

Memorandum

To: Honorable Jerome E. Horton, Chairman
Senator George Runner, Vice Chair
Honorable Fiona Ma, CPA, Second District
Honorable Diane L. Harkey, Fourth District
Honorable Betty T. Yee, State Controller

Date: August 3, 2015

From: 
Randy Ferris
Chief Counsel

Subject: Board Meeting, August 25-26, 2015
Chief Counsel Matters – Item J. Rulemaking
Petition to Amend Sales and Use Tax Regulation 1525.4,
Manufacturing and Research & Development Equipment

On Tuesday, July 21, 2015, the Legal Department received a petition dated July 21, 2015 (attached hereto), from Ms. Teresa Casazza on behalf of the California Taxpayers Association (petitioner or CalTax), pursuant to Government Code section 11340.6, requesting the amendment of California Code of Regulations, title 18, section (Regulation) 1525.4, *Manufacturing and Research & Development Equipment*. The petition seeks to amend the regulation to add clarifying language so that taxpayers may substantiate the useful life qualification by reference to warranties, maintenance agreements or industry replacement standards.

This matter is scheduled for the Board's consideration at the August 25-26, 2015, Board meeting on the Chief Counsel Matters Agenda. At the meeting, the Board may: (1) deny the petition; (2) grant the petition in part or in whole and commence the official rulemaking process to amend the regulation by ordering publication of a notice pursuant to Government Code section 11346.5; (3) direct staff to commence an interested parties process to consider the requested amendments in part or in whole; or (4) take any other action the Board deems appropriate.

This memorandum sets forth: (1) relevant background information pertaining to the adoption of Regulation 1525.4; and (2) a discussion of the petition and staff's response to the petition.

I. Background Information

A. *Sales and Use Tax Law*

Created by Assembly Bill 93 (AB 93) (Stats. 2013, Ch. 69), as amended by Senate Bill 90 (SB 90) (Stats. 2013, Ch. 70), Revenue and Taxation Code (RTC) section 6377.1 provides a partial exemption from sales and use tax on certain manufacturing, and research and

development, equipment sales and purchases. The partial exemption applies to qualifying sales and purchases made on or after July 1, 2014, and before July 1, 2022.

B. Drafting and Adoption of Regulation 1525.4

The Board understands that the intent of RTC section 6377.1 is to promote economic growth in California and drafted Regulation 1525.4 with this in mind. In general, to qualify for the partial exemption, the purchase must be for use by a qualified person, the item purchased must be qualified tangible personal property, and the use must be for a qualifying purpose. Regulation 1525.4 further defines terms in the statute, explains when the partial exemption does and does not apply, and provides sample partial exemption certificates to claim the exemption. Many of the provisions in the regulation are based on suggestions from interested parties during the interested parties process. A copy of the Formal Issue Paper for this rulemaking project is attached for your reference.

On July 17, 2014, the Board adopted Regulation 1525.4, *Manufacturing and Research & Development Equipment*, to implement RTC section 6377.1's partial exemption for the sale and use of equipment used primarily in manufacturing and research and development (R&D), which became operative as of July 1, 2014.

II. Discussion of the Petition

The petition requests that the Board amend Regulation 1525.4. The petition seeks to amend the regulation to add clarifying language so that taxpayers may substantiate the useful life qualification by reference to warranties, maintenance agreements or industry replacement standards.

CalTax believes that the statutory language is unclear and provides inconsistent guidance with regard to how taxpayers may substantiate, and how the BOE may verify, that qualified manufacturing and R&D equipment has a useful life of one or more years. CalTax further asserts that the current provisions may be interpreted to inadvertently disallow an exemption for qualified equipment unless it is capitalized on the relevant state income or franchise tax returns.

In its petition, the CalTax states:

Disparate treatment of taxpayers – Taxpayers purchasing the same piece of equipment for the same purpose may receive different tax treatment. For example:

Taxpayer A purchases qualifying equipment for use in manufacturing/R&D, and opts to report the expenditure as a capital expense over the next couple of years on his income tax returns. Taxpayer A is eligible for the exemption.

Taxpayer B purchases the identical equipment for use in manufacturing/R&D, but does not have the resources/staff to prepare/file/annually track capital assets, so he reports the expenditure as a

deduction on his tax returns. Taxpayer B may **NOT** be eligible for the exemption.

Disallowance of qualified equipment – Manufacturing and R&D equipment that meets ALL other statutory requirements, including qualifying uses by qualifying manufacturers and R&D companies engaged in qualifying activities for qualifying purposes, etc. may be disallowed the exemption because of how the taxpayer reports the cost of the equipment on his/her income tax returns.

