified person, and a construction contractor, purchasing property from a retailer in this state or engaged in business in this state, for use in a qualified construction contract, must timely furnish its own partial exemption certificate to the retailer (in the form shown in appendix B). Subdivision (g)(2) clarified that a construction contractor may independently qualify as a "qualified person" for purposes of the partial exemption. And, subdivision (g)(3) clarified how the $200 million cap applies to fixtures and materials sold or use in the construction of special purposes buildings and foundations.

Finally, subdivision (h) of the revised draft of proposed Regulation 1525.4 clarified that purchasers of qualified tangible personal property may file claims for refund with the Board regarding use tax transactions because consumers are directly liable for use tax. However, only retailers may file claims for refund with the Board regarding sales tax transactions because sales tax is directly imposed on and paid by retailers. Subdivision (h) also provides additional notice that claims for refund of sales and use tax must be timely filed in accordance with RTC section 6902.

Furthermore, Formal Issue Paper 14-001 informed the Board that Board staff and the interested parties had agreed to the provisions of the revised draft of Regulation 1525.4 attached to the issue, except for the following three items:

1. Waste Management's recommendation to include a specific example in subdivision (b)(8)(A) of the regulation explaining when a business in the recycling industry is a "qualified person";
2. The California Taxpayers Association's (CalTax's) recommendation to include alternative tests in subdivision (b)(8)(A)1 to provide that an establishment may be "primarily engaged" based on number of employees, employee hours, number of units produced, or capital investment; and
3. The California Poultry Federation's recommendation that the regulation clarify that the "establishment" concept can apply so that a person with a qualifying establishment can be a "qualified person" for purposes of that establishment, even if the person is otherwise an apportioning trade or business that would be precluded from the definition of qualified person by RTC section 6377.1, subdivision (b)(6)(B).

Business Taxes Committee Meeting

The Board considered Formal Issue Paper 14-001 during its Business Taxes Committee meeting on April 22, 2014. During the meeting, the Board heard public comments from Ms. Therese Twomey, CalTax's Fiscal Policy Director, Mr. Joe Vinatieri from Bewley, Lassleben, & Miller LLP, Ms. Nicole Rice, the California Manufacturers & Technology Association's Policy Director, Mr. Bill Mattos, President of the California Poultry

Federation, Mr. Brian Grant, Foster Farms' Tax Director, Mr. Chuck White, Director of Regulatory Affairs for the Department of Waste Management, Mr. Ralph Chandler, Regulatory Affairs Director for the California Refuse and Recycling Coalition, and Mr. Ken Dunham, Executive Director of the West Coast Lumber & Building Material Association. (See the transcript or video for more detail.) The Board also discussed the proposed regulation with Board staff.

During the Business Taxes Committee meeting, the Board also agreed with staff's recommendation to propose to adopt staff's revised draft of Regulation 1525.4, subject to two additional clarifications. First, the Board agreed with CalTax's recommendation to include an alternative test in subdivision (b)(8)(A)1 of the regulation to provide that an establishment may be primarily engaged based on "number of employees" with the condition that the number of employees be "based upon a full-time equivalency." Second, in response to Waste Management's recommendation, the Board agreed to add an example to subdivision (b)(8)(A), to provide that a business in the recycling industry may be regarded as a qualified person when the activities of the establishment are "reasonably" described in a qualifying four digit NAICS industry group. The Board Members unanimously voted to propose the adoption of the regulation, with the two clarifications noted above.

The Board determined that the adoption of the regulation is reasonably necessary for the specific purposes of implementing, interpreting, and making specific the provisions of RTC section 6377.1, prescribing the form of the partial exemption certificates that must be issued to retailers to claim the new partial exemption, and addressing all of the issues (or problems) identified above. The Board further determined that the regulation is reasonably necessary for the specific purposes of clarifying when a purchaser is primarily engaged in a qualifying line of business, and when a person is or is not a qualified person.