Failure to adhere to legislative intent – Some businesses, particularly smaller businesses, do not capitalize equipment due to unpredictable annual gross receipts and lack of economies of scale. An interpretation that limits qualification to capitalized equipment would disqualify many of the small businesses and equipment component parts that the Legislature intended be eligible for the exemption.

Accordingly, CalTax petitions the BOE to add clarifying language (see attachment to petition, at pp. 8-9) to allow eligible taxpayers purchasing qualified equipment to substantiate qualification under the “useful life” criteria by reference to a warranty, a maintenance agreement, or industry replacement standard of a duration of one or more years. The existing substantiation approach (by reference to treatment on state income or franchise tax returns) would be retained as one of the substantiation methods.

Staff recognizes that Revenue and Taxation Code section 6377.1 may be interpreted by some as ambiguous and potentially inconsistent in its drafting. Subdivision (b)(7)(A)(i) of RTC section 6377.1 states that “qualified tangible personal property” includes component parts and contrivances such as belts, shafts, moving parts, and operating structures. However, subdivision (b)(10) of RTC section 6377.1 states that “useful life” for tangible personal property that is treated 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 the purposes of this section. As pointed out by CalTax, one taxpayer may report the purchase of a belt as a capital asset, but another taxpayer, perhaps having fewer resources, may report an identical belt as an expenditure as a deduction on an income or franchise tax return rather than a capital asset.

CalTax asserts that the explicit language in subdivision (b)(7)(A)(i) makes it clear that the Legislature intended to include the component parts and contrivances of machinery and equipment. CalTax further asserts that limiting the exemption to property limited only by subdivision (b)(10) of that section would needlessly thwart the purpose and intent of RTC section 6377.1.

If the Board agrees that, in light of the entire statutory scheme, the Legislature intended to make the partial exemption available in all circumstances where a qualified person can establish that otherwise qualified tangible personal property has a useful life of one year or more, subject to approval by the Office of Administrative Law, this proposed amendment will address the issues raised by CalTax and effectuate such legislative intent.

If you need more information or have any questions, please contact Assistant Chief Counsel Robert Tucker at (916) 322-0437.

Approved:


Cynthia Bridges
Executive Director

Attachments: Petition dated July 21, 2015
 Business Taxes Committee Formal Issue Paper No. 14-001

RF:RT:hp

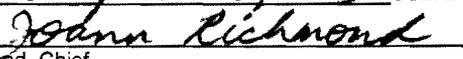
cc: Ms. Cynthia Bridges MIC:73
 Mr. Robert Tucker MIC:82

STATE BOARD OF EQUALIZATION



BOARD GRANTED PETITION AND AUTHORIZED
PUBLICATION

At the August 25, 2015 Board Meeting


Joann Richmond, Chief
Board Proceedings Division



July 21, 2015

State Board of Equalization
Attn: Ms. Cynthia Bridges, Executive Director
450 N Street, MIC: 17
Sacramento, CA 95814

RE: Petition to Add Language to California Code of Regulations Title 18, §1525.4,
Manufacturing and Research & Development Equipment

Dear Ms. Bridges:

Pursuant to Government Code section 11340.6 and the State Board of Equalization's authority under Revenue and Taxation Code section 7051, the California Taxpayers Association hereby petitions the State Board of Equalization to add clarifying language to California Code of Regulations Section 1525.4 – pertaining to the partial sales and use tax exemption for manufacturing and R&D equipment set forth in Revenue and Taxation Code section 6377.1 – so that taxpayers may substantiate useful life qualification by reference to either warranties, maintenance agreements or industry replacement standards.

Current statutory language is unclear, and provides inconsistent guidance with regard to how taxpayers may substantiate, and how the BOE may verify, that qualified manufacturing and R&D equipment has a useful life of one or more years. The current provisions may be interpreted to inadvertently disallow an exemption for qualified equipment unless it is capitalized on the state income/franchise tax returns. This results in:

- **Disparate treatment of taxpayers** – Taxpayers purchasing the same piece of equipment for the same purpose may receive different tax treatment. For example:

Taxpayer A purchases qualifying equipment for use in manufacturing/R&D, and opts to report the expenditure as a capital expense over the next couple of years on his income tax returns. Taxpayer A is eligible for the exemption.

Taxpayer B purchases the identical equipment for use in manufacturing/R&D, but does not have the resources/staff to prepare/file/annually track capital assets, so he reports the expenditure as a deduction on his tax returns. Taxpayer B may **NOT** be eligible for the exemption.

- **Disallowance of qualified equipment** – Manufacturing and R&D equipment that meets ALL other statutory requirements, including qualifying uses by qualifying manufacturers and R&D companies engaged in qualifying activities for qualifying purposes, etc. may be disallowed the exemption because of how the taxpayer reports the cost of the equipment on his/her income tax returns.
- **Failure to adhere to legislative intent** – Some businesses, particularly smaller businesses, do not capitalize equipment due to unpredictable annual gross receipts and lack of economies of scale. An interpretation that limits qualification to capitalized equipment would disqualify many of the small businesses and equipment component parts that the Legislature intended be eligible for the exemption.

To remedy these situations, CalTax petitions the BOE to add clarifying language (attachment) to allow eligible taxpayers purchasing qualified equipment to substantiate qualification under the “useful life” criteria by reference to either a warranty, a maintenance agreement, or industry replacement standard of a duration of one or more years. The existing substantiation approach (by reference to treatment on the state’s income/franchise tax returns) would be retained as one of the substantiation methods.

Thank you for your consideration of our petition.

Sincerely,

A handwritten signature in black ink that reads "TERESA CASAZZA". The signature is slanted and written in all caps.

Teresa Casazza
President, California Taxpayers Association

cc: Honorable Jerome E. Horton, Chairman
Senator George Runner, Vice-chair
Honorable Diane Harkey
Honorable Fiona Ma
Honorable Betty T. Yee, State Controller, c/o Deputy Controller Yvette Stowers

Attachment

ATTACHMENT

§ 1525.4. Manufacturing and Research and 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)(A) “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.

(B) For purposes of applying subdivision (b)(13)(A), tangible personal property that meets any one of the following criteria shall be deemed as having a useful life of one or more years for state income or franchise tax purposes:

1. Tangible property included under a warranty by the manufacturer or other third party to last one or more years shall be treated as having a useful life of one or more years for purposes of this regulation.

2. Tangible personal property that is included under a maintenance contract lasting one or more years shall be treated as having a useful life of one or more years for purposes of this regulation.

3. Tangible personal property that is normally replaced at intervals of one or more years, as established by industry or business practices or based on the actual experience of the person claiming the exemption, or is expected at the time of purchase to last one or more years, as established by industry or business practices or based on the actual experience of the person claiming the exemption, shall be treated as having a useful life of one or more years for purposes of this regulation.

(C) Examples: Useful life is determined by answering the following questions for tangible personal property:

Example 1. Is the tangible personal property capitalized for state tax purposes or accounting purposes?

- If the answer is "yes," it meets the useful life requirement.*
- If the answer is "no," go to the next question.*

Example 2. Is the tangible personal property warranted by the manufacturer or other third party to last one year or more?

- If the answer is "yes," it meets the useful life requirement.*
- If the answer is "no," go to the next question.*

Example 3. Is the tangible personal property normally replaced at intervals of one year or more, as established by industry or business practice? (This is commonly based on the actual experience of the person claiming the exemption.)

- If the answer is "yes," it meets the useful life requirement.*
- If the answer is "no," go to the next question.*

Example 4. Is the tangible personal property expected at the time of purchase to last one year or more, as established by industry or business practice? (This is commonly based on the actual experience of the person claiming the exemption.)

- If the answer is "yes," it meets the useful life requirement.*
- If the answer is "no," it does not meet the useful life requirement.*

(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.

Issue Paper Number 14-001



- Board Meeting
- Business Taxes Committee
- Customer Services and Administrative Efficiency Committee
- Legislative Committee
- Property Tax Committee
- Other

Proposed Regulation 1525.4, *Manufacturing and Research & Development Equipment*

I. Issue

Whether the Board should approve proposed Sales and Use Tax Regulation 1525.4, *Manufacturing and Research & Development Equipment*, to implement and explain the partial exemption from sales and use tax for sales and purchases of tangible personal property for use in specified manufacturing and/or research and development activities that was established by Revenue and Taxation Code (RTC) section 6377.1.

II. Alternative 1 – Staff Recommendation

Staff recommends approval of proposed Regulation 1525.4 to clarify RTC section 6377.1, as provided in Exhibit 2. Staff’s proposal defines terms, explains when the partial exemption does and does not apply, and provides sample partial exemption certificates to claim the exemption.

III. Other Alternatives Considered

Comments in response to staff’s third discussion paper were received from the California Taxpayers Association (CalTax); Waste Management; Qualcomm; Downey, Smith & Fier (DSF); the University of California, Los Angeles (UCLA); Oakley, Inc.; and the California Poultry Federation. (See Exhibits 3-9.) Submissions that included suggested revisions to staff’s proposed language that staff did not include in its recommendation are presented as Alternatives 2 and 3.

Alternative 2 – Waste Management Recommendation

Waste Management recommends that the definition of “qualified person” not preclude the recycling industry from qualifying for the partial exemption when the business does not have a specific four or six digit North American Industry Classification System (NAICS) code, provided that their activities and/or products are described in a qualified four digit industry group. (See pages 3-4 for a discussion of this issue; see also, Exhibit 4 and Agenda, Action Item 2.)