The Board anticipates that the adoption of proposed Regulation 1525.4 will benefit the Board, Board staff, and persons engaged in manufacturing, research and development, or both by:

- Providing guidance about and promoting awareness of the partial exemption for equipment used primarily in manufacturing and research and development provided by RTC 6377.1, and the requirements to qualify for the partial exemption;
- Implementing RTC section 6377.1, subdivision (c) by prescribing the form of the partial exemption certificate that qualified persons and construction contractors must issue to retailers, and providing sample partial exemption certificates that meets the required form for such persons to use;
- Interpreting and making specific RTC section 6377.1, subdivision (b)(6)(A) by defining what is meant by the requirement that a qualified purchaser be "primarily engaged" in a qualifying line of business;
- Interpreting and making specific RTC section 6377.1, subdivision (b)(7)(A)(iv) by further defining "special purpose buildings and foundations";

- Interpreting and making specific RTC section 6377.1, subdivision (f) by clarifying the application of the partial exemption in the context of certain lease transactions; and
- Interpreting and making specific RTC section 6377.1, subdivision (a)(4) by clarifying the application of the partial exemption to transactions involving construction contracts.

The adoption of proposed Regulation 1525.4 is not mandated by federal law or regulations. There is no previously adopted or amended federal regulation that is identical to proposed Regulation 1525.4.

DOCUMENTS RELIED UPON

The Board relied upon Formal Issue Paper 14-001, the exhibits to the issue paper, and the comments made during the Board's discussion of the issue paper during its April 22, 2014, Business Taxes Committee meeting in deciding to propose the adoption of Regulation 1525.4, described above.

ALTERNATIVES CONSIDERED

The Board considered whether to propose to adopt Regulation 1525.4 as recommended by staff in Formal Issue Paper 14-001 during its April 22, 2014, Business Taxes Committee meeting. In addition, the Board considered two reasonable alternatives to proposed Regulation 1525.4, where Board staff and interested parties had different proposed language.

First, RTC section 6377.1, subdivision (b)(6)(A) provides that the term qualified person means a person that is primarily engaged in those lines of business described in NAICS codes 3111 to 3399, inclusive, 541711, or 541712. Board staff suggested that proposed Regulation 1525.4, subdivision (b)(8)(A), clarify that a person may be a qualified person even if there is no applicable six digit NAICS code to describe the person's line of business, provided that their business activities are described in a qualified four digit industry group, without providing any examples. Waste Management suggested alternative language that added an example further clarifying that "the recycling industry will not be precluded from the definition of a '[q]ualified person' for not having a specific four or six digit NAICS code, provided that their activities and/or products are described in a qualified [four] digit [NAICS] industry group." (See Exhibit 4 to Formal Issue Paper 14-001.) After considering the proposed example, the Board (1) revised staff's suggested language to clarify that the business activity must be "reasonably" described in a qualified four digit industry group; (2) included a revised example in subdivision (b)(8)(A) of the proposed regulation, which clarifies that "a business in the recycling industry may be regarded as a qualified person when the activities of the establishment are reasonably described in a qualified four digit industry group"; and (3) excluded the reference to "products" from the example.

Second, as explained more fully above, the definition of "qualified person" in RTC section 6377.1, subdivision (b)(6)(A), uses the phrase "primarily engaged," and existing law does not specifically define what is meant by "primarily engaged" for purposes of RTC section 6377.1. Board staff suggested that proposed Regulation 1525.4, subdivision (b)(8)(A)(1), include alternative tests to ascertain if an establishment is primarily engaged in a qualifying line of business based on: (1) gross revenue; (2) operating expenses; (3) employee salaries and wages; or (4) value of production. CalTax suggested alternative language adding, in addition to the tests noted above; (5) number of employees; (6) employee hours; (7) number of units produced; or (8) capital investment. (See Exhibit 3 to Formal Issue Paper 14-001.) After considering whether staff's language excluded persons from the definition of "qualified person" that should qualify for the partial exemption, the Board added one additional test for primarily engaged based on "number of employees," but further clarified that the additional test is "based on full time equivalency."