Alternative 3 – CalTax Recommendation

CalTax recommends that with respect to an establishment, the test for determining whether a qualified person is “primarily engaged” should include more alternatives than the staff recommendation. (See pages 4-6 for a discussion of these issues; see also Exhibit 3 and Agenda, Action Item 3.)

IV. Background

General

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

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 taxes. RTC section 6377.1 exempts certain transactions from the state general fund taxes imposed by RTC sections 6051¹, 6051.3, 6201², and 6201.3, and the State's Education Protection Account tax imposed by Section 36, Article XIII of the State Constitution. Accordingly, from July 1, 2014, to December 31, 2016, the partial exemption will be 4.1875 percent. After the Education Protection Account tax expires on December 31, 2016, the partial exemption will be 3.9375 percent from January 1, 2017, to June 30, 2022.

If the Education Protection Account tax is extended, or there is any other tax rate change in the RTC sections covered by the exemption, staff will amend any references to the partial exemption rate in Regulation 1525.4 accordingly. Changes of this type are generally processed as Rule 100 revisions³.

Prior partial exemption for manufacturing equipment

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

V. Discussion

Staff believes the intent of RTC section 6377.1 is to promote economic growth in California and has drafted proposed Regulation 1525.4 with this in mind. In general, to qualify for the partial exemption, the purchase must be for use by a qualified person, the item purchased must be qualified tangible personal property, and the use must be for a qualifying purpose. Proposed Regulation 1525.4 further defines terms in the statute, explains when the partial exemption does and does not apply, and provides sample partial exemption certificates to claim the exemption. Many of the provisions in the proposed draft are based on suggestions from interested parties during the interested parties process.

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

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

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

The discussion below includes key issues that have changed since the last discussion paper or were raised in the final submissions from interested parties.

Definition of Qualified Person - Qualifying NAICS Codes

The partial exemption under RTC section 6377.1 is limited to persons primarily engaged in the lines of business described in Codes 3111 to 3399, inclusive, 541711, or 541712 of the NAICS published by the US Office of Management and Budget (OMB), 2012 edition.

The NAICS was developed under the direction and guidance of the OMB as the standard for use by Federal statistical agencies in classifying business establishments for the collection, tabulation, presentation, and analysis of statistical data describing the US economy. NAICS replaced the Standard Industrial Classification (SIC) system in 1997. According to the US Census Bureau's website, there is no central government agency with the role of assigning, monitoring, or approving NAICS codes for establishments. The Census Bureau assigns one NAICS code to each establishment based on its primary activity (generally the activity that generates the most revenue for the establishment) to collect, tabulate, analyze, and disseminate statistical data describing the economy of the United States. NAICS is a two through six digit hierarchical classification system, offering five levels of detail. Each digit in the code is part of a series of progressively narrower categories and the more digits in the code signify greater classification detail. The first two digits designate the economic sector, the third digit designates the subsector, the fourth digit designates the industry group, the fifth digit designates the NAICS industry, and the sixth digit designates the national industry.

The Census Bureau provides a search feature on their website at www.census.gov/naics that allows users to search for a NAICS code by keyword or code number. Businesses can also call or email the Census Bureau for assistance in determining their code. Various other government agencies, trade associations, and regulation boards adopted the NAICS classification system to assign codes to their own lists of establishments for their own programmatic needs. Generally, codes are derived from information that the business establishment has provided on surveys, forms or administrative records. For example, when a taxpayer registering with BOE does not know their NAICS code, they enter information about their type of business and then select a NAICS code from a list of codes generated by BOE's registration system.

RTC section 6377.1 provides that the partial exemption applies to purchases of qualified tangible personal property for use by a qualified person to be used primarily in research and development, or in any stage of the manufacturing, processing, refining, fabricating, or recycling of tangible personal property. One of the requirements is that the purchaser must be considered a qualified person in order for the partial exemption to apply.

In their submission (Exhibit 4), Waste Management points out that the legislature distinguished between four and six digit codes in RTC section 6377.1. The statute invokes the four digit NAICS codes for manufacturing, but the full six digit codes for research and development. Waste Management explains that recycling does not have a unique four digit NAICS industry group. Rather, recycling generally falls under the four digit code of the raw material being recycled. Waste Management operates facilities that processes various waste streams into raw materials which are then sold to other manufacturers. For example, glass is received by Waste Management, then sorted, crushed, sized, cleaned and processed into an intermediate product that is sold to other manufacturers for further processing. Waste Management suggests the following underlined text be added to the proposed definition of "qualified person" to clarify the proper use of the NAICS codes for a qualified taxpayer performing recycling activities:

“Qualified person” means a person that is primarily engaged in those lines of business described in Codes 3111 to 3399, inclusive, 541711, or 541712 of the North American Industry Classification System (NAICS) published by the United States Office of Management and Budget (OMB), 2012 edition. For purposes of this subdivision, with respect to Codes 3111 to 3399, a person will not be precluded from the definition of a “qualified person” for not having a specific six digit NAICS code, provided that their activities or products are described in a qualified four digit industry group. For example, the recycling industry will not be precluded from the definition of a “qualified 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 industry group.

Staff included much of the suggested first sentence in the staff recommendation, but not the second sentence. With regard to the first sentence, staff believes it is the *activities* of the business that qualify a person and deleted “or products” from the phrase, “...provided that their activities ~~or products~~ are described in qualified four digit industry group...” to reflect that belief. With regard to the second sentence, staff believes the example could be confusing because some recyclers may not be in a qualifying NAICS. Based on discussions with staff at the Census Bureau, staff believes that some recyclers fall under NAICS code 562920 for material recovery facilities.

In discussions after their submission was sent, Waste Management expressed their disagreement with the information staff received from the Census Bureau explaining that the four digit code, “5629 - Other Waste Management Services,” does not apply to recyclers. More importantly, the description for “562920 - Material Recovery Facilities” provided in the NAICS codes does not contemplate the further processing many recyclers perform prior to reselling the recycled material. While NAICS code 5629 may apply to the overall enterprise, it would not necessarily apply to an establishment which is processing recycled material for sale. Waste Management believes it was the intent of the Legislature to include within the definition of “qualified person” recyclers who are performing qualified manufacturing activities.

Definition of Qualified Person – Primarily Engaged

RTC section 6377.1 (b)(6)(A) provides that “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 NAICS. The definition of a qualified person is further interpreted and clarified in proposed Regulation 1525.4 (b)(8)(A).

Under the prior partial exemption for manufacturing equipment, qualified taxpayers were required to be engaged in the manufacturing lines of business described in specified SIC codes. RTC section 6377.1 is broader as it includes specified research and development activities (NAICS codes 541711, or 541712); however, the section is narrower in that it requires the person be *primarily* engaged in those lines of business described in NAICS codes 3111 to 3399, 541711, or 541712. The primarily engaged requirement is also found in Regulation 1532, *Teleproduction or Other Postproduction Service Equipment*.

Also modeled after Regulation 1525.2, Regulation 1532 provides a partial exemption for purchases of qualified equipment that will be used by a qualified person primarily engaged in teleproduction or other postproduction services. When Regulation 1532 was drafted, staff initially interpreted the term “qualified person” to mean the entire entity (e.g., a corporation) and that the entire entity must be primarily engaged in teleproduction or other postproduction activities in order to qualify for the partial

exemption. However, as the drafting of the regulation progressed, a more liberal interpretation was adopted to be consistent with Regulation 1525.2 and staff applied the primarily engaged test based on establishments within the entity.

Looking at Regulations 1525.2 and 1532 for guidance, and in response to comments from interested parties, staff's recommendation includes a two pronged test to determine whether a qualified person is "primarily engaged." First, a qualified person may meet the primarily engaged requirement based on their legal entity. That is, the person will be considered primarily engaged if in the prior financial year, the entity derived 50 percent or more of gross revenue from, or expended 50 percent or more of operating expenses in, a line of business described in the specified NAICS codes. If the qualified person does not meet the entity test, they may still be considered primarily engaged in a qualified line of business based on an establishment(s) within the entity.

Staff recommends that a person be considered "primarily engaged" as an establishment if, in the prior financial year, the establishment derived 50 percent or more of gross revenue from, or expended 50 percent or more of operating expenses in, a qualifying line of business. Alternatively, an establishment is primarily engaged if it allocated, assigned or derived 50 percent or more of either (1) employee salaries/wages, or (2) value of production to/from a qualifying line of business. CalTax, however, recommends additional criteria to determine whether an establishment is primarily engaged in a qualifying line of business.

As described in Alternative 3, CalTax recommends that in addition to the 50 percent tests based on either gross revenue or operating expenses, an establishment may be considered primarily engaged if in the prior year it allocated, assigned or derived 50 percent or more of any one of the following items to/from a qualifying line of business: (1) number of employees, (2) employee hours, (3) employee salaries/wages, (4) number of units produced, (5) value of production, or (6) capital investment⁴. In subsequent discussion, CalTax explained that these additional criteria allow qualified persons to meet the primarily engaged test when they would be wrongly eliminated based on the gross revenue or operating expense tests. For example, an establishment that would normally meet the operating expense test may not qualify because of unusual expenses attributed to a costing center in one year. This could occur when there is a large advertising expense (like a Super Bowl commercial) that eclipses all other expenses for the costing center that year.