Furthermore, the California Poultry Federation's suggested that Regulation 1525.4 clarify that the "establishment" concept can apply so that a person with a qualifying establishment can be a "qualified person" for purposes of that establishment, even if the person is otherwise an apportioning trade or business that would be precluded from the definition of qualified person by RTC section 6377.1, subdivision (b)(6)(B). In Formal Issue Paper 14-001, Board staff concluded that the provisions in RTC section 6377.1, subdivision (b)(6)(B) are specific and would not allow staff to apply the establishment concept as suggested by the California Poultry Federation. After considering the California Poultry Federation's suggestion during the April 22, 2014, Business Taxes Committee meeting, several Board Members recommended that the California Poultry Federation seek an amendment to RTC section 6377.1 that would fix the issue identified by staff, and the Board did not make any changes to staff's recommended language for Regulation 1525.4 in response to this suggestion.

During the Board's April 22, 2014, Business Taxes Committee meeting, the Board decided to propose to adopt Regulation 1525.4 as recommended by staff and with the two changes noted above because the Board determined that the adoption of the proposed regulation is reasonably necessary for all the reasons provided above. The Board did not reject any reasonable alternative to proposed Regulation 1525.4 that would lessen any adverse impact the proposed action may have on small business or that would be less burdensome and equally effective in achieving the purposes of the proposed action. No reasonable alternative has been identified and brought to the Board's attention that would lessen any adverse impact the proposed action may have on small business, be more effective in carrying out the purposes for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

INFORMATION REQUIRED BY GOVERNMENT CODE SECTION 11346.2, SUBDIVISION (b)(5) AND ECONOMIC IMPACT ASSESSMENT REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)(1)

AB 93, as amended by SB 90, added section 6377.1 to the RTC effective July 11, 2013. Section 1 of AB 93 specifies that it is the intent of the Legislature in adding RTC section 6377.1 to exempt manufacturing equipment from state sales and use taxes in order to make California more competitive in attracting new businesses to this state. And, the Board anticipates that RTC section 6377.1 will have some economic impact on business and state revenue.

The Board is proposing to adopt Regulation 1525.4 to implement, interpret, and make specific the provisions of RTC section 6377.1, define and further define statutory terms, including "qualified person," explain when the partial exemption does and does not apply, prescribe the form of the partial exemption certificate that must be provided to the retailer pursuant to RTC section 6377.1, subdivision (c), and provide sample partial exemption certificates to be used for claiming the partial exemption,. In addition, the Board intends to make the sample partial exemption certificates set forth in Appendices A and B to proposed Regulation 1525.4 available to the public on the Board's website.

The Board anticipates that the adoption of proposed Regulation 1525.4 will benefit the Board, Board staff, and persons engaged in manufacturing, research and development, or both by:

- Providing guidance about and promoting awareness of the partial exemption for equipment used primarily in manufacturing and research and development provided by RTC 6377.1, and the requirements to qualify for the partial exemption;
- Implementing RTC section 6377.1, subdivision (c) by prescribing the form of the partial exemption certificate that qualified persons and construction contractors must issue to retailers, and providing sample partial exemption certificates that meets the required form for such persons to use;
- Interpreting and making specific RTC section 6377.1, subdivision (b)(6)(A) by defining what is meant by the requirement that a qualified purchaser be "primarily engaged" in a qualifying line of business;
- Interpreting and making specific RTC section 6377.1, subdivision (b)(7)(A)(iv) by further defining "special purpose buildings and foundations";
- Interpreting and making specific RTC section 6377.1, subdivision (f) by clarifying the application of the partial exemption in the context of certain lease transactions; and
- Interpreting and making specific RTC section 6377.1, subdivision (a)(4) by clarifying the application of the partial exemption to transactions involving construction contracts.

All of the provisions in proposed Regulation 1525.4 are fully consistent with current law, including RTC section 6377.1, and there is nothing in proposed Regulation 1525.4 that would significantly change how individuals and businesses would generally behave in response to RTC section 6377.1 in the absence of the proposed regulatory action. Therefore, the Board estimates that the proposed regulation will not have a measurable economic impact on individuals and business that is in addition to whatever economic impact RTC section 6377.1 will have on individuals and businesses. And, the Board has determined that the proposed adoption of Regulation 1525.4 is not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000, because the Board has estimated that the proposed regulation will not have an economic impact on California business enterprises and individuals in an amount exceeding fifty million dollars ($50,000,000) during any 12-month period.

In addition, the Board has determined that proposed Regulation 1525.4 does not impose any costs on any persons, including businesses, which are not already imposed by RTC section 6377.1, and the Board has determined that there is nothing in proposed Regulation 1525.4 that would impact revenue. Therefore, based on these facts and all of the information in the rulemaking file, the Board has determined that the adoption of proposed Regulation 1525.4 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California.

Furthermore, proposed Regulation 1525.4 will not regulate the health and welfare of California residents, worker safety, or the state's environment. Therefore, the Board has also determined that the adoption of proposed Regulation 1525.4 will not affect the benefits of the regulation to the health and welfare of California residents, worker safety, or the state's environment.

The forgoing information also provides the factual basis for the Board's initial determination that the adoption of proposed Regulation 1525.4 will not have a significant adverse economic impact on business.

The adoption of proposed Regulation 1525.4 may affect small businesses.

Proposed Text of

California Code of Regulations, Title 18, Section 1525.4,

Manufacturing and Research & Development Equipment,

(A new regulation to be added to the California Code of Regulations)

1525.4. Manufacturing and Research & Development Equipment.

(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, including leases, 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 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 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 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, provided that the qualified person will use the resulting improvement on or to real 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 is more efficient or 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, including repackaging of such goods when repackaging is required to meet the needs of a specific customer. Packaging necessary to consolidate the goods prior to shipping or to protect them during transportation to the customer 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 at the time the qualified tangible personal property is purchased.

(5) "Primarily" means 50 percent or more of the time.

(6) "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 as defined in subdivision (b)(3), if required. "Process" includes testing products for quality assurance which occurs prior to the tangible personal property being altered to its completed form,

including packaging as defined in subdivision (b)(3), if required. 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.

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

(8) (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. With respect to Codes 3111 to 3399, a person will not be precluded from the definition of a "qualified person" when there is no applicable six digit NAICS code to describe their line of business, provided that their business activities are reasonably described in a qualified four digit industry group. For example, a business in the recycling industry may be regarded as a qualified person when the activities of the establishment are reasonably described in a qualified four digit industry group. For the purpose of this subdivision:

1. A qualified person may be "primarily engaged" either as a legal entity or as an establishment within a legal entity. "Legal entity" means "person" as defined in RTC section 6005.

A person is "primarily engaged" as a legal entity if, in the prior financial year, the legal entity derives 50 percent or more of gross revenue (including inter-company charges) from, or expends 50 percent or more of operating expenses in a line of business described in Codes 3111 to 3399, inclusive, 541711 or 541712 of the NAICS. For example, a legal entity is a qualified person primarily engaged in a qualifying line of business if the legal entity's gross revenue from manufacturing constitutes 50 percent or more of the total revenue for the legal entity. For purposes of research and development activities, revenues could be derived from, but are not limited to, selling research and development services or licensing intellectual property resulting from research and development activities.

A person is "primarily engaged" as an establishment if, in the prior financial year, the establishment derives 50 percent or more of gross revenue (including inter-company and intra-company charges) from, or expends 50 percent or more of operating expenses in a qualifying line of business. Alternatively, an establishment is "primarily engaged" if, in the prior financial year, it allocates, assigns or derives 50 percent or more of any one of the following to or from a qualifying line of business: (1) employee salaries and wages, (2) value of production, or (3) number of employees based on a full-time equivalency.