Acknowledging interested parties' concerns, staff added two additional alternative tests to meet the primarily engaged requirement: a test based on employee salaries/wages, and a test based on value of production, as discussed above. Staff believes these two additional tests would account for interested parties concerns when they do not meet either the gross revenue test or the operating expense test. Staff does not believe the other four additional tests recommended by CalTax are necessary given the other options available. Staff is also concerned that the additional alternatives are not viable indicators of the primary activity of the establishment.

Additional revisions agreed on by staff and interested parties. In response to comments in other submissions, staff made additional revisions to the definition of qualified person to which staff and interested parties agree. These revisions include, for purposes of determining if an entity or establishment is primarily engaged in research and development activities, clarification that gross revenues may be derived from, but are not limited to, selling research and development services or licensing intellectual property resulting from research and development activities. Staff's

⁴ In their original submission, CalTax included another alternative: (7) Other reasonable measurement that is representative of an establishment's level of activity in a qualifying line of business. CalTax later withdrew this alternative.

recommendation further explains that 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 business derives 40 percent of its gross revenue from qualified manufacturing activities, 40 percent from non-qualifying activities, and 20 percent from qualifying research and development activities, the business would have met the primarily engaged test because 60 percent of the gross receipts are from qualifying activities. (See Exhibit 5, Qualcomm submission.) Staff's recommendation also clarifies that 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. (See Exhibit 6, DSF submission.)

In subsequent discussions, Qualcomm, DSF, and UCLA indicated that their concerns had been addressed and they did not need their additional suggested revisions put forward as alternative language for the Board to consider.

Definition of Qualified Person - Establishment

When a qualified person does not meet the primarily engaged test as a legal entity, they may still qualify as an establishment. Key to this determination is the definition of "establishment." Staff's recommendation provides that "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.

Initially, staff's proposed definition referenced only physical locations (including any portion or portions thereof). Staff believed this was an easily understood definition that would include the same group of taxpayers as discussed in the interested parties' submissions. However, staff expanded its recommendation to include "cost center" or "economic unit" to address CalTax's concerns that under staff's proposed language, some of their members would be ineligible for the exemption not because of their activities, but because their records do not reference physical location. They also pointed out that BOE audit staff would not be able to verify the establishment was primarily engaged in a qualifying activity because their records for cost centers do not reference physical addresses. CalTax was further concerned that staff's language would require businesses to recreate their financial records to show that they have a qualified establishment.

Exclusion from the Definition of Qualified Person

Subdivision (b)(6) of RTC section 6377.1 explains who is included and who is excluded from the definition of a qualified person:

(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.

As explained in the prior discussion sections, staff included the provisions of RTC section 6377.1 (b)(6)(A) in proposed Regulation 1525.4 (b)(8)(A) and provided further clarification that “primarily engaged in those lines of business” could be tested at either the entity or establishment level.

The provisions of RTC section 6377.1 (b)(6)(B), however, exclude certain businesses from the definition of “qualified person.” Consequently, those businesses excluded by statute cannot take advantage of the partial exemption. Staff included the provisions of 6377.1 (b)(6)(B) in Regulation 1525.4 (b)(8)(B). Staff also added clarifying information from RTC section 25128 (b) in the last sentence:

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.

In their submission, the California Poultry Federation expressed their concern that a single entity which has both agricultural operations (e.g., NAICS code 1123) and manufacturing operations (e.g., NAICS codes 3111 or 3116) may be prohibited from claiming the partial exemption. (See Exhibit 9.) They propose that the regulation clarify that the “establishment” concept can apply such that a person with a qualifying establishment can be a “qualified person” for purposes of that establishment, even if it is otherwise an apportioning trade or business required to apportion its business income pursuant to subdivision (b) of the RTC section 25128.

Staff believes provisions in RTC section 6377.1 (b)(6)(B) are specific and would not allow staff to apply the establishment concept to businesses that fall under that exclusion. While RTC section 6377.1 (b)(6)(A) (Subparagraph A) describes persons who are included in the term qualified person, the statute goes on to state that notwithstanding Subparagraph A, the definition of qualified person is limited by RTC section 6377.1 (b)(6)(B) (Subparagraph B). Subparagraph B specifically excludes certain trades or businesses required to apportion their income or subject to apportionment under RTC section 25128, from claiming the partial exemption. Therefore, regardless of whether a business otherwise meets the definition of a qualified person, any business that falls under the exclusion is statutorily excluded from claiming the partial exemption.