For purposes of this test, the gross revenues may be derived from a combination of qualified manufacturing lines of business and from qualified research and development lines of business. For example, if a company derives 40% of its gross revenues from qualified manufacturing activities and 40% from non-qualified manufacturing activities; but, the remaining 20% of its gross revenues are derived from qualified research and development contracts, the company would qualify because overall, 60% of the gross revenues are from qualifying activities.

Similarly, the test for operating expenses from qualifying manufacturing or research and development lines of business cited in the qualifying NAICS codes would be considered in combination.

There may be more than one qualifying establishment within a legal entity.

In the case of a nonprofit organization or government entity, "primarily engaged" with regard to gross revenue means 50 percent or more of the funds allocated to the entity or establishment are attributable to a qualifying line of business.

In cases where the purchaser was not primarily engaged in qualifying 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.

2. For purposes of this subdivision, "establishment" includes multiple or single physical locations (including any portion or portions thereof), and those locations or combinations of locations (including any portion or portions thereof) designated as a "cost center" or "economic unit" by the taxpayer, where a qualified activity is performed, and for which the taxpayer maintains separate books and records that reflect revenue, costs, number of employees, wages or salaries, property and equipment, job costing, or other financial data pertaining to the qualified activity. A physical location may be described in more than one NAICS code.

3. An entity or establishment primarily engaged in manufacturing activities may purchase qualified tangible personal property subject to the partial sales and use tax exemption for use in research and development, provided all other requirements for the exemption are met. An entity or establishment primarily engaged in research and development may purchase qualified tangible personal property subject to the partial sales and use tax exemption for use in manufacturing, provided all other requirements for the exemption are met. Where a person is primarily engaged as a legal entity, that person shall be considered a "qualified person" for purposes of this regulation for all purchases made by the legal entity, provided all other requirements of the exemption are met. Where a person conducts business at more than one establishment 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.

(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 as defined in subdivision (d) of RTC section 25128.

(9) (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 or exceeds standards established by this state or any local or regional governmental agency within this state at the time the qualified tangible personal property is purchased.

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 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 and the construction or reconstruction of which is specifically designed and used exclusively for the specified purposes as set forth in subdivision (a) (the qualified purpose). Special purpose buildings and foundations also include foundations for open air structures that may not have ceilings or enclosed walls but are used exclusively for the specified purposes as set forth in subdivision (a).

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

c. A building or foundation 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 or foundation for nonqualified purposes does not preclude the structure from being a special purpose building and foundation. "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 and/or foundation does not qualify as a special purpose building and foundation, a qualified person may establish that a portion of the structure 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 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. The extraction process includes such severance activities as mining, oil and gas extraction.

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, compressing, or any other activity that does not otherwise change the physical properties of any such waste.

(11) "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.

(12) "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 person does not establish the capability or method for developing or improving the product or the appropriate design of the product.

(13) "Useful life." 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. 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)(3) 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.

On occasion a potential qualified person may not know at the time of purchase whether they will meet the requirements for the purpose of claiming the partial exemption until the expiration of the one year period following the date of purchase as provided in subdivision (b)(8)(A). The purchaser may issue a partial exemption certificate at the time of the purchase based on the expectation that the purchaser will meet the requirements of the regulation. If those requirements are not met, the purchaser will 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 purchased.

If the purchaser pays the full amount of tax at the time of purchase and later becomes aware that the requirements of this regulation are met, they may issue a partial exemption certificate to the retailer. If a retailer receives a certificate from a qualified person under these circumstances, or if the retailer receives a certificate from a contractor purchasing qualified tangible personal property for use in the performance of a construction contract for a qualified person, the retailer may file a claim for refund as provided in subdivision (h).