Definition of Special Purpose Building and Foundation

Included in the definition of “qualified tangible personal property” are 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. The language in proposed Regulation 1525.4 (b)(9)(A)4, defining these structures was primarily taken from Regulation 1525.2, *Manufacturing Equipment*, and the MIC regulations. In their submission, CalTax suggested several deletions to these sections because they thought the sections were

unnecessarily confusing or duplicative. Staff agreed that the deleted text below was duplicative and removed it from its proposal:

(b)(9)(A)4.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, ~~which machinery and equipment, after installation, will become affixed to or a fixture of the real property,~~ and the construction or reconstruction of which is specifically designed and used exclusively for the specified purposes as set forth in subdivision (a) (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).

Staff believed the other recommended deletions were important to the definition of special purpose buildings and did not therefore, make those deletions. After further discussions with CalTax, they decided not to pursue their additional deletions as alternative language for the Board to consider.

Blanket Partial Exemption Certificates

Based on discussion at the interested parties meeting, staff deleted the provision in the previous draft of proposed Regulation 1525.4 (c)(2) which stated:

Qualified persons or contractors claiming the partial exemption through a blanket exemption certificate may identify transactions subject to the partial exemption by making a clear reference to the blanket partial exemption certificate in a contemporaneous document or documents such as their written purchase orders, sales agreements, leases, or contracts. Such documents referencing the blanket partial exemption certificate must include a description of the property being purchased.

While this provision is similar to language in Regulation 1532, *Teleproduction or Other Postproduction Service Equipment*, the provision is not found in other partial exemption regulations such as Regulation 1533.1, *Farm Equipment and Machinery*. In those other partial exemption regulations, the person issuing the exemption certificate is only required to identify transactions that are not subject to the blanket certificate. Deleting the above paragraph makes proposed Regulation 1525.4 similar to the provisions found in Regulation 1533.1. Corresponding revisions were also made in Appendices A and B.

Clarification to Construction Contractors Subdivision

Based on CalTax's recommendation, staff clarified in subdivision (g)(1) who is responsible for unreported tax if it is later determined that a structure does not qualify as a special purpose building, or if material purchased under a partial exemption certificate is not used for a qualifying purpose. Specifically, if a contractor accepts an exemption certificate from a qualified person for the construction of a special purpose building and it is later determined that the building does not qualify, the qualifying person will be liable for the tax. If a contractor issues an exemption 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.

Staff also clarified in subdivision (g) that a contractor can also be a “qualified person” because they manufacture tangible personal property. When a contractor is a qualified person, the contractor is also subject to the \$200 million yearly limitation provisions separate from the limitation provisions that apply to the contractor’s customers.

Claims for Refund/Offsetting Use Tax on Returns

At the suggestion of interested parties, staff previously added subdivision (h) to explain when qualified purchasers may file a claim for refund or request their vendor file a claim for tax paid on transactions subject to the partial exemption. Qualified purchasers may file a claim for refund with the Board on use tax transactions, including purchases where the use tax was collected by a retailer who reported the use tax to the Board. 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.

Staff’s current recommendation also includes a suggestion by CalTax to clarify that when a purchaser is filing a claim for refund with BOE for use tax, it is not necessary for the purchaser to provide the seller with a partial exemption certificate. However, when the purchase is a sales tax transaction and the purchaser is requesting the seller file a claim for refund on their behalf, the purchaser must provide the seller with a partial exemption certificate.

In their submission, CalTax further requested a new subdivision be added to allow qualified purchasers who paid use tax (to a vendor or directly to BOE) to use any qualifying manufacturing or research and development partial exemption to offset sales and use tax liability on their sales and use tax return. To be timely, the offsetting claim must be filed with the Board or taken within the period specified in RTC section 6902. CalTax explained that filing a claim for refund may represent a substantial administrative burden for some businesses. Allowing taxpayers to claim an offset on their return would also mitigate BOE workload to process these claims for refund. In subsequent discussions with CalTax, they decided not to pursue this proposal as alternative language for the Board to consider.

Staff appreciates the withdrawal of the proposed offset procedure because staff believes the correct procedure is for the taxpayer to file a claim for refund for the overpayment. BOE does not allow purchasers to offset returns for other unclaimed tax exemptions or exclusions, even when those transactions are use tax transactions. With regard to BOE workload concerns, staff plans to monitor incoming claims for refund related to the manufacturer’s exemption and will redirect staff resources or request additional resources if needed.

VI. Alternative 1 - Staff Recommendation

A. Description of Alternative 1

Staff recommends approval of proposed Regulation 1525.4 to clarify RTC section 6377.1 as provided in Exhibit 2. Staff’s proposal defines terms, explains when the exemption does and does not apply, and provides sample partial exemption certificates to be used for claiming the exemption.