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)(5), 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 by construction contractors as an exemption certificate when they are purchasing qualified tangible personal property for use in a construction contract for a qualified person.

(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 certificate forms set forth in Appendix A and Appendix B may be used as blanket partial exemption certificates. In absence of evidence to the contrary, a retailer may accept an otherwise valid blanket partial exemption certificate in good faith if the certificate complies with the requirements set forth in this subdivision.

When purchasing tangible personal property not qualifying for the partial exemption from a seller to whom a blanket exemption certificate has been issued, the qualified person or contractor must clearly state in a contemporaneous document or 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.

If contemporaneous physical documentation, such as a purchase order, sales agreement, lease, or contract is not presented for each transaction, any agreed upon designation which clearly indicates which items being purchased are or are not subject to the partial exemption certificate, such as using a separate customer account number for purchases subject to the partial exemption, will be accepted, provided the means of designation is set forth on the blanket exemption certificate.

(3) 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), or

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.

(4) 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.

(5) 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)(3).

(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. This limit includes fixtures and materials sold or used in the construction of special purpose buildings and foundations.

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, as well as the period January 1, 2022 to June 30, 2022. Accordingly, for calendar years 2014 and/or 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.

There is no proration of the $200,000,000 limit when the purchaser is a qualified person for only a portion of a calendar year. For example, if the qualified person began business on October 1, 2016, the qualified person may purchase up to $200,000,000 in qualified tangible personal property in the three months of 2016 they were in business.

(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 purchaser 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 may apply to rentals payable paid by a qualified person for a lease period beginning on or after July 1, 2014, with respect to a lease of qualified tangible personal property to the qualified person, which property is used primarily in an activity described in subdivision (a), notwithstanding the fact that the lease was entered into prior to the effective date of this regulation.

For purposes of this subdivision, in the case of any lease that is a continuing "sale" and "purchase" under subdivision (b)(1) of Regulation 1660, the one-year test period specified in subdivision (d)(2) of this regulation runs from the date of the first rental period which occurs on or after July 1, 2014, provided that the other conditions for qualifying for the partial exemption have been met. Any such rentals payable subject to the partial exemption shall continue to be taxed at the partial rate after expiration of the one-year period and lasting until such time as the lessee ceases to be a qualified person, converts the property for use in a manner not qualifying for the exemption, uses the property in a manner not qualifying for the partial exemption, or the partial exemption otherwise ceases to apply.

(g) Construction Contractors. The application of sales and use tax to construction contracts is explained in Regulation 1521, *Construction Contractors*. The terms "construction contract," "construction contractor," "materials," "fixtures," "time and material contract," and "lump sum contract" used in this regulation refer to the definitions of those terms in Regulation 1521. Nothing in this regulation is intended to alter the basic application of tax to construction contracts.

(1) Partial Exemption Certificates. As provided in subdivision (c)(1), construction contractors performing construction contracts for construction of special purpose buildings and foundations should obtain a partial exemption certificate from the qualified person (Appendix A). Contractors purchasing property from a retailer in this state or engaged in business in this state for use in the performance of a qualifying construction contract for a

qualified person must timely furnish the retailer with a partial exemption certificate in order for the partial exemption to be allowed (Appendix B).

If a contractor accepts a certificate from a qualified person for the construction of a special purpose building or foundation and it is later determined that the building or foundation is not a qualifying structure as provided in subdivision (b)(9)(A)4., the qualifying person will be liable for the tax as provided in subdivision (e). If a contractor issues a certificate to its vendor to purchase tangible personal property for use in a construction contract for a qualified person subject to the partial exemption, and instead uses those materials for another purpose, the contractor will be liable for the tax as provided in subdivision (e).

(2) Construction Contractors as Qualified Persons. Equipment used by a construction contractor in the performance of a construction contract for a qualified person does not qualify for the partial exemption. For example, the lease of a crane used in the construction of a special purpose building does not qualify. However, a contractor that is also a qualified person as defined in subdivision (b)(8) may purchase property subject to the partial sales and use tax exemption provided all requirements for exemption are met. Like any other qualified person, a contractor making purchases qualifying for the exemption is subject to the $200,000,000 limit provided in (d)(1) with regard to the contractor's purchases for his or her own use.

(3) $200,000,000 Limit. As explained in subdivision (d)(1), the $200,000,000 limit for the partial exemption includes fixtures and materials sold or used in the construction of special purpose buildings and foundations. In a time and material contract, the qualified person may consider the billed price of materials and fixtures to be the purchase price of these items for the purposes of the limit. In a lump-sum contract, the qualified person must obtain this information from job cost sheets or other cost information provided by the construction contractor.

(h) Claim for Refund. Qualified purchasers, or contractors purchasing qualified tangible personal property for use in the performance of a construction contract for a qualified person, who paid tax or tax reimbursement to the seller or the Board may file a claim for refund with the Board if the purchase was a use tax transaction. However, if the purchase was a sales tax transaction, a claim for refund for sales tax must be filed by the retailer who reported the sale and the qualified purchaser must issue the seller a partial exemption certificate. In order to be timely, the claim for refund must be filed with the Board within the period specified in section 6902 of the RTC.

Note: Authority cited: Section 7051, Revenue and Taxation Code. Reference: Section 6377.1, Revenue and Taxation Code.

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 at the rate of 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 periods occurring on or after July 1, 2014 and before July 1, 2022, for leases of 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;

☐ 2. for research and development;

☐ 3. to maintain, repair, measure, or test any property being used for (1) or (2) above; **or**

☐ 4. as a special purpose building and/or foundation.

Description of qualified tangible property purchased or leased[1]:

____

____

____

If this is a specific partial exemption certificate, provide the purchase order or sales invoice number and a precise description of the property being purchased. If you want this certificate to be used as a blanket certificate for future purchases, describe generally the type of property you will be purchasing and ask your vendor to keep this certificate on file.

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)[2] 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 by law, I am required to report and pay the state tax (calculated on the sales price/rentals payable of the property) at the time the tangible personal property is so purchased, removed, converted, or used if:

- the purchase exceeds the $200 million limitation;
- the property is removed from California within one year of the date of purchase or lease;
- converted for use in a manner not qualifying for the exemption; **or**
- used in a manner not qualifying for the partial exemption.

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 See Regulation 1525.4, subdivision (b)(9) for a description of what is included and excluded from "qualified tangible personal property."

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

Appendix B

CONSTRUCTION CONTRACTS - 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 at the rate of 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:

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 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[1]:

If this is a specific partial exemption certificate, provide the purchase order or sales invoice number and a precise description of the property being purchased. If you want this certificate to be used as a blanket certificate for future purchases, describe generally the type of property you will be purchasing and ask your vendor to keep this certificate on file.

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)[2] 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.

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] See Regulation 1525.4, subdivision (b)(9) for a description of what is included and excluded from "qualified tangible personal property."

[2] Published by the US Office of Management and Budget, 2012 edition.

Regulation History

Type of Regulation: Sales and Use Tax

Regulation: 1525.4

Title: *Manufacturing and Research & Development Equipment*

Preparation: Andrew Kwee
Legal Contact: Andrew Kwee

Proposed Regulation 1525.4, *Manufacturing and Research & Development Equipment*, implements, interprets, and makes specific Revenue and Taxation Code section 6377.1's partial exemption for the sale and use of equipment used primarily in manufacturing, and research and development.

History of Proposed Regulation:

July 17-18, 2014	Public Hearing
May 30, 2014	OAL publication date; 45-day public comment period begins; Interested Parties mailing
May 20, 2014	Notice to OAL
April 22, 2014	Business Tax Committee, Board Authorized Publication (Vote 5-0)

Sponsor: NA
Support: NA
Oppose: NA