B. Pros of Alternative 1

Staff believes its proposal provides clear guidance that broadly interprets the provisions of RTC section 6377.1.

C. Cons of Alternative 1

Interested parties disagree with some of staff's proposed language within the definition of "qualified person." They believe that staff's proposal excludes persons that should qualify for the partial exemption.

D. Statutory or Regulatory Change for Alternative 1

No statutory change is required. However, staff's recommendation does require a regulatory change.

E. Operational Impact of Alternative 1

Staff will publish proposed Regulation 1525.4 and thereby begin the formal rulemaking process. As part of the implementation of RTC section 6377.1, staff has already sent a Special Notice to affected taxpayers and developed an industry webpage on the BOE website. The BOE's industry webpage will be updated when Regulation 1525.4 is approved by the Office of Administrative Law (OAL).

F. Administrative Impact of Alternative 1

1. Cost Impact

The workload associated with publishing the regulation and updating the BOE webpage is considered routine. Any corresponding cost would be absorbed within the BOE's existing budget.

2. Revenue Impact

None. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact of Alternative 1

Staff believes its proposal clearly and broadly interprets the provisions of RTC section 6377.1. Following Board approval and authorization to publish proposed Regulation 1525.4, staff will post on the BOE website sample partial exemption certificates based on Appendices A and B.

H. Critical Time Frames of Alternative 1

The provisions of RTC section 6377.1 become operative July 1, 2014. Staff believes Board approval and authorization to publish proposed Regulation 1525.4 will provide staff and interested parties with further direction pending approval by OAL. Staff anticipates OAL will complete their review and approval of the regulation by the end of September 2014.

VII. Alternative 2

A. Description of Alternative 2

Waste Management recommends that the definition of qualified person include the language "[f]or example, the recycling industry will not be precluded from the definition of 'qualified person' for not having a specific four or six digit North American Industry Classification System (NAICS) code, provided that their activities and/or products are described in a qualified four digit industry group."

FORMAL ISSUE PAPER 14-001

B. Pros of Alternative 2

- This alternative provides that a person will not be precluded from the definition of “qualified person” for not having a specific four or six digit NAICS code, provided their activities or products are described in a qualified four digit industry group. By an example, it includes a specific reference to the recycling industry.
- Waste Management believes these revisions are consistent with the intent of the Legislature to include within the definition of “qualified person” recyclers who are performing qualified manufacturing activities.

C. Cons of Alternative 2

- Staff believes the reference to products in the proposed language, “provided their activities or products are described in a qualified four digit industry group” expands the provisions of the regulation beyond the statute because it is the activities of the business that determine the NAICS code, not the products.
- Staff believes the example provided in this alternative could be confusing because some recyclers may not be in a qualifying NAICS code.

D. Statutory or Regulatory Changes for Alternative 2

No statutory change is required. However, the alternative does require a regulatory change.

E. Operational Impact of Alternative 2

Same as Alternative 1.

F. Administrative Impact of Alternative 2

1. Cost Impact

Same as Alternative 1.

2. Revenue Impact

None. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact of Alternative 2

Waste Management believes that this alternative properly includes recyclers performing manufacturing activities.

H. Critical Time Frames for Alternative 2

Same as Alternative 1.

VIII. Alternative 3

A. Description of Alternative 3

CalTax recommends that determining whether an establishment is “primarily engaged” in a qualifying activity should include more alternative tests for a taxpayer to choose from than the options available under staff’s recommendation.

B. Pros of Alternative 3

- CalTax believes this alternative would allow establishments to meet the definition of primarily engaged when they would be wrongly eliminated based on the gross revenue test, operating expense test, employee salaries/wages test, and value of production test.

C. Cons of Alternative 3

- Staff believes the four additional criteria recommended by CalTax (number of employees, employee hours, number of units produced, and capital investment) are not necessary, given the four other allowed measurements (gross revenues, operating expenses, employee wages/salaries, and value of production). Staff is also concerned that the additional alternatives are not viable indicators of the primary business activity of the establishment.

D. Statutory or Regulatory Changes for Alternative 3

No statutory change is required. However, staff's recommendation does require a regulatory change.

E. Operational Impact of Alternative 3

Same as Alternative 1.

F. Administrative Impact of Alternative 3

1. Cost Impact

Same as Alternative 1.

2. Revenue Impact

None. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact of Alternative 3

CalTax believes this proposal qualifies persons primarily engaged in qualifying activities who may not meet the primarily engaged tests included in the staff recommendation.

H. Critical Time Frames for Alternative 3

Same as Alternative 1.

Preparer/Reviewer Information

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

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